INTERNATIONAL MONETARY FUND

Staff Country Reports

December 1995

IMF Staff Country Report No. 95/125

Latvia—Recent Economic Developments

This report on recent economic developments in Latvia was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with this member country. As such, the views expressed in this document are those of the staff team and do not necessarily reflect the views of the Government of Latvia, or the Executive Board of the IMF.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

Recent Economic Developments

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October 6, 1995

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Latvia: Basic Data

Social and demographic indicators 1/

Area	64,589 sq. km.
Population	2.5 million
Urban	69 percent
Rate of population growth	- 1.4 percent per year
Life expectancy at birth	
Male	61 years
Female	74 years
Infant mortality rate (per 1,000 births)	15.1
Hospital beds (per 10,000 inhabitants)	120
Physicians (per 10,000 inhabitants)	34

	<u>1992</u>	<u>1993</u>	<u>1994</u>
<u>Shares of gross output</u>		<u>(In percent of total GDP)</u>	
Agriculture and fishing	17.6	15.3	8.9
Mining and quarrying	0.2	0.1	0.2
Manufacturing	28.2	21.9	21.0
Electricity	1.5	4.9	6.0
Construction	5.0	4.4	6.5
Services	47.5	53.5	57.5
<u>GDP</u>			
Nominal GDP (million lats)	1,005	1,594	1937
GDP per capita (lats)	381	617	766
Real GDP (percentage change)	- 35	- 15	2
Consumer prices (percentage change, end-period)	958	35	26
<u>General government finances</u>		<u>(In millions of lats)</u>	
Total revenue	282	534	704
(in percent of GDP)	(28.2)	(35.8)	(36.3)
Total expenditure	282	519	736
(in percent of GDP)	(28.2)	(34.8)	(38.0)
Financial balance	- -	15	- 32
(in percent of GDP)	(- -)	(1.0)	(- 1.7)
Net Lending	8	6	48
(in percent of GDP)	(0.8)	(0.4)	(2.5)
Fiscal Balance	- 8	9	- 80
(in percent of GDP)	(- 0.8)	(0.6)	(- 4.1)
<u>Money and credit (end period)</u>		<u>(In millions of lats)</u>	
Net foreign assets	195	313	370
Broad money	251	462	687
Domestic credit	108	266	448
Velocity (level)	5.6	3.6	3.3
<u>Balance of payments</u>		<u>(In millions of U.S. dollars)</u>	
Total exports	831	998	997
Total imports	1,046	1,158	1,375
Current account balance	25	151	- 86
Official reserves, in months of imports of goods and nonfactor services	1.5	4.4	4.5
Exchange rate, lats per U.S. \$, end-period	0.843	0.595	0.548

Sources: Latvian authorities; and staff estimates.

1/ Data for 1994 or latest available.

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I. Overview

During 1994 Latvia began to enjoy the fruits of its steadfast efforts to achieve macroeconomic stabilization and the transformation to a market economy. GDP grew by 2 percent, after three years of economic decline in which output is estimated to have fallen by around 50 percent. Real wages also increased in 1994, after sharp declines in earlier years. While the unemployment rate increased to around 6 1/2 percent of the labor force, it remained well below expectations and also below unemployment rates in Western Europe.

The rate of inflation continued to fall, to 26 percent in the year to December 1994, the lowest in the three Baltic countries. The current account moved into deficit as imports grew sharply and the economy began to absorb foreign resources. The reorientation of trade continued, and exports to the West grew strongly. Capital inflows more than offset the current account deficit, resulting in a further build-up of reserves at the Bank of Latvia, to around 4 1/2 months of imports and goods and services at year-end. After more than a year of gradual nominal appreciation, the exchange rate of the lats was pegged to the SDR in February 1994 and has remained fixed since then. The remonetization of the economy continued and interest rates gradually fell.

Owing primarily to a sharp increase in the onlending of foreign resources, a fiscal deficit was recorded in 1994, in contrast to the surplus in the previous year. While the 1994 financial deficit was held below the budgeted figure of 2 percent of GDP, lending to the enterprise sector--notably energy companies--caused a sharp worsening in the broader fiscal balance. The problems in the energy sector were symptomatic of the slower progress in the structural area, where reform has been lagging behind stabilization efforts. Privatization of medium- and large-scale enterprises accelerated in 1994, albeit at a slower pace than expected. The relatively slow progress in areas such as enterprise restructuring (due in part to the absence of an adequate bankruptcy law) and the registration of private land have become bottlenecks in the transformation of the economy and in the development of financial markets and institutions, thus compromising the effectiveness of stabilization policies. Protectionist pressures led to high agricultural tariffs.

Some of these problems contributed to the difficulties experienced in the first half of 1995. The financial deficit in this period was larger than budgeted as tax administration weakened and revenues were insufficient to cover large expenditure increases, especially on wages and pensions. Fiscal problems were exacerbated by a weakening economy, due in part to a banking crisis which emerged in the second quarter. Three of the ten largest banks failed, and the collapse of the country's largest bank (Bank Baltija) resulted in losses of around 8 percent of GDP. The failure of this bank can be attributed to a combination of bad banking, weak enforcement of prudential regulations, and reported malfeasance. Deposit withdrawals occurred in other banks as confidence in the banking system was shaken, but

there were no major bank runs and confidence has been restored. Foreign exchange outflows also occurred as foreign investors and residents lost confidence, but the exchange rate peg held firm and stability returned to the foreign exchange market.

II. Developments in the Domestic Economy

Due to the still relatively poor quality of statistics, data on the real economy in Latvia need to be interpreted with care. Although the transition from the Soviet national accounting system based on "net material product" to an accounting system incorporating the output of all sectors, including the services sector, is now complete, national accounts data in Latvia continue to suffer from a poor coverage of the emerging private sector. This leads to an understatement of the level of GDP in official national accounts data. Similarly, the decomposition of nominal growth rates into unit value and volume changes, although improving, still suffers from a lack of reliable price deflators for different sectors.

1. Aggregate demand

After a cumulative decline of nearly 50 percent between 1990 and 1993, due to the large terms of trade shocks and the collapse of the Eastern markets in the early phases of the transition period, real GDP is estimated to have increased by 2 percent in 1994. The quarterly GDP path suggests that after the steep decline in output during the first half of 1992, the decline in GDP decelerated considerably during 1993, and the trough in output was reached in the first quarter of 1994 (Chart 1). GDP growth became positive in the second quarter of 1994 and accelerated in the fourth quarter of 1994. The strong growth carried over into the first quarter of 1995. Since then, economic activity has weakened considerably, largely on account of the banking crisis.

The turnaround in economic activity in 1994 in Latvia is concurrent with similar developments in the two other Baltic countries; Lithuania's GDP is estimated to have increased by 2 percent in real terms, Estonia's by 3 percent. Most countries in the former Soviet Union, however, continued to record substantial declines in economic activity. The weighted real growth rate in 1994 for the 12 CIS countries was -13 percent, which suggests that the early and strong reforms undertaken by Latvia and the other Baltic countries, which initially caused larger and earlier output declines, are beginning to bear fruit.

The increase in real GDP in 1994 was led by strong investment growth, primarily in the construction and services sectors. The share of gross capital formation in GDP is estimated to have grown significantly in 1994 (Table 1). Private and public consumption also grew, driven by the increases in real wages. Reflecting the strong growth in investment, the current account balance swung from a surplus of 6.7 percent of GDP in 1993 to a deficit of 2.5 percent in 1994. This shift is the result of an

CHART 1
LATVIA
MACROECONOMIC INDICATORS

Sources: Data provided by the Latvian authorities; and staff estimates.

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increase in imports of almost 30 percent in real terms, combined with growth in aggregate real exports of only 1 percent. ^{1/} In addition, foreign direct investment increased in 1994, reflecting increased confidence by foreign investors on account of successful stabilization and the low level of external debt. Private domestic savings decreased as a percentage of GDP while public savings became negative for the first time (to the tune of 1 percent of GDP), following large wage and pension increases in late 1993 and in the second half of 1994. The increase in investment occurred primarily in the private sector; public investment remained very low, at one percent of GDP.

Preliminary estimates suggest that the economy grew strongly through the first quarter of 1995, but since then has weakened considerably. The main reason for this slowdown in economic activity lies in the emergence of a banking crisis which was precipitated by the collapse of the largest bank in Latvia (Bank Baltija) at the end of May 1995. The closure of Bank Baltija and the earlier failure of several smaller banks led to the freezing of more than 30 percent of private sector deposits in the Latvian banking system.

2. Supply

Data for the sectoral composition of GDP show that the performance of different sectors varied widely during 1994 (Table 2). Two of the major sectors, construction and services, grew in real terms. Services account for close to 60 percent of nominal GDP, underlining Latvia's comparative advantage in transit trade. Energy production stabilized in real terms. Production in manufacturing and, especially, in agriculture continued to decline, and now combined account for less than 30 percent of nominal GDP.

a. Agriculture

Agricultural output declined further in 1994 to just under 9 percent of GDP, down from 15 percent in 1993 and over 20 percent in 1990. In real terms, agricultural production fell by almost 30 percent in 1994, after declines of 14 percent and 29 percent in the two previous years. Whereas the collapse from 1990 onwards can largely be attributed to the erosion of markets for agricultural goods in the former Soviet Union, the recent weakness primarily reflects continuing difficulties in developing new markets because of quality problems, lack of marketing experience (packaging, etc.), small farm sizes, lack of equipment in most private farms and, consequently, low productivity.

^{1/} Nevertheless, the redirection of exports away from the former Soviet Union toward the West continued. Whereas exports to CIS countries declined by 32 percent in real terms in 1994, exports to all other countries increased by 34 percent.

Nevertheless, privatization of the agricultural sector has continued at a relatively fast pace in 1994. Private farms in 1994 produced 68 percent of all meat, 72 percent of all cereals and almost 100 percent of all potatoes, after only accounting for, respectively, 27 percent, 7 percent, and 62 percent in 1992. Private farms now represent 75 percent of all sown area and produce 73 percent of all agricultural products (Table 3). The production gains of private farms have been, however, due to their increasing number, rather than improvements in productivity. Data on productivity per agricultural employee are still not available, but a comparison of the yields per hectare of several crops suggests that private farms are only slightly more productive than state-owned farms and that their productivity has actually decreased since 1990. For example, yields of cereals for private farms are only 6 percent higher than yields for state-owned farms and for most other product groups yields are about the same for state-owned and private farms.

The reason for this development might lie in the often inefficiently small farm size (the average size of a private farm was 20 hectares in 1994) and widespread lack of equipment. On average, only every fifth private farm has a tractor and only every tenth private farm has a tractor-pulled plough. When farms are privatized, the former cooperative generally retains ownership of most machinery and other capital assets. In addition, farmers have limited access to credit, partly because of their inability to pledge land as collateral. As of end-July 1995, only 6 percent of all land in Latvia had been measured and registered.

b. Manufacturing

After substantial falls in the production of manufactured goods in the previous two years, official statistics recorded a modest decline of 4 percent in 1994. This is also reflected in the small decrease in the share of manufacturing in nominal GDP from 22 percent to 21 percent. Manufacturing appears to have turned the corner, with positive growth in real terms in the second half of 1994 and in the first quarter of 1995. Data on volume changes in industrial production are unreliable due to the incomplete coverage of new and newly privatized companies, as well as the poor quality of price deflators. Nonetheless, the data suggest that the growth in manufacturing was led by the production of textiles, paper and paper products, and chemicals, especially plastics. The turnaround in manufacturing is also evident in the developments in energy consumption, which in 1994 declined only slightly, despite higher prices and some improvements in energy efficiency.

c. Energy

The production of energy stabilized in real terms in 1994. It appears that the main power plants in Latvia were able to make some progress in improving energy efficiency in 1994, since an equal amount of energy was produced using fewer inputs of primary energy (Table 4). The consumption of

coal and gas (natural and liquified) both declined by around 40 percent, while the consumption of heavy fuel oil increased by 24 percent.

d. Construction

Construction recovered substantially in 1994 and was, besides services, the engine of the moderate growth that the Latvian economy enjoyed in 1994. The share of the construction sector in nominal GDP increased by more than 2 percentage points and real growth of more than 20 percent was recorded, despite the low level of public investment. Hence, the growth in construction appears to be entirely based on private sector activities, especially the construction of private residences and tourist facilities, with only minor investments in infrastructure.

e. Services

As in previous years, the share of services in nominal GDP increased in 1994. For the first time, however, output in services also increased in real terms, by more than 8 percent. Services can be subdivided into four broad categories. First, many services which were previously discouraged, such as tourism and some forms of entertainment, are likely to have continued to increase in 1994. Second, services which have grown disproportionately in line with the transition from a centrally planned to a market economy, such as financial services, continued to show positive growth through 1994, but can be expected to slow in 1995. Third, services which are closely related to real output, such as retailing and transportation, contributed moderately to the overall increase in services in 1994, and can be expected to gain additional importance over the medium term. Finally, services provided by the Government, such as education and health care, can be expected to shrink further as these services are provided more efficiently.

III. Labor Market, Wages, and Prices

1. Labor market and wages

The slow upward trend in unemployment continued through 1994. Average unemployment increased from 4.9 percent in 1993 to 6.4 percent in 1994 (Table 5). In the first six months of 1995, unemployment remained broadly unchanged.

The proportion of long-term unemployed has continued to increase from 39 percent of all unemployed in June 1994 to over 50 percent in June 1995. This points to a steady segmentation of the labor market, in which it becomes increasingly difficult for parts of the population to find jobs. The segmentation is underlined by the large regional differences in unemployment rates. The southeastern part of Latvia near the Russian border reports unemployment rates of around 24 percent, with unemployment in individual towns of up to 40 percent, due to the closing of several large

enterprises and the continuing decline in agricultural production. Unemployment in Riga, on the other hand, did not exceed 2 percent during 1994.

The proportion of the unemployed receiving unemployment benefits has remained low, at 44 percent in June 1995. The low proportion of benefit recipients is related to the relatively stringent eligibility requirements, and to the low level of benefits, which are defined as 90 percent of the minimum wage. 1/ While the minimum wage was raised in October 1994 from LVL 22.5 to LVL 28, unemployment benefits in mid-1995 were only around 25 percent of the average wage in the state sector (Table 6).

To be eligible for unemployment benefits an applicant must be a permanent resident of Latvia, must prove that he/she is actively looking for a job by reporting once a month to the employment office, and must have worked for six months in the previous year, with all social taxes paid. Benefits are paid by the former employer for one month, followed by six months of state-funded payments. Since January of 1994, municipalities can apply for an extension of the period in which unemployed benefits are paid from six months to twelve months, which has been granted to 105 municipalities under the condition that the unemployed participate in unpaid public works programs during the extension period. When the eligibility for unemployment benefits ends, those individuals still unemployed are eligible to receive social assistance. It is likely that the extension of the benefits period to twelve months contributed to the increase in measured long-term unemployment.

In step with the increased proportion of long-term unemployed, the public works program was extended. In 1994, 21,000 unemployed participated in the social works program for an average period of 2.5 months. In addition, retraining programs continue to be an important part of the labor market policy of the Government. During 1994, 13 percent of the recipients of unemployment benefits participated in such programs, which offer computer, accounting and other business related courses, as well as training in many trades and crafts.

Real wages underwent a prolonged period of decline in 1990-92, falling by more than 35 percent, in line with the decline in output. By mid-1995, real wages had recovered to more than 80 percent of their 1990 level (Table 6). 2/

1/ For some population groups (very young, army service, etc.) the benefit is only 70 percent of the minimum wage.

2/ A consistent series for wages is only available for the state sector, although the Central Statistical Bureau has recently started publishing wage data for the whole economy as well.

2. Price developments

The liberalization of most prices in Latvia was completed at the end of 1992; only a few administered prices remain, including in the transport and energy sectors, as well as rents for residential apartments. Prices are administered by several different agencies. Heating prices, for example, are set by local Governments, while prices of transportation and mail services are set by the Ministry of Economy. Any time the administering agency proposes a price increase of more than 5 percent, the agency has to submit its justifications to the Anti-Monopoly Committee, whose approval is required. The Committee's decision is based on cost calculations submitted by enterprises, the ability of consumers to pay, and the level of profit of the enterprise.

Energy, i.e., electricity, gas, and heating, is the most important group of products for which prices are still administered. Prices for gas, used for purposes other than heating, appear to be based on actual costs after the 33 percent increase in April 1995. On the other hand, electricity prices, tariffs for heating and hot water, as well as tariffs for heating gas, do not make adequate provision for capital costs.

Following a sharp fall during the first two years of the stabilization program, the decline in the rate of inflation has slowed. After inflation of around 950 percent in 1992, prices rose by only 36 percent in 1993 (Chart 2, Table 7). Inflation surged in the fourth quarter of 1993, when the standard VAT rate was increased from 12 percent to 18 percent, and remained high in the first quarter of 1994. Price pressures eased during the summer months, largely on account of seasonal factors. However, inflation accelerated in the fall of 1994 and remained high through the first quarter of 1995, due to the general wage increase in budgetary organizations (granted in October), the imposition of higher import tariffs on agricultural goods, and the surge in domestic liquidity stemming from the balance of payments surplus. For 1994 as a whole, prices increased by 26 percent. Price pressures eased in mid-1995 amid the banking crisis, and the rate of inflation fell to 23 percent in the year to August 1995.

Increases in administered prices, which were generally at an extremely low level at the beginning of the transition process, have contributed to recent inflation outcomes. Prices of administered goods have a weight of approximately 20 percent in the CPI and increased by about 50 percent during 1994, far above the average price growth for all other goods (less than 20 percent). Developments have been quite similar in the first six months of 1995. Administered prices grew by about 20 percent in the six months to June 1995, while prices for all other goods increased by less than 12 percent.

An additional reason for the persistence of relatively high measured inflation could be that the CPI may be a somewhat imperfect measure of inflation in a rapidly changing economy. In particular, at times of large quality improvements, the CPI will overstate inflation, since goods would no

longer be strictly homogeneous. The producer price index, which may be less affected by quality changes, lends support to the notion that underlying inflation may be somewhat lower than suggested by the CPI; this index increased by 11 percent in the year to June 1995. 1/

Table 8 shows price increases of sub-groups of goods and services, which are divided into categories which might be thought of as tradable and nontradable. These data suggest that prices of nontradables have recently risen at a substantially more rapid pace than those of tradables. A large part of recent inflation may therefore be due to the continuing adjustment of the relative price of nontradables, due to their low starting point. If productivity growth in the tradable sector exceeds that in the nontradable sector, prices in Latvia can be expected to continue to rise faster than in Latvia's major trading partners for some time to come. 2/

IV. Public Finance

1. Introduction

The sharp decline in the Latvian economy in the period from 1991 to 1993 created major problems for fiscal policy. However, through prudent policies, the authorities recorded balanced fiscal positions in 1992 and 1993. Indeed, the revenue to GDP ratio--at around 36 percent--has remained among the highest in the Baltic and CIS countries. As a result, Latvia has avoided large scale central-bank credit creation, which has occurred in many CIS countries. More recently, revenue growth has been insufficient to cover large real expenditure increases, especially on wages and pensions, and as a result, deficits have been recorded.

The primary focus in Latvia is on the government "financial deficit", defined as revenues less expenditures. A broader measure of government financial transactions is given by the "fiscal deficit" which also includes net lending, defined as lending by the Government to the non-government sector less repayments. This broader measure includes the onlending of foreign loans contracted by the central government. Privatization receipts, which have been fairly small, are also included in net lending.

The finances of the general government in Latvia consist of the central government "basic" budget, the social budget, the local government budgets (Box 1), and a number of smaller special funds and special budgets. While

1/ The producer price index measures the ex-factory price of domestically produced manufactured goods; services, consumption taxes, and imports are excluded.

2/ For an extensive discussion of the initial undervaluation of the real exchange rate in Latvia, and the "Balassa-Samuelson effect", see Anthony Richards and Gunnar Tersman, "Growth, nontradables, and price convergence in the Baltics", IMF Working Paper 95/45, April 1995.

CHART 2
LATVIA
INFLATION IN CONSUMER PRICES

Source: Data provided by the Latvian authorities.

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the 1995 budget law included for the first time all levels of government in the calculation of a general government balance, in practice there is significant decentralization of fiscal policy. For example, in the first half of 1995, the basic budget controlled by the Ministry of Finance accounted for only 43 percent of revenues and 49 percent of expenditures at the general government level.

Box 1. Local government financing

Latvia is administratively divided into 26 regions and 7 cities. The regions are subdivided into around 560 municipalities, typically with populations of 1000 to 5000 people, with significant scope for consolidation to reduce administrative costs and improve economies of scale in service provision. In 1995, local government revenues come from three major sources: (i) revenues from taxes collected on their behalf by the central government, most notably the personal income tax; (ii) transfers from central government, mainly through the Local Budget Equalization Fund (LBEF); and (iii) own revenues from local taxes and fees. Transfers from the central government were reduced in 1995, but local governments received the entire amount of personal income tax, as opposed to around 50 percent in 1994. According to the 1995 budget, the LBEF will receive around LVL 63 million from the central government, and around LVL 12 million from the income tax revenues of the wealthier municipalities and towns. Transfers from the LBEF are based on expenditure needs reflecting factors such as the number of children and pensioners in the population of each area. Unlike in earlier years, transfers in 1995 are largely on an untied basis, with the exception of the requirement of a certain level of per capita health expenditures.

The largest of the special or extrabudgetary funds is the social budget which is managed by the Social Insurance Fund operating under the authority of the Ministry of Welfare, Labor and Health, and which accounted in the first half of 1995 for around 30 percent of general government transactions. The social budget consists of revenues from the social (or payroll) tax and expenditures on old-age pensions and other transfers including sick leave and unemployment benefits. The social budget was independent of the basic budget in 1991 and 1992, but these budgets were consolidated in 1993 and 1994, before being separated again at the start of 1995. The recent separation appears to have favored the social budget at the expense of the basic budget and permitted the social budget to increase pensions during 1995 at times when the basic budget was subject to expenditure controls. Other funds, including the road and forest funds, also receive earmarked revenues from various taxes, fees and fines.

The Treasury Department within the Ministry of Finance has now taken over all the basic functions of controlling the cash execution of the central government basic budget and all reporting and accounting responsibilities. Significant progress has also been made in the area of budgeting. Some medium-term analysis has begun, and the first steps in the preparation of the 1996 budget began earlier than in previous years. However, given the significant volatility of revenues and the limited

financing capacity of the government, budget implementation is focussed on controlling expenditures to fit within available cash resources (Chart 3).

A Public Investment Program (PIP), managed by the Ministry of Economy, was established in late 1994 with World Bank and EU/Phare assistance. Projects eligible for the PIP include both general government projects and investments by state enterprises that are suitable for government-guaranteed official foreign financing. Expenditure on the PIP in 1995 from both domestic and foreign resources was budgeted at around 2 1/2 percent of GDP, predominantly in energy, transport and the environment. Actual implementation in the first half of the year was significantly below budget.

2. Fiscal developments

a. 1994 outcome

The 1994 budget provided for a general government financial deficit of LVL 40 million, or around 2 percent of GDP, following a surplus of around 1 percent of GDP in 1993. This deficit was expected to occur entirely at the central government level; local government budgets and extrabudgetary funds were projected to be balanced. The shift into deficit reflected large increases in wages in budgetary organizations (around 25 percent), old-age pensions (around 50 percent) and other social benefits in November 1993. These higher expenditures were partly offset by increased revenues from the VAT and from the introduction of new excises on gasoline, diesel, and automobiles in November 1993. ^{1/}

With the exception of a hiccup in the second quarter, when temporary tax deferrals were granted to some taxpayers, deficit outcomes in the first three quarters of 1994 were below budgeted levels. As a result, supplementary budgets were adopted in April and October that allowed for pension increases of around 8 1/2 percent in May and 12 percent in November. Wages in budgetary organizations were also increased by around 24 percent in November after significant upward drift through 1994, and the minimum monthly wage was raised from LVL 15 to LVL 22.5 in April and to LVL 28 in October. The net effect of the growth in old-age pensions in late 1993 and through 1994 was that pensions rose by over 25 percent in real terms on a year-average basis in 1994. Average wages in budgetary organizations grew in real terms by around 10 percent.

The second supplementary budget provided for expenditure increases of LVL 45 million and led to fiscal pressures in the fourth quarter of 1994. However, with tight control over discretionary expenditures, the general government financial deficit was limited to LVL 15 million (2 1/2 percent of quarterly GDP) in the fourth quarter, and to LVL 32 million (1 3/4 percent

^{1/} The standard VAT rate was increased from 12 percent to 18 percent in November 1993. The VAT rate on food was increased from 6 percent to 10 percent at that time, and from 10 percent to 18 percent in June 1994.

CHART 3
LATVIA
FISCAL DEVELOPMENTS

Sources: Data provided by the Latvian authorities, and staff estimates.

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of GDP) for 1994 as a whole (Table 9). The central government outcome was slightly better than projected, while local governments ran a small deficit, reflecting a bank loan taken out by Riga City Council to make heating payments (Tables 10 and 11).

Problems in the energy sector also contributed to a sharp increase in net lending by the central government. Around half of the total net lending of LVL 48 million (2 1/4 percent of GDP) represented loans by the central government to three public enterprises (the energy and gas companies and the Lata group of agricultural companies). The remainder of net lending included the onlending of foreign resources through the banking system and project lending by international organizations, including the World Bank and the EBRD.

The total fiscal deficit for 1994 was therefore around 4 1/4 percent of GDP, a swing of nearly 5 percent of GDP from 1993. The majority of net lending was financed by foreign loans, while the financial deficit was essentially financed through the banking system, mainly through the sale of Treasury bills. The face value of Treasury bills outstanding rose from LVL 2 million at end-1993 to LVL 30 million at end-1994 (Table 12). The Treasury bills of 28-day maturity accounted for around 30 percent of this amount, while bills of 91-day maturity accounted for the remainder. The discount rate on Treasury bills fell gradually through the year as investor interest grew, largely from banks wishing to reduce excess reserves.

b. 1995 budget and January-June 1995 outcome

The 1995 budget provided for a central government financial deficit of LVL 40 million (1 3/4 percent of GDP) and balanced budgets in local governments and the special funds. Projections indicated, however, that the achievement of the overall deficit target for the general government would require some shift in revenue and expenditures between the basic and social budgets, or the build-up of a surplus in the social budget to offset a larger deficit in the basic budget.

General government revenues were projected to rise from 36 1/4 percent of GDP in 1994 to 37 1/2 percent in 1995, while expenditures were projected to increase from 38 percent of GDP to 39 1/4 percent of GDP in 1995, although these increases largely reflected the inclusion of around 20 special funds that were previously outside the budget process. Consequently, the underlying revenue to GDP ratio was budgeted to remain approximately constant. The continued strength in revenues also reflected: (i) the full-year effect of the increase in the VAT rate on food in June 1994; (ii) growth in wage-related taxes from increases in real wages; and (iii) projected improvements in tax administration in the collection of customs and excises, and the widening of excises on energy products. In the case of expenditures, growth in 1995 largely reflected the full-year effect of wage and pension increases that occurred in the fourth quarter of 1994, along with some new initiatives in priority areas including education and agriculture. A modest increase in investment was budgeted, which, together

with planned extrabudgetary investment in the PIP would increase overall public investment to around 2 1/2 percent of GDP. Defense expenditures were expected to remain below 1 percent of GDP.

Net lending was projected to fall significantly in 1995, being limited to the onlending of funds under the Public Investment Program to avoid loans to make up for losses in the energy companies as had occurred in 1994. As a result, the overall fiscal deficit was expected to contract from 4 1/4 percent of GDP in 1994 to around 2 1/4 percent of GDP in 1995. Apart from the foreign financing of the PIP, the deficit was expected to be financed by the sale of government securities, with a planned shift into longer maturities than the 28- and 91-day securities that had hitherto been issued.

Revenue performance in the first quarter of 1995 was below projections, resulting in a general government financial deficit of LVL 19 million (3 1/2 percent of quarterly GDP), versus the projected deficit of LVL 15 million. However, more significant divergences from the budget projections became apparent early in the second quarter when the expected seasonal pick-up in revenues did not materialize. Tax arrears increased by 20 percent (LVL 31 million, or around 15 percent of actual quarterly revenues) in the second quarter, with increases in arrears on all major taxes, and tax evasion was also reported to have increased. Expenditures on discretionary items, including investment and supplies and maintenance, were cut significantly, but this was insufficient to prevent a further quarterly deficit of around LVL 19 million (3 1/4 percent of GDP). The deficit for the first half of the year, at LVL 38 million, was nearly equal to the budgeted deficit for the whole of 1995.

The weakening in revenues can be attributed primarily to three interrelated factors: (i) the banking crisis; (ii) a weakening in economic activity (Chart 1); and (iii) weak tax administration. Apart from its indirect effects on economic activity, the banking crisis is likely to have affected revenues through three channels: (i) at least LVL 6 million in government deposits were frozen in Bank Baltija and other failed banks; (ii) some taxpayers were--and some claimed to be--unable to pay taxes because of frozen current accounts in the failed banks; and (iii) bank failures have reportedly caused a shift to cash transactions which may have led to lower compliance with tax laws.

Problems in tax administration appear, however, to be the major cause of revenue weakness. There were delays in early 1995 in several planned improvements in administration, including the introduction of a national database of taxpayers with unique tax identification numbers, and the introduction of a specialist unit to monitor and audit tax payments by the largest taxpayers. There have also been personnel problems in the State Revenue Service, as reflected in the resignation of senior officials in April 1995. Administrative problems associated with the introduction of new tax laws may also have affected revenues: the profit tax was replaced by a corporate income tax in April, and a new law on the VAT formally replaced

the law on the turnover tax, even though the latter had been administered as a VAT for some time.

The financing of the larger than expected deficit also became a problem in the second quarter as banks reduced their Treasury bill purchases on account of liquidity problems and the lack of flexibility in the cut-off discount rate in weekly securities auctions. Between early March and early July, the face value of the outstanding stock of Treasury bills fell from LVL 58 million to LVL 24 million, with interest in the 91-day and the new 182-day securities virtually disappearing.

Commercial banks partly offset the rundown in their Treasury bill holdings by increasing direct lending to the government in the second quarter. These short maturity loans did not suffer from the perceived lack of liquidity of Treasury bills, which banks attributed to the very limited participation by the Bank of Latvia in the secondary market. In net terms, however, commercial banks significantly reduced their credit to the government, and the government fully drew down its credit line with the Bank of Latvia. 1/ Faced with financing pressure, the government negotiated a LVL 20 million increase in its credit line in May, to be repaid by November 1995.

The deficit for 1995 is projected to be higher than budgeted, given the larger-than-expected deficit in the first half of 1995 and the decisions to increase pensions by around 7 percent from July 1 and to begin compensation to depositors of failed banks. Deposit compensation of LVL 500 per depositor was planned, with budget constraints limiting the initial payment in 1995 to LVL 200 per depositor, with a further LVL 100 per year over the next three years. The budgetary cost would be LVL 23 million (1 percent of GDP) in 1995, and would total around LVL 55 million over three years. A supplementary budget providing for deposit compensation was submitted to Parliament in August. The revised deficit would be around LVL 90 million (3 3/4 percent of GDP); including net lending, the fiscal deficit would amount to 4 1/2 percent of GDP.

3. Revenue structure

There have been major changes to tax legislation in Latvia in recent years, including the passage of a package of laws and amendments in late 1994 and early 1995 (see Appendix I for a description of the tax system as of June 30, 1995). The aim of this legislation has been the implementation of a tax system appropriate for a market economy and consistent with Latvia's plans for membership in the European Union. The tax package included an umbrella law that authorizes the imposition of taxes and fees,

1/ The Government's credit line at the Bank of Latvia in 1995 is based on a November 1994 agreement that allows credit up to a daily maximum of LVL 15 million. However, the monthly-average and end-month credit was scheduled to fall to zero by the end of 1995.

and provides for a broad range of penalties, including significant fines, and the seizure of bank accounts, cash, goods and property. Cash transactions over a certain size are forbidden, and new regulations allow for presumptive taxation, including the power to impose higher taxes based on surveys of businesses. Banks must now transfer tax payments to the state budget within one day or pay high fines.

Taxes on goods and services include the VAT, excise taxes, and customs taxes. With the exception of excise taxes which are shared with the road fund (gasoline) and a special health budget (alcohol), these accrue entirely to the central government budget. VAT revenues were around 9 percent of GDP in the first half of 1995, a significant increase from 5 1/2 percent of GDP in 1993 before the increases in VAT rates. The tax base for the VAT is relatively broad by international standards, and now covers the services of public utilities.

Revenues from customs, mainly from import tariffs, were less than 1 percent of GDP in the first half of 1995. Revenues from this source have been essentially flat in nominal terms for about two years and have underperformed budget projections in this period. Latvian borders are reportedly extremely porous, and there is little control over goods in transit. Shortages of equipment, including weighing scales at some border posts, hinder administration.

Excise revenues, which were equivalent to around 2 percent of GDP in the first half of 1995, are primarily from excises on gasoline, diesel and alcohol. The tax bases for excises on gasoline and diesel were recently broadened to cover substitute products. A recent study based on automobile usage suggests tax evasion of around 30-40 percent of potential revenues, primarily due to poor border control. Evasion of excises on alcohol and tobacco is also high, but should be reduced by the recent introduction of tax stamps on these products. The excise on gasoline, at around 17 percent of the pump price (or 8 U.S. cents per liter), has been unchanged for nearly two years and is low compared with Western European rates.

Taxes on income include the corporate and personal income taxes and the social tax. The personal income tax yielded around 5 percent of GDP in the first half of 1995. A flat rate of 25 percent applies to personal income after standard deductions, with a 10 percent surtax on higher incomes. The low yield of this tax by international standards reflects: (i) the relatively low rate structure; (ii) relatively generous deductions for taxpayers and their dependents; and (iii) exemptions for pensions and agricultural income.

The corporate income tax, which replaced the profit tax in 1995, yielded only 2 percent of GDP in the first half of 1995, down from nearly 4 percent of GDP in 1994. The decline of this tax over time may in part reflect the gradual weakening of the links between public enterprises and the central government: tax payments in the past may have had a "negotiated" aspect. Other factors include: (i) increases in real wages

which have reduced profits; (ii) falls in the profitability of the re-export of raw materials from Russia and other FSU countries; and (iii) generous tax holidays to businesses with foreign capital which encourage domestic residents to make investments via offshore companies. Such tax holidays have been curtailed under the new corporate income tax law.

Revenues from the social tax were around 11 1/4 percent of GDP in the first half of 1995, a yield similar to that of recent years. While there are different rates for different industries, the standard tax rate of 38 percent (paid mainly by the employer) is higher than in Lithuania and Estonia which have rates of 31 and 33 percent, respectively. Since an individual's pension payments are unrelated to previous social tax payments, there is little incentive for individuals to ensure that the correct social tax payments are made on their behalf, and many employers do not contribute, or pay social taxes only on the minimum wage.

The majority of taxes, including those accruing to the local governments, are collected by the State Revenue Service which was formed in April 1994, following the merger of the State Finance Inspection Board and the Customs Department. Social tax revenues are collected by a separate tax administration in the Social Insurance Fund. As noted above, tax administration appears to have weakened recently. While the new umbrella tax law allows for harsh penalties, there have apparently been few instances of the prosecution of wrongdoers. The collection of identified tax liabilities is also weak, with tax arrears increasing across all major taxes in 1995. Official tax deferrals account for a relatively small proportion of this increase. The majority of large debtors are state enterprises.

4. Expenditure structure

A comparison of the pattern of expenditures in Latvia and other countries suggests a number of noteworthy points (Table 13). In terms of economic classification, expenditures in Latvia are dominated by payments of wages, old-age pensions and other transfer payments. Spending on these categories, which is high by international standards, accounted for around two-thirds of general government expenditure in the first half of 1995 or around 26 percent of GDP, up from around 23 1/2 percent of GDP in 1993. Expenditures on investment and interest are lower than in most other countries. At the functional level, expenditures on health, education, and social security and welfare are relatively high by international standards.

General government employment in Latvia is quite high by international standards. For example, Latvia has around 70 general government employees per 1000 population which is close to the average in OECD countries, but far above the average levels of lower income countries. 1/ Latvia's relatively

1/ For details of government employment in other countries, see Aart Kray and Caroline Van Rijckeghem, "Employment and wages in the public sector--A cross-country study", IMF Working Paper 95/70, July 1995.

high level may be explained in part by its high degree of public sector provision in some sectors--e.g., health, education and agriculture--relative to many other countries (Box 2). Wages in budgetary organizations are linked to an official wage scale that was last increased in late 1994. There has, however, been significant drift in budgetary organization wages, due in part to the decision in late 1994 to grant a staggered 41 percent increase to teachers, following strikes to correct perceived problems in wage relativities.

Box 2. Expenditures on health and education

Due to the high level of budgetary expenditures on wages in Latvia there has been considerable discussion about reform in health and education. Latvia has a very high number of doctors, at around 3.4 doctors per thousand population, compared with an average of 2.5 per thousand in industrial countries. Budget financing provides for relatively low salaries, though actual salaries may be higher through reallocation of expenditures in hospitals and the widespread practice in budgetary organizations of requesting budget wage funding for more positions than there are employees. The number of hospital beds is also very high at around 12 per 1000 population, and the average length of hospital stay is around twice the average for the Nordic countries. These indicators suggest that there is scope for reform in health care. One aspect of this reform is the introduction of patient fees to reduce unnecessary hospitalization and allow closure of institutions. From August 1995, medical establishments are able to charge (and retain) up to 25 percent of the cost of treatment, which in hospitals is estimated at LVL 8-12 per patient-day. Hospital charges had previously been limited to LVL 0.45 per day (LVL 0.05 for pensioners and children) or less than US\$1 per day.

Education expenditures are also high by international standards. The central government is responsible for the provision of higher education and vocational training, while local governments provide pre-school to secondary general education. The salaries of teachers in local schools are paid by the central government while local governments finance all other costs of general education. Elementary and secondary education are free, while fees are charged for pre-school education, meals and transportation. Between 1990 and 1993 there were falls in the number of students in all forms of education, from kindergarten to tertiary, as the population declined. In the same period, however, there were increases in the number of both teachers and schools at the comprehensive and tertiary level.

Interest expenditures were around 1 percent of GDP in the first half of 1995. While nominal interest rates are relatively high in Latvia, the stock of debt is still small. This stock includes Treasury bills and credit from the Bank of Latvia, but the major component is around LVL 63 million (2 1/2 percent of GDP) of bonds issued, mainly in 1994, in conjunction with the restructuring of the two state-owned banks, the Universal Bank of Latvia and the Latvian Savings Bank. These nontradable bonds carry maturities of up to 7 years.

Expenditures on investment are low, in part because of compression of "discretionary" expenditures in recent years due to the large expenditure increases on wages and transfers. Budgetary investment expenditures were around 3/4 percent of GDP in the first half of 1995, down from a little over

1 percent in 1993 and 1994. Indeed, investment expenditures have been below budgeted amounts each year since 1993. Non-budgetary investment under the Public Investment Program will supplement budgetary investment in 1995, but this component is also expected to be below planned amounts. Expenditures on supplies and maintenance have also been cut sharply in 1995 and in recent years.

5. Social security and the social safety net

Social expenditures in Latvia include various types of social security benefits (including old-age, disability and survivors pensions), unemployment and retraining benefits, family benefits (including child-care benefits, family allowances, maternity leave and birth grants) and social assistance for low-income residents (Tables 14 and 15). In total, these cost around 16 percent of GDP in the first half of 1995. With the exception of social assistance, all these benefits are paid by the central government, though in some cases benefits are disbursed by enterprises which withhold a corresponding amount of social taxes.

In 1995, the majority of expenditures are to be paid from the social budget, the exceptions being family allowances, child-care benefits, maternity leave and social pensions (pensions to people with no work history) which are paid by the basic budget. Expenditures on these items by the basic budget was budgeted at around LVL 43 million in 1995. These payments were not considered to be insurance-related and were therefore not transferred to the social budget; this allocation is one reason why the financial situation of the social budget was better than the basic budget in 1995.

The major social expenditure item is the old-age pension. The current old-age pension system provides almost universal coverage from age 55 for women and 60 for men, with earlier retirement ages for certain categories of individuals. The current formula, introduced in late 1993, provides for a base pension of 30 percent of the average wage, with an increase of 0.4 percent of the average wage for each year of work history up to a maximum of 38 years. Actual pensions in mid-1995 were somewhat below what would be implied by the formula because the general budgetary situation has not allowed all indexation increases that the formula would accommodate. Pensions remain untaxed.

The affordability of the current pension system is threatened in the long term by the ageing population and in the short term by weak tax administration. In particular, individual pensions are not linked to social tax payments, so individuals have little incentive to ensure that the correct social tax payment is made on their behalf, and there has been a significant increase in the ratio of pensioners to contributors in recent years. In July 1995, a major package of legislation was introduced into Parliament that would significantly overhaul the social security system including old-age pensions and sickness, disability, maternity, unemployment and funeral benefits (Box 3). The aim of the proposed reforms is to ensure

the continued affordability of a social security system and to move toward a funded insurance system that links individual benefits more closely to prior contributions, thus reducing labor market distortions.

Family allowances are the major categorical benefit. These are paid on a per-child basis and were budgeted to cost around 1 1/4 percent of GDP in 1995. The nominal value of these has been held fixed for some time. The elimination of this benefit was planned, but subsequently rejected, at the start of 1994 when tax deductions for children were introduced in the personal income tax law.

Expenditures on unemployment benefits and retraining were budgeted at around LVL 19 million in 1995 (3/4 percent of GDP). Actual spending will most likely be somewhat lower due to the lower-than-expected number of registered unemployed and the low ratio of these who receive benefits.

Social assistance in Latvia in 1995 is mainly administered by local governments and financed out of own revenues and untied transfers from the central government, as opposed to previous years when the central government provided matching grants. Because of differences in revenue capacity in different areas, there are great differences in both the thresholds for receiving means-tested benefits and the amounts paid in benefits. Social benefits are typically paid in "tied" form rather than in cash, and include heating allowances, assistance in kind, food coupons and free school lunches. The difficulty in assessing the need for such expenditures is exacerbated by the lack of measures of poverty, though differential unemployment rates would suggest large differences in poverty rates. Beginning in August 1995, a new household survey of 8,000 households by the Central Statistical Bureau (with the support of the World Bank and UNDP) is expected to provide information that will assist in the design of an improved social safety net.

V. Monetary Developments

1. Monetary and exchange rate policies

Exchange rate stability has been the main goal of monetary policy in Latvia, with the lats pegged to the SDR since February 1994. Under these circumstances, the behavior of monetary aggregates during 1994 was largely determined by developments in the foreign exchange market; velocity continued the downward trend observed since late 1992, reflecting increased confidence in the lats (Chart 4). After cumulative net purchases of nearly US\$300 million in 1993, the Bank of Latvia became a net seller of foreign exchange during the first quarter of 1994 (Chart 5). Large inflows of foreign exchange to the Bank of Latvia resumed in the second half of the year, however, and by end-December gross official reserves had increased by over US\$100 million vis-à-vis their end-1993 level, reaching US\$626 million.

CHART 4
LATVIA

VELOCITY OF BROAD MONEY 1/

Source: Data provided by the Latvian authorities.

1/ Nominal GDP divided by end-of-period broad money (including foreign exchange deposits).

CHART 5
LATVIA
NET PURCHASES OF FOREIGN EXCHANGE BY THE BANK OF LATVIA
(Cumulative, in millions of US\$)

Source: Bank of Latvia.

Box 3. Social insurance reform

The proposed pension reform calls for the replacement over time of the current "pay as you go" system by a three-tier system that has been designed with World Bank assistance. The first tier would provide a modest level of benefits related in part to contribution history, but with a minimum government-provided pension to protect the lifetime poor. The second tier would be a mandatory, funded system of privately managed savings accounts. The third tier would be a voluntary, funded system for those who wished to save for higher retirement incomes.

The exact nature of the new system will be unclear until the relevant legislation is passed by Parliament. However, it is expected that implementation would begin in 1996 with the first tier. From 1996, social tax payments on behalf of all employees would be credited to individual accounts which will accrue interest in line with average wage growth. Upon retirement, annual pensions would be calculated as the accumulated balance divided by the average post-retirement life expectancy. Benefits would be indexed in line with price (rather than wage) growth. The second tier would not be introduced before 1998, to ensure that capital market development in Latvia has progressed sufficiently so that there will be sufficient assets for the investment of the funded component.

It has been proposed that the social tax rate would be unified for all employees at 38 percent, and that around half the tax payment will be made by the employee. Since the majority of the social tax payment would be attributed to the retirement account of individual employees who may regard it more as savings than as a tax, it is expected that this will lead to a significant reduction in evasion of social tax payments.

The minimum pensionable retirement age would be unchanged for men at 60, but would increase for women from 55 to 56 in 1996, and by half a year each calendar year until it reaches 60. While earlier proposals for a gradual increase in the retirement age to 65 have not been accepted, it is expected that many people will work past the minimum retirement age since the new pension formula will ensure a significantly higher pension for those who work longer: the previous formula had only very small increases with each year of work history and in practice provided no incentive to work past the minimum retirement age. This will have a beneficial effect on the budget, because these workers will continue to pay income tax and because part of the social tax payments are used to fund benefits other than pensions.

The proposed legislation would also reform other benefits. Sick leave benefits would be reformed from the current government-funded system to make the individual responsible for the first day and the employer for the remainder of the first two weeks, at which point the social budget would take over payments, which would be based in part on previous social tax payments. In addition, benefits would be limited to 80 percent of average earnings, rather than 100 percent as before.

Unemployment benefits would also be reformed to provide a greater link to individual contributions. Benefits would shift from a system with benefits set at 70 or 90 percent of the minimum wage to an insurance benefit of 50 percent of the previous wage, with an extra 5 percent for each 5 years of employment history. In addition, to provide an incentive for job search there would be gradual cuts to benefits after three and six months, with their elimination after nine months (at which time social assistance might become available).

In view of the fixed exchange rate policy and its limited use of market-based monetary instruments, the Bank of Latvia did not mop up the liquidity generated through the balance of payments. Having ruled out a nominal appreciation of the lats, the Bank of Latvia's strategy in 1994 was to accommodate higher monetary growth and to continue to run a tight credit policy, both by restricting refinance credits and by keeping credit to the Government within the negotiated amounts under the credit line agreement. In the event, reserve money increased by 20 percent in 1994, which represented a 5 percent decline in real terms (Table 16). Broad money, however, rose by almost 50 percent during the year, or 18 percent in real terms (Table 17). The sharp increase in the multiplier was the result of the build-up of the Treasury-bill market (Box 4), which led to a marked reduction in banks' excess reserves during the year. The reserve/deposit ratio declined from 23 percent in December 1993 to 12 percent in December 1994, due to increased purchases of Treasury bills by commercial banks and, to a lesser extent, to changes in the reserve requirement later in the year (Section 3). The currency/deposit ratio remained high in 1994, at around 45 percent (Chart 6).

Monetary developments during the first half of 1995 were shaped by the emergence of a banking crisis (see Chapter VI) as well as budgetary difficulties, which caused a drastic change in liquidity conditions. In view of the high degree of dollarization in the Latvian economy and the large number of transactions which are still cash-based, the deflationary impact of bank failures is likely to be somewhat smaller than suggested by the observed decline in monetary aggregates. The Bank of Latvia extended only a modest amount of liquidity support to troubled banks. By contrast, a large emergency credit line (of LVL 20 million) was granted to the Government in May 1995, due to its difficulties in financing a growing deficit through sales of Treasury bills. The failure of several banks early in the year and the associated loss in public confidence led foreign investors to gradually pull out funds during the first quarter, resulting in more foreign exchange outflows than expected based on projected seasonal patterns. The pressure on the foreign exchange market built up in May, with the closure of Latvia's largest bank, which led to a sharp increase in the demand for foreign exchange and precipitated a banking crisis. The Bank of Latvia's heavy intervention to defend the lats, combined with an increase in the refinance rate, succeeded in restoring stability in the foreign exchange market. ^{1/} Despite a loss in official reserves of around US\$90 million in May/June, gross international reserves stood at US\$540 million at end-June, or the equivalent of 3 1/3 months of imports of goods and nonfactor services.

^{1/} On June 1, the Bank of Latvia raised its refinance rate by 1 1/2 percentage points to 26 1/2 percent per annum.

CHART 6
LATVIA

MONEY MULTIPLIER AND BANK RESERVES

Sources: Bank of Latvia; and staff calculations.

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Box 4. The Treasury-bill Market

The Primary Market

Treasury bills were introduced in Latvia in December 1993, largely as an instrument for budget financing. Initially, only 28-day bills were offered in the weekly auctions, but 91-day bills and 182-day bills were introduced in October 1994 and March 1995, respectively. The denomination of T-bills was initially established at LVL 100,000 (about US\$200,000), which is around the par-value of bills offered in much larger financial markets, but this amount could be split into smaller denominations for sale to nonbanks. The auctions are carried out by the Bank of Latvia in its capacity as fiscal agent of the Government. An Auction Committee consisting of two representatives each from the Bank of Latvia and the Ministry of Finance is in charge of the technical aspects of the auctions, but the Bank of Latvia participates only in an advisory capacity. The Ministry of Finance determines the amounts to be issued, the maturities and the cut-off rates for each auction. Cut-off rates have been determined largely based on short-term fiscal considerations and, as a result, until more flexibility was allowed when the cut-off rate was eliminated in June 1995, auction rates did not always reflect market forces.

Participation in the auctions is limited to commercial banks; although the central bank may participate on a noncompetitive basis, in practice it only purchases T-bills in the secondary market. Nonbanks can participate through commercial banks, but their share in the total amount of bills outstanding is very small. In order to increase participation in the auctions and encourage sales to nonbanks, the Ministry of Finance recently announced the reduction of the minimum denomination of T-bills to LVL 10,000 to banks, and to LVL 100 to nonbanks effective from September 27, 1995.

T-bills are auctioned according to a multiple-price auction system (each bank receives the amount bid at the bid price). Five days prior to the auction date the Ministry of Finance announces the amount of the issue, the maturities and the purchase and redemption dates. Settlement takes place two days after the auction date by debiting banks' correspondent accounts at the Bank of Latvia and crediting the Treasury account. The Bank of Latvia also serves as central depository for the securities, issued in book-entry form. The results of each auction, including amounts offered, bid and sold, and the average discount rate are published by the Ministry of Finance after the auction.

Although during the past year banks showed growing interest in investing in T-bills and the stocks outstanding increased steadily, the auctions have often been undersubscribed; the overall undersubscription for the period January 1994-July 1995 was about 40 percent of the total amount offered. This problem became more acute from March 1995 on, with a substantial weakening in the demand for bills reflecting banks' liquidity problems. Particularly affected was the demand for longer maturities, in view of the uncertainty generated by the banking crisis and fiscal slippages. Given its difficulties in rolling over T-bills, the Ministry of Finance raised the cut-off discount rates gradually during the subsequent months, severing the prevailing link between the T-bill discount rates and the Bank of Latvia refinance rate. As a result of increased interest rate flexibility and the improvement in banks' liquidity position, a recovery in the outstanding stocks of T-bills took place, together with a significant increase in the number of participating banks. While in 1994 the number of banks bidding for the 28-day securities never exceeded nine, the average number in July-August 1995 was about 12.

Box 4 (continued). The Treasury-bill Market

The Secondary Market

The secondary market in T-bills is still very thin; few banks are really active and the amounts traded are small. A small-scale "secondary window" was established at the Bank of Latvia in April 1994 to buy and sell short-dated (less than the original maturity) T-bills with a view to increasing their liquidity and encouraging the development of a secondary market. The bid/offer prices are quoted daily by the Bank of Latvia and determined on the basis of the result of the previous auction. Amounts traded in the secondary window are limited to a quota for securities purchases for the Bank's own portfolio and, until July 1995, to a limit established under the credit line agreement between the Bank of Latvia and the Ministry of Finance (up to LVL 2 million from the total amount under the credit line). In July 1995, the credit line agreement expired and since then one single limit applies for purchases of Treasury bills for the Bank's own portfolio. This ceiling had been raised to LVL 5 million in May 1995, leading to a significant increase in activity in the secondary market. Until July 1994, most secondary deals were effected through the Bank of Latvia, but subsequently the Government used up the total amount available under its credit line and the Bank of Latvia ceased operating the secondary window. Activities resumed in September 1994, but since then the Bank of Latvia's share in secondary market transactions has declined, as banks are trading mainly with each other.

Reserve money behavior mirrored developments in the foreign exchange market, falling gradually from January 1995, and dropping sharply in May in the wake of the Baltija collapse and the ensuing large sales of foreign exchange by the Bank of Latvia. The money multiplier fluctuated somewhat during the first half of the year, mainly reflecting instability in the currency/deposit ratio as a by-product of the banking crisis. For the semester as a whole, however, only a very small decline in the multiplier took place, and both reserve money and broad money fell by about 17 percent in real terms. If deposits blocked in insolvent banks are excluded, the real money supply fell by 35 percent during the first half of the year. Reflecting the sharp decline in money demand, the downward trend in velocity was reversed in the second quarter of 1995. After experiencing a liquidity squeeze and negative reserve positions for several months, the banking system started to accumulate excess reserves again in June 1995 (Chart 6).

2. Credit, deposit and interest rate developments

After more than doubling in 1993, credit to the private sector (including state enterprises) increased by 38 percent in 1994, or by about 9 percent in real terms. A sharp deceleration in credit to enterprises led to a decline in real terms in total credit to the private sector during the first half of 1995. This decline reflected banks' tight liquidity position, as well as credit rationing by banks on account of the growing uncertainty, falling lending rates and a continued lack of collateral to secure credits. By contrast, credit to households continued to increase strongly, and at the end of June 1995 accounted for 10 percent of total credit to the private sector, compared to 2 percent at the end of 1992 (Table 18). As discussed further in Chapter VI, most credits are given on a short-term basis, with

about 60 percent of total credit denominated in foreign currency. The latter include balance of payments loans disbursed to domestic users as medium-term credits (3 to 5 years).

Following a 53 percent increase in 1994, deposit growth was interrupted in February 1995 as public confidence in the banking system began to fall. Although no major bank runs have taken place, total deposits declined by 10 percent during the first seven months of the year, mostly reflecting the withdrawal of deposits by households and state enterprises. As a result, the share of household deposits declined sharply in the second quarter, after a steady increase since 1992 (Table 19). Reflecting the uncertainties generated by the banking crisis, households shifted from term deposits to demand deposits and cash, while enterprises switched to foreign exchange-denominated deposits (Chart 7).

Commercial banks' deposit and lending rates have fallen gradually from the very high levels observed in 1993, reflecting declining inflationary expectations. Interest rates on credits and deposits denominated in foreign currency have remained very high compared with foreign rates. Despite the declining trend, which started in mid-1994, lending rates continue to be high in real terms due to persistently high credit risk, while real deposit rates have turned negative, further encouraging deposit withdrawals (Chart 8). The persistence of a wide spread between deposit and lending rates reflects, inter alia, high default premiums and the adoption of loan-loss provisions in 1994 (Chart 9).

The Bank of Latvia reduced its refinance rate from 27 percent to 25 percent per annum during 1994, with a view to bringing downward pressure on market rates. However, given the small amount of refinance credits granted by the central bank, changes in the refinance rate have only a limited direct impact on market rates. Although deposit rates have become significantly negative in real terms, banks have been reluctant to raise them because they fear, after the experience with Bank Baltija, that higher deposit rates would be associated with higher risk by the public.

Until April 1995, Treasury bill discount rates followed the declining trend displayed by banks' interest rates (Chart 10). Treasury bill rates then increased sharply, reaching 33 percent at end-June for 28-day securities. This reflected a higher risk premium on Government securities, and a more flexible approach toward setting the cut-off rate. With activity in the Treasury bill market picking up, the discount rate on 28-day securities has become effectively the reference rate in Latvia.

3. Monetary policy instruments

Over the last couple of years, the Bank of Latvia has made some progress toward developing indirect monetary instruments, but has not actively used them for day-to-day liquidity management. The Bank of Latvia's main policy instrument during this period has been its purchases and sales of foreign exchange, with the objective of stabilizing the

exchange rate. Besides intervention in the foreign exchange market, other instruments available to the Bank of Latvia include refinance facilities, reserve requirements, term deposits, and purchases/sales of government securities in the secondary market.

Refinance credit is provided in the form of auctioned credit (uncollateralized) and lombard credits (collateralized); 1/ in addition, since February 1995, emergency refinance credit secured by Treasury bills and privatization vouchers has been available for banks in financial difficulties, at the discretion of the Bank of Latvia Board. There is a ceiling on total central bank credit to banks (currently at LVL 2.5 million), but starting from May 1995 this limit does not apply to collateralized credit. Despite the tight liquidity situation of banks, demand for lombard credits was low during the first half of the year, due to the high rate and short maturity of the facility, as well as the requirement for collateral. 2/

Credit auctions were introduced in late 1993 and are held weekly. In October 1994, the maturity of these credits was reduced from two months to one month, a more typical maturity for central bank credit. The number of participants continues to be very small, largely reflecting the low ceiling on the amounts auctioned. Auction rates have therefore had little influence on market rates.

Since July 1993, a uniform reserve ratio of 8 percent applies to commercial banks' lats and foreign-currency denominated deposit liabilities. In order to limit the amount of cash reserves used as eligible assets to meet the reserve requirement, since September 1994 banks have been allowed to hold only up to 50 percent of their required ratio in the form of vault cash. The reserve requirement must be maintained on a daily average basis.

In order to add a liquidity-absorbing instrument to its portfolio, the Bank of Latvia started accepting term deposits from commercial banks in March 1995. The new instrument was designed with a view to avoiding any disruption to the Treasury bill market: the minimum denomination of the deposits was established at LVL 10,000 (vs. LVL 100,000 for Treasury bills at that time) and the rate of remuneration was set at 16 percent per annum. Furthermore, these deposits are nonnegotiable and cannot be withdrawn before term (31 days). Interest in this instrument has been very limited, initially because banks held little excess reserves and later reflecting the higher remuneration of Treasury bills.

1/ Starting from October 1995, all central bank credit to banks will be collateralized.

2/ The lombard rate is a penal rate, set at 5 percentage points above the refinance rate, or 31.5 percent per annum at the end of June, 1995. Lombard credits cannot be drawn for more than 7 consecutive days or for more than 14 days during a month.

CHART 7
LATVIA

DEPOSITS AT COMMERCIAL BANKS

Sources: Bank of Latvia, and staff calculations

CHART 8
LATVIA

INTEREST RATES
(In percent per annum)

Sources: The Bank of Latvia, and staff estimates

1/ Three-month moving average, credits and deposits of 3-6 months' maturity

2/ Computed on the basis of the three-month moving average of the monthly inflation rate

CHART 9
LATVIA
COMMERCIAL BANKS' INTEREST RATE SPREAD 1/
(In percent per annum)

CHART 10
LATVIA
DISCOUNT RATE ON 28-DAY TREASURY BILLS
(Monthly average, in percent per annum)

Sources: Ministry of Finance; and staff calculations.

The Bank of Latvia's participation in the Treasury bill market is effected through its purchases and sales of Treasury bills at its secondary market window. This window was set up in April 1994 with the objective of encouraging secondary market development and paving the way for the active use of open-market operations in the near future. Activity at this window is limited by the Bank of Latvia's tight credit policies and the amounts of securities purchased are subject to ceilings (Box 4).

Although indirect monetary instruments have been introduced, the structural weaknesses in the banking and enterprise sectors (discussed in Chapter VI) have hindered financial market development and limited the Bank of Latvia's ability to conduct market-based monetary policy. In particular, the lack of a competitive banking system and of developed money and interbank markets has reduced the effectiveness of refinance policies in influencing the level of banks' reserves and market interest rates, and thus hampered the workings of the monetary policy transmission process. Another hindrance to active liquidity management is the lack of expertise in forecasting liquidity and the Government's cash flows, the latter complicated by the fact that the Government holds accounts in several commercial banks.

VI. Financial Sector Reform and the Banking Crisis

1. Introduction

Financial liberalization started in earnest after currency reform in mid-1992. Liberalization measures adopted in the early stages of reform included the phasing out of directed and subsidized credits and interest rate controls, the introduction of current account convertibility, and the elimination of all restrictions on capital movements. During the first stages of financial sector reform, the Soviet monobank system was dismantled and a large number of commercial banks were established. Moreover, the Bank of Latvia was created and given a large degree of autonomy to perform all traditional central banking functions, including regulation and supervision of banks. Since then, the Bank of Latvia has established a solid reputation as an independent central bank through the implementation of firm monetary policy.

Although the process of financial deregulation has been largely completed, some crucial elements needed for a successful financial sector reform are still lacking, including a more competitive and sound banking system, an effective regulatory framework, developed financial markets, and an efficient and safe payments system. Additional progress in these areas to a large extent requires an acceleration in other structural reforms, including enterprise restructuring, the development of markets for land and real estate, and improvements in the legal framework, notably regarding bankruptcy procedures, and the transfer of ownership.

As a result of insufficient progress in structural reform, a financial system vulnerable to market failure and to exogenous shocks emerged from the monobank system. The fragility of the financial and nonfinancial institutions which developed in the new, deregulated environment set the stage for the 1995 banking crisis. Liberal licensing requirements allowed the establishment of an excessive number of commercial banks without the necessary capital, adequate banking skills, appropriate accounting methods and internal control procedures. The lack of effective regulatory mechanisms to enforce discipline, together with the moral hazard associated with the generalized perception of implicit Government guarantees, allowed banks to take excessive risks and adopt unsound lending policies. These led to the build-up of weak portfolios and eventually to sizable losses. The submission of banks' audited reports for 1994 in April 1995 and the closure of Latvia's largest bank a few weeks later exposed the distortions in the banking sector accumulated over the previous years and precipitated a banking crisis.

2. The banking sector

As in other transition economies, the financial sector in Latvia is dominated by banking institutions, with little activity in the money, securities, and capital markets. 1/ Given the large number of banks, the fragility of several institutions and the forthcoming increase in minimum capital requirements, 2/ a further consolidation of the banking sector, through mergers and liquidations, is inevitable in the near future. The process of downsizing the banking sector in Latvia is already well underway, with a sharp decline in the number of licensed banks taking place during the last couple of years--from 63 banks at the end of 1993 to 41 banks at the end of July 1995. The activities of many of these have recently been curtailed, and only 17 "core" banks hold unrestricted licenses, including the right to accept household deposits. The "core" banks are the largest banking institutions in Latvia, and at the end of June 1995 accounted for 78 percent of capital, 82 percent of assets and 86 percent of deposits in the banking sector. These banks are regarded as basically sound and have in fact reported interim profits for the first half of the year.

Among the licensed banks, there are three state-owned banks (the Universal Bank of Latvia (Unibank), the Latvian Savings Bank (LSB) and the Mortgage and Land Bank) and one foreign bank (Société Générale). 3/ The

1/ Major steps have been taken to create an organized securities market in Latvia, including the adoption of a legal framework to regulate the operations of the securities market, the Riga Stock Exchange (RSE) and the Central Depository. The RSE started operations in July 1995, but trading is still thin.

2/ The minimum capital requirement is currently LVL 100,000 (around US\$200,000), but will be raised to LVL 1 million in March 1996 and to LVL 2 million in March 1998.

3/ Dresdner Bank has a representative office in Riga.

Unibank is in the process of being privatized. The other banks are privately-owned or joint-stock companies with private and state capital. Several banks have foreign participation, with a predominance of Russian capital, the latter attracted by the liberal system in Latvia as well as familiarity with the business environment and the possibility of using the Russian language.

The Unibank was created in late 1993 from the merger of 21 former branches of the Bank of Latvia. The bank's profitability improved significantly after its nonperforming loans were replaced by long-term government bonds in April 1994, resulting in positive after-tax profits both in 1994 and in the first half of 1995. Much progress has been made in restructuring and modernizing the bank's operations, with technical assistance from the World Bank and EU-Phare. Furthermore, a four-stage privatization program is on the agenda for 1995/96. During the first stage, the Unibank's share capital was increased by LVL 2.5 million, funded by retained profits and reserves. The second stage, launched in May 1995, comprised the sale of 50.001 percent of the Government shares to the public, bank clients and employees, in exchange for privatization certificates. The third stage of privatization will involve a further increase in the bank's capital through a private placement, and the final stage will be completed with the sale of all remaining government shares through the RSE, possibly as early as the first quarter of 1996.

By contrast, progress in restructuring the Latvian Savings Bank (LSB) has been slow and the prospects for a speedy privatization remain slim. Although to date the Government has issued bonds amounting to about LVL 40 million to replace impaired assets and recapitalize the bank, largely as a result of poor lending policies and an unwieldy branch network, the LSB incurred substantial losses in 1994 and is currently undercapitalized. Recent deposit withdrawals in the wake of the banking crisis have compounded these difficulties and contributed to stalling the restructuring process.

In addition to deposit-taking institutions, the financial sector includes the Latvian Investment Bank (LIB), 16 pawnshops and one credit union. The LIB was established in March 1993 to provide medium- and long-term project financing to small- and medium-sized enterprises. Its shareholders are the Latvian Government (35 percent), the EBRD (35 percent), the FinFund, the SwedFund and the German Investment and Development Company, DEG (10 percent each). The number of projects meeting the LIB's standards is still relatively small. The bank's strategy is to invest heavily in staff training (extensive technical assistance has been provided by the EBRD and the Nordic Investment Bank) and continue its cautious lending policies. A major goal for the LIB during 1995 is to develop instruments to extend medium-term financing in domestic currency.

3. Structural characteristics

The Latvian banking sector is plagued by a number of structural weaknesses, including undercapitalization, weak portfolios, excessive

segmentation, limited competition and an ineffective regulatory framework. Although the banking sector's capital and reserves rose significantly in the past two years (Table 20), at the end of June 1995, 13 banks were out of compliance with the 10 percent risk-weighted capital adequacy ratio. Most banks are expected to face severe difficulties in meeting the increased minimum capital requirement (LVL 1 million) by March next year. Furthermore, bank recapitalization during the past couple of years has been partly funded through loans extended to shareholders. The large degree of insider lending and the interlocking ownership patterns between banks and enterprises have been compounded by the poor quality of loan portfolios--at the end of June 1995 nonperforming loans represented 17 percent of the total credits of operating banks (25 percent if failed banks are included). Nevertheless, banks continue to show reluctance to make provisions on a timely basis. Furthermore, the availability of speculative foreign capital during the past few years encouraged risky lending behavior and increased banks' exposure to exchange risk.

Despite the large number of banks, competition is limited and the market is highly segmented. As of end-June 1995, the five leading banks accounted for 70 percent of deposits and about 55 percent of both credits and total assets of the banking system. The same banks accounted for 42 percent of total paid-up capital (Table 20). Only 10-15 banks are active in the Treasury bill, interbank and foreign exchange markets. Competition for deposits remains strong among the larger banks, with wide branch networks, while the smaller banks have a limited market share and cater to a specific and narrow clientele, such as corporate clients, but also often to their own shareholders ("pocket banks"). Several banks specialize in services, mainly related to foreign exchange transactions, and provide little credit. Others cater to the lucrative transit business, often providing credits denominated in foreign currency; some banks concentrate their business in specific regions. Although there is no legal impediment to the entry of foreign banks, there is currently only one foreign bank operating in the country.

4. The regulatory framework

The experience of other countries has demonstrated the crucial role of strong prudential regulation and supervision in the early stages of financial liberalization, when effective market discipline was still lacking. The Bank of Latvia is aware of the importance of banking supervision and has taken a number of steps during the last couple of years to build up an effective supervisory capacity and achieve a gradual and orderly consolidation of the banking sector. However, the progress achieved in introducing prudential regulations and in monitoring financial institutions has not always been matched by adequate enforcement.

Off-site monitoring is performed on the basis of report forms introduced in early 1994 and the computerized financial database developed by the Bank of Latvia's Banking Supervision Department, the latter expected to be used soon as an early-warning system. On-site inspection is carried

out annually or more frequently in case of problem banks. Prudential regulations still need to be tightened to conform with EU standards (Table 21). Furthermore, some key prudential ratios are less restrictive than in the other Baltic countries (Table 22), although the enforcement of these regulations also remains crucial.

In 1994, the Bank of Latvia introduced rules for loan classification and provisioning and external audit requirements for banks. New regulations on capital adequacy and risk concentration were adopted in July 1994. The limits on banks' foreign exchange exposure, insider lending and large loans were reduced by the Bank of Latvia Council in July 1995, but implementation may be delayed until January 1996, depending on whether an amendment to the draft law on credit institutions is confirmed by Parliament. Licensing procedures have been considerably tightened with the introduction in December 1994 of two regulations which raised minimum registered capital for new banks to LVL 2 million and enhanced the Bank of Latvia's authority with respect to bank mergers and changes in bank management and shareholders. Transitional arrangements were established to modify minimum capital requirements in order to bring them closer to EU standards. A Credit Institutions Supervisory Committee was created in late 1994 to assist the Banking Supervision Department in finding solutions for problem banks, which continue to be kept under close scrutiny.

The licenses of 8 commercial banks were revoked in 1994; most of these were small institutions, with negligible impact on the system. During the first seven months of 1995, the activities of another 15 banks, including some of the largest ones, were suspended, this time with serious systemic implications (Section 6). Despite visible progress, effective banking supervision in Latvia is complicated by a number of factors, including the availability of resources and expertise to deal with a growing number of problem banks. Although the Bank of Latvia has increasingly devoted resources to this area, staff training on the basic principles of commercial banking in a market economy and on banking supervision necessarily takes time. The staff constraint is compounded by the difficulties in the implementation of prudential rules before banks' balance sheets have been cleaned up, the quality of loan portfolios improved and reliable accounting systems adopted at the enterprise level. Bank reform is unavoidably linked to progress in enterprise restructuring and privatization, which in turn necessitate the introduction of adequate bankruptcy laws to promote financial discipline. Slow progress in these areas has hampered efficient financial intermediation and complicated the task of the supervisory authorities. Furthermore, although supervisory standards have been tightened during the past two years, lax supervisory and licensing policies in the early stages of financial reform allowed the proliferation of unsound banks and encouraged imprudent behavior.

5. Liberalization and financial intermediation

Financial liberalization has brought about a substantial increase in the holdings of financial assets by the public; deposits in the banking

system increased by 74 percent in 1993 and 53 percent in 1994. However, as in other transition economies, preference for cash has remained high (currency in circulation accounts for almost 1/3 of the money supply), which may reflect long-standing habits, the illegal nature of some transactions, intentions of evading taxes, and the overall uncertainty associated with the reform process.

The rapid growth in the financial sector has not been matched by increased availability of medium- and long-term credit to the private sector. Credit to the private sector as a proportion of total bank assets has declined substantially since end-1992 (Table 20); the share of trade financing (typically short-term loans denominated in foreign exchange) has remained high during this period, averaging 40 percent in 1994-95. Although the share of short-term loans in banks' portfolios has declined steadily in the past 18 months to June 1995, bank financing is largely in the form of unsecured short-term credits, which accounted for around 70 percent of total credits at the end of June 1995 (Table 23). The supply of medium- and long-term credit is limited by the lack of safe investment opportunities, expertise in risk assessment and well-defined property rights, which impairs the use of collateral in loan contracts. Some degree of disintermediation has been observed after financial deregulation, notably via interenterprise credit and mobilization of deposits by nonbanking institutions.

The small role of financial intermediation in Latvia reflects the persistence of high credit risk, lack of collateral, and slow progress in privatization. The continuous inflow of speculative funds from abroad, which followed interest rate deregulation, provided short-term trade financing and, given the high demand, sustained interest rates at very high levels, hampering investment in other activities. The high rates charged by a few large banks heavily involved in the lucrative transit trade pushed interest rates upwards and created significant distortions in the overall rate structure. Interest rates have fluctuated wildly and have shown little relation to the maturity structure of the underlying assets/liabilities, while the spreads between lending and deposit rates remain excessive.

6. The banking crisis

The growing distress in the Latvian banking system turned into a full-fledged crisis after the publication, in early April, of banks' audited reports for 1994 and the subsequent closure of Bank Baltija (which accounted for 30 percent of total deposits at end-March 1995). 1/ The audited reports revealed the fragile situation of the banking system, as 2/3 of the audited banks recorded losses in 1994 and lacked an adequate capital base to

1/ Of the 54 licensed banks at the end of March 1995 (deadline for the audited 1994 reports), 43 submitted their reports on time (and three banks later). Of the banks which failed to submit audited reports, six have ceased operations, including Baltija and two other large banks (Centra and Deposit).

provide a cushion against these losses. The losses were a result of poor implementation of credit policies (widespread practices of insider lending, capitalization of interest on unpaid debt, overexposure), aggravated by banks' large open positions in foreign exchange. Furthermore, the decline in profit margins on trade financing, as a result of liberalization of prices in Russia, exposed banks highly dependent on high risk short-term financing.

A series of bank scandals early in the year, culminating with the closure of Bank Baltija in late May, undermined depositors' confidence in the banking system and resulted in deposit withdrawals and capital flight. After steady growth for two consecutive years, bank deposits declined in February, in the wake of the Government intervention in the Lainbanka. ^{1/} Bank Baltija's failure, a few weeks later, came at a time when uncertainty about fiscal policy promoted further currency substitution. Since mid-1993, when Baltija bought several of the former commercial branches of the Bank of Latvia, the bank had adopted a very aggressive policy to increase its market share, by offering higher interest rates and lower minimum deposits than its competitors. At the same time, Bank Baltija concentrated its lending on high-risk short-term loans, while neglecting to invest in internal risk management controls and to follow prudential guidelines. The bank also continued to increase its open position in foreign exchange. As a result, its financial situation deteriorated rapidly and by early 1995 it became insolvent. The prolonged state of distress increased the incentive for further risk-taking, while the bank's size ("too-big-to-fail") encouraged expectations of a government bail-out. By the time the bank's operations were suspended, most of its assets had been stripped, leaving negative worth of up to 8 percent of GDP. In addition to bad banking practices, notably lending to insiders, fraudulent and criminal activities were uncovered.

As discussed in Chapter V, the banking crisis led to substantial portfolio shifts, the withdrawal of foreign funds invested in Latvia, a sharp decline in the demand for money and a contraction in the banking system's role in intermediation. To restore confidence in the banking system after the Baltija collapse, the Government promised to compensate depositors of failed banks in the amount of LVL 500 per depositor; LVL 200 per depositor are to be transferred in 1995, with the remaining sums to be paid over the next three years. In addition, a package of banking legislation, including laws on deposit insurance, on the establishment of a rehabilitation agency for banks, and a new law on credit institutions, was drafted to provide the legal basis for deposit compensation, introduce bankruptcy procedures for banks and generally strengthen the regulatory framework. These laws were adopted during Parliament's summer recess, but as of end-September 1995, they were still under review by Parliament.

^{1/} In February 1995, the Ministry of Interior ordered armed intervention in Lainbanka, charging its management with abuse of authority and fraudulent behavior. The case received ample press coverage.

As part of the efforts to restore domestic and international confidence in the banking system, in August 1995 the Bank of Latvia announced to the public a list of the "core" banks which hold unrestricted licenses and are allowed to accept deposits from households. Other recent measures taken by the Bank of Latvia to strengthen banking supervision include the increased use of external auditors to monitor the "core" banks on a quarterly basis, the introduction of transitional arrangements for a further tightening of prudential regulations (discussed in Section 4), a requirement for banks to establish an internal control department from November 1995, and changes in the organization of the banking supervision department, including an increase in the number of staff and improvements in the use of available information. As far as enforcement is concerned, a recent amendment to the administrative code has empowered the Bank of Latvia to impose fines on bank management for violation of prudential regulations; in addition, the Bank of Latvia has proposed amendments to the criminal code to introduce sanctions in cases of bank fraud. In order to improve communications, the Credit Institutions Supervisory Committee has been meeting weekly with banks to discuss their problems and suggest solutions. The Bank of Latvia also established recently a working group to study possible improvements in the payments system.

VII. External Sector

1. Overview

Given Latvia's entrepôt role, with significant transit and re-exporting activities and a relatively open trade and payments regime, balance of payments developments continue to be difficult to monitor. Considerable progress has been made in the coverage of customs-based trade data, including in the important area of energy trade. However, difficulties still remain with valuation and with decomposition of nominal trade flows into volume and unit value indices. In the area of services and transfers there are significant problems with reporting from enterprises. There is considerable room for improvement of capital account statistics, particularly in the areas of foreign direct investment, and enterprise and bank reporting of short-term capital flows and medium- and long-term external borrowing.

Notwithstanding the above difficulties, the revised balance of payments for 1994 and the preliminary balance of payments for the first half of 1995 show only relatively small unidentified "net errors and omissions". 1/ These data suggest that Latvia registered a current account deficit equivalent to US\$86 million, or 2.5 percent of GDP in 1994, and US\$79 million, or 3.6 percent of GDP in the first half of 1995 (Table 24). Trade deficits were recorded in both 1994 and the first half of 1995. As a

1/ However, net errors and omissions may conceal large offsetting errors and omissions for individual entries in the balance of payments.

result of an increase in domestic demand, the trade balance with countries outside the Baltics, Russia and other countries of the FSU moved into deficits in 1994 and in the first half of 1995. Due to lower energy imports, trade with the Baltics, Russia and other countries of the FSU registered smaller deficits than in previous years.

Latvia received US\$155 million of foreign direct investment in 1994 and US\$100 million in the first half of 1995, mainly as a result of investment in the telecommunications sector. Taking into account disbursements of medium- and long-term credits of US\$107 million in 1994, the overall balance of payments for the year registered a surplus of US\$139 million. ^{1/} Following significant intervention in the foreign exchange market in 1994, the gross convertible currency reserves of the Bank of Latvia reached US\$626 million at end-year, or the equivalent to 4 1/2 months of imports of goods and nonfactor services. Capital flows were reversed in the first half of 1995 due to the emergence of the banking crisis and budgetary difficulties. Preliminary data indicate that the overall balance of payments for the first half of 1995 showed a deficit of US\$184 million, and gross convertible reserves of the Bank of Latvia declined by US\$86 million.

2. Merchandise trade

a. Direction of trade

Progress in macroeconomic stabilization and Latvia's open trade system have contributed to the ongoing reorientation of trade toward the West. A gradual shift of trade toward Western countries led to an increase in the share of exports to countries outside the Baltics, Russia and other countries of the FSU, from 46 percent in 1993 to about 50 percent of total exports in 1994, and to 54 percent in the first half of 1995. The share of imports from countries outside the Baltics, Russia and other countries of the FSU also increased from 35 percent in 1993 to 54 percent of total imports in 1994, and to 60 percent in the first half of 1995. This reorientation of trade is associated with the ongoing industrial restructuring, in particular in the wood product, textile and chemical industries. Another contributing factor is the reduction in energy imports from Russia due in part to more efficient use of energy.

Germany, Finland, Sweden and the United Kingdom are Latvia's largest trading partners in Europe (Table 25). The share of exports to Germany in relation to total Latvian exports to countries outside the Baltics, Russia and other countries of the FSU, increased from 14 percent in 1993 to about 26 percent in the first half of 1995. In the same period, the share of exports to the United Kingdom increased from 10 percent to 21 percent. As regards imports, the share of imports from Germany increased from 20 percent of total Latvian imports from outside the Baltics, Russia and other

^{1/} The overall balance is defined as the change in the net foreign assets of the banking system, including the use of Fund credit, net.

countries of the FSU in 1993 to about 26 percent in the first half of 1995. In the same period, the share of imports from Finland increased from 9 percent to 18 percent.

Compared to 1993, the distribution of Latvia's trade with the Baltics, Russia and other countries in 1994 and in the first half of 1995 changed in favor of the other Baltic countries (Table 26). Although the share of Russia remained above 50 percent of both exports and imports, the share of exports to other Baltic countries increased by about 5 percentage points and the share of imports from other Baltic countries rose by about 7 percentage points.

b. Commodity composition of trade

The commodity composition of Latvian exports shifted in 1994 and in the first half of 1995 away from mineral products and rail/tram vehicles and parts toward exports of wood and wood products (Table 27). While the share of mineral products and rail/tram vehicles and parts fell from 14 percent and 13 percent respectively in 1993, to 3 percent and 7 percent respectively in the first half of 1995, the share of wood products rose from 9 percent to 28 percent. The shift suggests that re-exporting activities, concentrated mostly in the category of mineral products (including fuels), have declined significantly. From 1993 to the first half of 1995, changes have occurred also in the commodity composition of Latvian imports. As a result in part of the decline in re-exporting activities, the share of mineral products in total imports declined by 25 percentage points. Due partly to the ongoing industrial restructuring, the share of machinery and electrical equipment increased by 8 percentage points.

3. Services and transfers

The estimated services balance in 1994 and in the first half of 1995 continued to show significant surpluses of US\$292 million and US\$106 million, respectively. 1/ Net transport revenues generated almost all the recorded surpluses, mainly as a result of sea transport services provided by Latvia's shipping and transportation enterprises. Due to the low level of external debt (10 percent of GDP at end-1994), interest payments are not a significant factor in Latvia's balance of payments. Indeed, interest payments in 1994 were more than offset by interest earnings on Latvia's relatively high international reserves. However, due to a decline in international reserves in the first half of 1995, interest earnings were exceeded by interest payments. Unrequited net current transfers in 1994 were US\$64 million, compared to US\$78 million in 1993.

1/ Including income and transfers balance.

Preliminary data for the first half of 1995 show net current transfers of US\$26 million. 1/

4. Capital account

Movements in capital flows, in particular private flows related to the enterprise and banking sectors, remain difficult to monitor. There is only partial coverage of data on foreign direct investment and capital flows reported by enterprises. Efforts are underway to achieve more complete coverage through comprehensive reporting by enterprises and banks to the Central Statistical Bureau and to the Bank of Latvia.

Foreign direct investment (FDI) in Latvia is governed by the Law on Foreign Investment which was adopted in November 1991 and amended in February 1993, in June 1994, and in March 1995. The Latvian Development Agency analyzes FDI from information obtained from the Latvian Enterprise Registry and the Central Statistical Bureau. Foreign direct investment is estimated at US\$155 million for 1994 and US\$100 million for the first half of 1995. About half of the amount invested in 1994 and in the first half of 1995 was in the telecommunications sector, as a result of the sale by the Government of 30.1 percent of the shares of Lattelekom to the foreign joint venture holding company Tiltis.

Through end-February, 1995, the transport, storage and communications sector had received 33 percent of the stock of FDI, the financial intermediation sector and manufacturing sector received 29 percent and 25 percent respectively, with 8 percent going to wholesale and retail trade. About 24 percent of the inflows of FDI originated from Denmark, another 17 percent and 11 percent from the United States and from Germany respectively, and 7 percent from the United Kingdom. 2/ Russian companies represented 23 percent of the number of registered companies with foreign capital share, companies from Germany and the United States accounted for 12 percent and 9 percent respectively, and companies from Sweden represented 7 percent.

In addition to purchases from the Fund under the Systemic Transformation Facility and the second stand-by arrangement, disbursements of medium- and long-term official and officially-guaranteed financing in 1994 amounted to US\$107 million, about the same level as in 1993. They

1/ There are considerable shortcomings in recording unrequited transfer flows, including the recording of foreign aid and the value of transfers of foreign technical assistance. Furthermore, information is not available on (possibly significant) private transfers from persons of Latvian descent living abroad.

2/ The large share of FDI originated in Denmark reflects the fact that the joint venture holding company Tiltis--with shares held by companies in the United Kingdom and Finland and by the International Finance Corporation--was registered in Denmark.

included disbursements of US\$20 million under the World Bank import rehabilitation loan, US\$24 million from the JEXIM Bank as co-financing of the World Bank loan, US\$25 million from the EBRD for the energy sector and improvement of Riga airport, and other official and private disbursements from Finland and Germany. Disbursements of official and officially-guaranteed financing slowed considerably in the first half of 1995, reaching only US\$12 million. They included small disbursements under the World Bank import rehabilitation loan, agriculture development loan, and heating project loan, as well as private disbursements from Germany.

Taking into account repayments of medium- and long-term debt and other capital, the total capital account in 1994 registered a surplus of US\$274 million compared to US\$186 million in 1993. In the first half of 1995, the capital account balance shifted to an estimated deficit of US\$93 million, due to the low level of external disbursements of medium- and long-term loans and the large capital outflow associated with uncertainties related to the banking crisis and pressures on the budget.

5. External debt and debt service

External debt disbursed and outstanding is estimated at US\$359 million at end-1994, equivalent to 10 percent of GDP. Reflecting low external disbursements and an increase in nominal GDP in the first half of the year, the stock of external debt at end-June 1995 increased to US\$373 million, while the debt-to-GDP ratio fell to 9 percent. In August, 1995, Latvia placed in the private international bond market a two-year ¥4 billion issue (equivalent to US\$41 million) at 5.4 percent annual interest. External debt service as a percent of exports of goods and nonfactor services increased from 5 percent in 1994 to 6 percent in the first half of 1995.

New guidelines with regard to the domestic utilization of the EU/G-24 credits were established by the Government in 1994. According to the guidelines, the assessment of individual risk and creditworthiness of the ultimate borrowers lies with the commercial banks which channel these funds to enterprises. Based on quarterly reports submitted by enterprises, the External Credit Commission of the Ministry of Finance was in mid-1995 undertaking an overall assessment of domestic utilization of EU/G-24 credits, in particular regarding the prospects of repayment to the Government.

In 1994 and in the first half of 1995, Latvia contracted about ten public or publicly-guaranteed foreign loans. The credits contracted include an enterprise and financial sector loan for US\$35 million, an agriculture development loan for US\$25 million, a heating project loan for US\$14 million and an environment loan for US\$4 million, all from the World Bank. A US\$10 million road project loan was contracted from the EBRD.

6. International reserves

Gross official reserves at end-1994 reached US\$626 million, equivalent to 4 1/2 months of imports of goods and nonfactor services. In the first half of 1994, the Bank of Latvia was a net seller of foreign exchange. However, given foreign exchange inflows during the second half of 1994, the Bank of Latvia made significant net purchases of foreign exchange. Due to seasonal factors, as well as the uncertainty created by the failure of a number of large banks, the Bank of Latvia sold significant amounts of foreign exchange during the first half of 1995. At end-June 1995, gross official international reserves declined to US\$540 million, equivalent to 3 1/3 months of imports of goods and nonfactor services.

7. Exchange rate

Starting in March 1993, the lats was gradually introduced to replace the interim currency, the Latvian ruble ^{1/} and became the sole legal tender in October 1993. Following a period of managed floating, the lats has been pegged to the SDR since February 1994 at a rate of SDR 1 = LVL 0.7997. Since its introduction until February 1994, the lats appreciated in nominal terms by nearly 25 percent against the U.S. dollar and by about 190 percent against the Russian ruble (Chart 11). The nominal appreciation observed vis-à-vis the U.S. dollar after February 1994 (12 percent in the period to June 1995) reflects the depreciation of the dollar relative to the other currencies in the SDR basket. With respect to the Russian ruble, the nominal value of the lats increased by 255 percent during the period February 1994-April 1995, but declined by about 10 percent between April and June 1995, as the ruble strengthened against the U.S. dollar.

Between March 1993 and June 1995, the lats appreciated in real terms by about 130 percent against the U.S. dollar. By contrast, the lats depreciated by 40 percent in real terms against the Russian ruble, as the wide inflation differential was less than fully offset by the nominal appreciation. During the same period, the lats appreciated in real terms by about 105 percent against a basket comprising Latvia's seven largest Western trading partners. ^{2/} With respect to the currencies of the CIS and

^{1/} Latvia left the ruble area on July 20, 1992, when the Latvian ruble replaced the Russian ruble as sole legal tender in Latvia and was allowed to float.

^{2/} Nominal and real effective exchange rates were calculated using trade weights and CPIs. For countries outside the Baltics, Russia and other countries of the FSU, seven of Latvia's largest trade partners (75 percent of total trade) were included: Denmark, Finland, Germany, The Netherlands, Sweden, the United Kingdom and United States. For the CIS and the Baltics, five countries (95 percent of total trade) were included; Belarus, Estonia, Lithuania, the Russian Federation and Ukraine. Given Latvia's large trade in services, and valuation problems with respect to trade flows, results reported should be interpreted with caution.

Baltics, following a real depreciation in 1993, the lats remained broadly stable in real terms in 1994 and in the first half of 1995.

Despite the pronounced real appreciation of the exchange rate, the Latvian economy appears to remain competitive. Real exports to the West have continued to rise at a steady pace. On the other hand, wages rose by over fifty percent in dollar terms in 1994 and continued to increase in the first half of 1995. The average wage expressed in U.S. dollars in the second quarter of 1995 was about US\$190, which is similar to average wages in Estonia, but higher vis-à-vis Lithuania (Table 28). Nonetheless, wages data suggest that, compared to Eastern and Central Europe, a considerable margin of competitiveness remains.

VIII. Systemic Developments

Following the successful completion of the liberalization of prices, wages, foreign trade, and the exchange system, the agenda of structural reforms has now shifted to the more time-consuming process of privatization and institution building. Privatization of small enterprises has proceeded quickly, while initial progress in privatization of large enterprises was slower than expected as a result of the decentralized approach adopted. However, the legal framework for large enterprise privatization has improved with the adoption of a new privatization law in February 1994 and the establishment of the Privatization Agency and the State Property Fund in mid-1994. During the past year, momentum in privatization has picked up and three international tenders were launched. Interenterprise arrears in the energy sector remain a problem, however, as does the absence of a functioning bankruptcy law, and the slow pace of land registration and apartment privatization.

1. The role of privatization vouchers

As in a number of Central and Eastern European countries, privatization vouchers were designed to play a major part in Latvia's program to transfer land and other state and municipal property into private hands. Distribution of these vouchers began in September 1993 and by the end of July 1995, 96.5 percent of the population had received vouchers with a nominal value of LVL 2.9 billion. Vouchers were issued according to a formula based on the number of years lived in Latvia and the citizenship status of the recipient. The nominal value of each voucher was set at LVL 28, and the total face value was intended to represent the value of all property that would be privatized with vouchers.

Vouchers can be used to acquire land, apartments, as well as shares in and property of state-owned enterprises and are canceled following their use. In addition, individuals can sell their vouchers to licensed trading firms and investment funds. As of mid-1995, individuals had disposed of some 15 percent of their vouchers by purchasing shares and property directly from the agencies selling assets, i.e., the Privatization Agency, the

CHART 11
LATVIA
EXCHANGE RATES

Sources: IMF, International Financial Statistics, data provided by the Latvian authorities and staff estimates.

1/ Increase implies an appreciation.

2/ Trade-weighted, comprising Belarus, Estonia, Lithuania, the Russian Federation, and Ukraine.

3/ Trade-weighted, comprising Denmark, Finland, Germany, The Netherlands, Sweden, U.K., and U.S.

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Ministry of Agriculture and municipalities. Vouchers have also been sold to various enterprises wishing to use them in their own acquisitions under the privatization program. The total volume of trading in vouchers by dealer companies reached some 45 million units (compared with a total number issued of 103.5 million) during the period from August 1, 1994 to July 1, 1995. The average price was about one lats per voucher, which is substantially below the nominal value of LVL 28, and probably reflects overestimation of the value of enterprises, the slow progress in apartment privatization, and general uncertainty over the course of privatization.

2. Privatization of land and real estate

Latvia has separate laws governing privatization of land in rural and urban regions. Legislation in both of these areas was modified in late 1994, making legal persons (i.e., enterprises) eligible to own land. Rural and urban land can now be privatized by citizens of Latvia, legal entities registered in Latvia which are at least 51 percent owned by Latvian citizens, and foreign legal entities registered in countries that have agreements with Latvia on protection of investments. Natural persons who are not Latvian citizens are ineligible to buy land, and must sell inherited or restituted land within three years. Latvian citizens can, in principle, buy, sell and collateralize land without restrictions. However, this is only possible if the plot in question has been entered into the Land Registry. Registration is proceeding quite slowly, and by August 1995 only about 25,000 of 400,000 total plots of land had been registered. It is expected that the process of land registration will take up to eight years. The slow progress in the registration of land, and the difficulties in mortgaging land, have been cited as major factors impeding the development of financial markets.

Purchases of land by eligible legal persons are subject to greater complications since the law on land reform in urban areas requires Cabinet approval for such purchases. As the necessary implementing regulations and institutions have not yet been enacted, it has not been possible for enterprises to gain ownership of land in cities and towns. The slow pace of restitution is another factor behind the sluggish development of a real estate market in Latvia. The total number of claims filed concerning rights to land is about 350,000, of which some 50,000 have been settled. During the first half of 1995, restitution claims were settled at a rate of approximately 2,500 per month, with corresponding entries made in the Land Register at about half of that rate. It seems unlikely that the restitution process will be completed before the year 2000, especially as more than 100,000 additional claims are expected to be filed in the future. The reform continues to proceed at a more rapid rate in the rural areas than in towns. At the end of 1994 there were more than 64,000 private farms in Latvia, compared with some 4,000 in 1989 and 17,500 in 1991, though the majority of these are based on usage rights rather than actual private ownership.

Progress in the privatization of residential housing has been the slowest in the area of real estate. The relevant law was not adopted until July 1995, and the regulations necessary to implement it are yet to be issued by the Government. According to the law, residential housing may be purchased by holders of privatization vouchers, and entities eligible to own land are allowed to purchase residential housing owned by the central and municipal governments. Vouchers will be accepted as payment at their face value. Cash will also be accepted in some proportion to be decided by the local commissions which are to be set up. Apartments will first be offered for privatization to present tenants or their family members, and they will have until July 1, 1999 to accept the offer. The generally low level of rents is likely to act as a deterrent for a rapid privatization of residential housing.

3. Enterprise reform

The privatization of small enterprises, mainly by local governments, is significantly advanced. Around 85 percent of all trade, catering and service enterprises, which numbered around 4,000 at the start of the transition process, have been either sold or leased with an option to buy; the majority of these have been leased. However, the process has been considerably slower in the case of larger enterprises, which numbered around 1,000. Under the old law, privatization was decentralized and proposals were forwarded by the relevant branch Ministries to the Ministry of Economy for final approval. Around 260 enterprises were privatized by lease or were transformed into companies under this law, mainly in 1993 and 1994. Privatization of agricultural enterprises, however, proceeded under a different law, subject to Ministry of Agriculture approval. Under the new privatization law adopted in early 1994, state enterprises are passed from the State Property Fund within the Ministry of Finance (which oversees the management of most enterprises) to the Privatization Agency, which is a nonprofit organization under the general supervision of the Ministry of Economy. The Cabinet must approve each enterprise for privatization and the method which the Privatization Agency proposes for its privatization. Around 240 enterprises or property units were approved for transfer to the Privatization Agency between May and December 1994. In the first half of 1995 such approvals continued at a rate of about 20 companies per month.

The Privatization Agency's preferred methods of privatization are international tenders and public offerings of shares through the Riga Stock Exchange. Three international tenders have been announced: in November 1994, April 1995, and September 1995. The first tender included 45 enterprises in various sectors of the economy. Sales agreements are expected to be concluded for about 35 of these before the end of 1995. For a number of the remaining enterprises the process has been complicated by restitution claims or other factors, and for four companies liquidation is the only option. The second tender offered 46 companies for sale and offers were received for about two thirds of them. The most recent tender includes 34 companies. In public offerings, a controlling interest in the companies to be privatized is first sold to a strategic investor through an auction

procedure, after which lots of 20 percent to 30 percent of the company's share capital are auctioned for vouchers to employees and the general public. Three enterprises were sold by this method in the first pilot program in early 1995, and another thirteen companies were privatized during the second round in mid-1995. Altogether, the Privatization Agency privatized around 100 enterprises or property units in the first eight months of 1995, though many of these were relatively small. About ten enterprises were liquidated outright. There are, however, more than 300 enterprises cleared for privatization and awaiting their turn.

In general, the speed at which large Latvian enterprises have been privatized has been uneven. In some aspects, however, the low number of companies privatized may be a misleading guide to the proportion in value terms that has been privatized. In particular, the more profitable enterprises may have been privatized (i.e., leased with an option to buy) by managers under the old law, and the remaining enterprises may be generally weaker and with little value, with the exception of a few large ones (e.g., the utilities and shipping company) where decisions on privatization are politically sensitive. The banking crisis which unfolded in early 1995 and thus coincided with the first tenders and public offerings, has probably reduced the willingness of investors--particularly foreigners--to acquire assets in Latvia. On the legal side, the difficulties for legal persons to own land has likely also reduced the perceived value of Latvian companies for foreign buyers. The requirement introduced in mid-1994 that a 50 percent share of any enterprise must be privatized for vouchers also adds rigidity to the process. Finally, privatized companies are charged a special levy of 10 months' salary per laid-off worker.

It is recognized that the current bankruptcy law in Latvia is inadequate, as in practice it has applied only to a handful of cases. A new bankruptcy law is currently under preparation. It is expected that the new law will be easier to implement and therefore reduce the current uncertainties in the relationships between debtors and creditors, thus helping enforce financial discipline among enterprises. This--along with improved corporate governance and more vigorous oversight--may help prevent the weakening in profitability and financial strength that has reduced the value of many state enterprises in the period before their privatization.

4. Interenterprise arrears and the energy sector

Problems of interenterprise arrears in Latvia are primarily in the energy sector (Table 29). For example, Latvijas Gaze, the importer and distributor of natural gas, is owed significant amounts by enterprises and heating companies but faces pressure not to cut off supply to debtors. Domestic arrears on gas were around LVL 50 million at end-June 1995, compared with LVL 47 million a year earlier. As a result of payments totaling US\$16 million in the first half of the year, the stock of external arrears on natural gas fell to US\$11 million at end-June 1995. The financial problems of the heating companies are in turn generally due to pressures from local governments to set tariffs below cost-recovery levels.

as well as to difficulties in collecting payments from customers. In particular, in addition to the political difficulty in cutting off supply to low-income customers, it is typically not technically feasible to cut off heating and hot water supplies to individual delinquent customers. Arrears for heating and hot water rose from LVL 41 million in mid-1994 to LVL 51 million at end-June 1995. In electricity provision, tariffs are apparently below full cost levels including capital, but there are fewer technical problems in cutting off electricity supply. Therefore, the level of arrears has actually fallen in this sector, from LVL 19 million in mid-1994 to LVL 15 million in mid-1995. The total level of domestic arrears in the energy sector was around LVL 115 million in June 1995 (4.8 percent of GDP).

A governmental commission set up to study the problem of energy arrears concluded in late 1994 that an extensive restructuring of the energy sector in Latvia was necessary. Privatization of a significant part of the energy sector in Latvia would seem to offer the best chance of distancing decisions concerning energy prices and supplies from political considerations. One step in this direction is the planned sale of a minority interest in Latvijas Gaze to a strategic foreign investor.

Table 1. Latvia: Savings–Investment Balance 1/

	1992	1993	1994
<u>(In percent of nominal GDP)</u>			
Foreign savings <u>2/</u>	– 1.6	– 6.7	2.5
Gross national savings	26.8	23.6	16.2
Government <u>3/</u>	1.4	2.3	– 0.5
Nongovernment <u>4/</u>	25.4	21.3	16.7
Gross domestic savings	18.0	19.7	14.2
Gross domestic investment	25.2	16.9	18.7
Government	1.4	1.3	1.1
Nongovernment	23.7	15.6	17.6
Fixed investment	16.0	13.2	16.9
Change in stocks	9.0	3.7	1.8
<u>(Annual percentage change)</u>			
Memorandum item:			
Real GDP growth rate	– 35.2	– 14.8	1.9

Sources: Latvian authorities; and staff estimates.

1/ Columns may not sum due to rounding.

2/ External current account deficit (+).

3/ Government current balance.

4/ Derived as residual.

Table 2. Latvia: Sectoral Output

	1990	1991	1992	1993	1994
<u>(As percent of total nominal GDP)</u>					
Agriculture and fishing	21.9	23.1	17.6	15.3	8.9
Mining and quarrying	0.2	0.2	0.2	0.1	0.2
Manufacturing	34.5	35.7	28.2	21.9	21.0
Energy	1.8	2.3	1.5	4.9	6.0
Construction	9.7	5.8	5.0	4.4	6.5
Services	31.9	32.9	47.5	53.5	57.5
<u>(Real output change from previous year, percent)</u>					
Agriculture and fishing	...	-2.1	-29.2	-14.4	-28.1
Mining and quarrying	...	-12.0	-45.5	-50.0	11.7
Manufacturing	...	0.4	-48.7	-32.6	-4.2
Energy	...	-2.8	-29.6	-11.0	0.1
Construction	...	-40.6	-59.0	-49.8	20.7
Services	...	-11.8	-15.1	-10.5	8.2

Source: Central Statistical Bureau.

Table 3. Latvia: Agricultural Production

	1990	1991	1992	1993	1994
<u>(In thousand tons, unless otherwise specified)</u>					
Livestock, Meat Production (index)	100	92.1	75.4	50.0	41.2
Meat, deadweight	308	296	247	193	136
(Index of Production)	(100)	(94.9)	(81.9)	(64.7)	(44.3)
Of which: private farms (percent of total)	26.9	31.5	39.4	52.2	68.4
Beef and veal	125	132	120	107	68
Cattle (thousand heads)	1,439	1,383	1,144	678	551
Pork	152	126	101	68	54
Pigs (thousand heads)	1,401	1,247	867	482	501
Poultry	40	33	21	13	11
Poultry (thousand heads)	10,321	10,395	5,438	4,124	3,700
Milk Production	1,893	1,741	1,479	1,157	1,001
(Index of Production)	(100)	(91.9)	(78.0)	(61.1)	(52.8)
Egg Production	819	761	596	389	360
(Index of Production)	(100)	(92.9)	(72.7)	(47.5)	(44.0)
Crop Production (index)	100	105.1	93.2	93.2	70.9
Cereals	1,622	1,336	1,152	1,235	901
(Index of Production)	(100)	(82.4)	(71.0)	(76.1)	(55.5)
of which: private farms (percent of total)	6.7	14.1	35.1	61.7	71.5
Area sown (thousand hectares)	686	657	703	696	489
Sugarbeets	439	378	463	298	228
(Index of Production)	100	86.1	105.5	67.9	51.9
Area sown (thousand hectares)	15	15	25	12	12
Potatoes	1,016	944	1,167	1,272	1,045
(Index of Production)	100	92.9	114.9	125.2	102.9
of which: private farms (percent of total)	61.9	73.8	84.8	93.0	96.5
Area sown (thousand hectares)	80	82	97	88	80
Fodder	3,307	2,891	1,662	1,339	921
(Index of Production)	100	87.4	50.3	40.5	27.9
of which: private farms (percent of total)	14.9	22.2	47.7	59.4	78.9
Area sown (thousand hectares)	789	820	843	718	607
Vegetables	217	169	209	251	285
(Index of Production)	100	77.9	96.3	115.7	131.3
Area sown (thousand hectares)	11	13	19	19	18
Memorandum items:					
Yield per hectare for cereals (in kg)					
private farms	29	26	16	19	19
state-owned farms	23	20	17	16	18

Sources: Central Statistical Bureau; and staff calculations.

Table 4. Latvia: Energy Consumption

	1990	1991	1992	1993	1994
(In thousand tons, unless otherwise specified)					
Coal	1,066	807	663	599	427
Gasoline	721	514	493	478	459
Diesel oil	1,419	1,069	790	722	558
Heavy fuel oil	1,659	1,242	1,134	1,116	1,388
Natural gas (million cubic meters)	2,926	2,961	2,150	1,412	1,010
Liquefied petroleum gas	84	76	59	61	52
Electricity (million kilowatt hours)	10,230	9,869	7,912	6,425	6,259

Source: Latvian authorities.

Table 5. Latvia: Labor Market Indicators
(In thousands)

	1992 Dec.	1993				1994				1995	
		March	June	Sept.	Dec.	March	June	Sept.	Dec.	March	June
Registered Unemployed											
Total	31.3	49.6	64.6	72.8	76.7	87.2	85.1	81.0	83.9	85.7	77.9
Of which:											
Women	18.4	27.7	34.5	39.3	40.8	45.2	43.7	42.5	43.5	43.7	39.9
Long term unemployed	3.7	7.2	11.9	18.7	25.3	31.0	33.2	35.6	36.1	37.8	39.1
Benefit recipients	25.2	38.6	48.3	49.8	44.3	37.4	33.7	37.9	42.7	39.1	34.4
Memorandum items:											
Hidden unemployment 1/	40.1	30.3	20.6	19.1	14.5	11.8	8.3	7.3	7.7	8.5	8.0
Total employment	1,308	1,293	1,270	1,253	1,245	1,235	1,209	1,201	1,196	1,193	...
Unemployment rate (As percent of labor force)	(2.3)	(3.7)	(4.8)	(5.4)	(5.8)	(6.5)	(6.4)	(6.2)	(6.5)	(6.7)	(6.1)

Source: Central Statistical Bureau.

1/ Defined as the full time work equivalent of working time that is reported lost due to enforced reduced hours and unpaid leave.

Table 6. Latvia: Average Wages

	State sector	Budgetary organizations	State enterprises	Minimum wage	Average wage
	(In lats per month)			(In dollars)	
1990: Jan – March	1.4	1.0	1.4	...	...
Apr – June	1.3	1.1	1.4	...	...
July – Sep	1.3	1.1	1.4	...	...
Oct – Dec	1.8	1.2	2.0	...	...
1991: Jan – March	1.8	1.5	1.9	0.8	...
Apr – June	2.3	2.1	2.3	1.0	...
July – Sep	2.7	2.2	2.8	1.3	...
Oct – Dec	4.4	3.8	4.6	1.4	...
1992: Jan – March	9.5	9.1	9.7	3.0	14.9
Apr – June	19.6	17.0	20.3	5.8	27.7
July – Sep	25.9	19.9	28.5	8.8	34.1
Oct – Dec	41.5	32.5	46.1	15.0	45.8
1993: Jan – March	43.5	34.5	48.4	15.0	55.6
Apr – June	47.5	41.6	51.0	15.0	73.3
July – Sept.	52.3	39.5	60.9	15.0	81.5
Oct – Dec.	61.3	50.2	68.8	15.0	101.6
1994: Jan – March	68.3	54.0	73.2	15.0	113.1
Apr – June	76.2	61.0	86.0	22.5	132.8
July – Sept.	79.1	57.8	95.9	22.5	144.2
Oct – Dec.	90.5	74.4	106.1	28.0	168.1
1995: Jan – March	90.0	73.3	102.4	28.0	168.2
Apr – June	98.1	80.2	111.6	28.0	192.2
	(Real wages, index 1990=100)			(Real terms, 1991=100)	
1990 average	100.0	100.0	100.0	n.a.	...
1991 average	83.7	96.4	81.4	100.0	...
1992 average	70.6	79.5	70.5	67.3	...
1993 average	71.0	77.0	74.6	61.1	...
1994 average	79.5	84.7	86.6	65.2	...

Sources: Latvian authorities; and staff calculations.

Table 7. Latvia: Inflation in Consumer Prices

Month	Consumer price index	Inflation over previous month	Inflation over same month last year	Inflation over previous quarter	Average inflation during the year
1990 December	100.0	12.5	...	4.2	...
1991 December	362.4	49.7	262.4	39.6	124.4
1992 December	3,834.8	2.6	958.1	53.8	951.2
1993: January	3,995.9	4.2	571.9		
February	4,111.8	2.9	365.3		
March	4,210.4	2.4	256.1	12.9	...
April	4,223.1	0.3	221.7		
May	4,210.4	-0.3	183.4		
June	4,307.2	2.3	151.6	3.4	...
July	4,341.7	0.8	112.1		
August	4,267.9	-1.7	79.3		
September	4,353.7	2.0	63.1	1.7	...
October	4,519.1	3.8	35.4		
November	4,916.8	8.8	31.5		
December	5,167.6	5.1	34.8	12.7	109.0
1994: January	5,363.9	3.8	34.2		
February	5,546.3	3.4	34.9		
March	5,640.6	1.7	34.0	13.3	...
April	5,792.9	2.7	37.2		
May	5,804.5	0.2	37.9		
June	5,920.6	2.0	37.5	5.8	...
July	5,985.7	1.1	37.9		
August	6,099.4	1.9	42.9		
September	6,160.4	1.0	41.5	4.2	...
October	6,240.5	1.3	38.1		
November	6,365.3	2.0	29.5		
December	6,518.1	2.4	26.1	4.8	36.0
1995: January	6,746.2	3.5	25.8		
February	6,962.1	3.2	25.5		
March	7,143.1	2.6	26.6	9.0	...
April	7,278.8	1.9	25.7		
May	7,380.7	1.4	27.2		
June	7,491.4	1.5	26.5	6.2	...
July	7,513.9	0.3	25.5		
August	7,491.4	-0.3	22.8		

Sources: Latvian authorities; and staff calculations.

**Table 8. Latvia: Price Changes of Tradables and Nontradables
(Percent change)**

	1994	1995 (to end-May)
Tradables		
Food, alcohol and tobacco	16.4	11.7
Clothing and footwear	34.3	10.4
Household goods	15.7	9.2
Nontradables		
Housing	37.5	19.5
Health care	62.8	15.1
Transport and communication	37.1	16.3
Leisure, cultural, educational	55.0	18.0
Other goods and services	50.9	8.6
Total	26.3	13.2

Sources: Latvian authorities; and staff calculations.

Table 9. Latvia: Summary of General Government Operations

	1992	1993	1994	1994 1st. half	1994 2nd. half	1995 1st. half 1/
(In millions of lats)						
Revenue	282.2	533.9	703.9	312.4	391.5	406.1
Of which:						
Profit tax	56.0	116.5	74.1	32.5	41.6	23.3
Income and social tax	123.3	225.2	328.8	142.5	186.3	186.2
Taxes on goods and services	65.0	129.5	228.0	101.2	126.8	133.0
Expenditure	282.4	518.6	736.2	325.8	410.5	444.2
Wages and salaries	61.8	112.9	170.0	80.5	89.5	110.6
Transfers to households	96.4	207.9	312.1	145.1	167.1	183.9
Interest	1.4	13.6	13.1	3.5	9.6	11.1
Other current	108.2	167.3	219.4	88.9	130.6	129.7
Investment 2/	14.7	16.9	21.6	7.8	13.8	8.9
Financial surplus(+)/deficit(-)	-0.2	15.3	-32.3	-13.4	-18.9	-38.1
Net lending	-8.0	-6.1	-47.8	-28.2	-19.6	-3.5
Of which: Privatization revenue	...	2.1	7.1	3.4	3.7	6.0
Fiscal surplus(+)/deficit(-)	-8.2	9.3	-80.1	-41.6	-38.5	-41.6
Composition of financial balance	-8.2	15.3	-32.3	-13.4	-18.9	-38.1
Central government	-9.3	9.7	-33.3	-21.4	-11.9	-42.4
Basic budget	...	...	...	...	...	-42.0
Social budget	...	...	...	...	...	-0.4
Local governments	6.3	2.5	-6.2	3.7	-9.9	2.1
Extrabudgetary funds	-5.3	3.2	7.2	4.3	2.9	2.2
Financing of fiscal balance	8.2	-9.3	80.1	41.6	38.5	41.6
Domestic	11.4	-21.7	45.1	16.9	28.2	35.5
Banking system	3.0	-9.3	36.0	11.1	24.8	39.1
Other domestic	8.4	-12.4	9.1	5.8	3.3	-3.6
Foreign	-3.2	12.5	35.0	24.7	10.3	6.1
(In percent of GDP)						
Revenue	28.2	35.8	36.3	35.6	37.0	35.7
Of which:						
Profit tax	5.6	7.8	3.8	3.7	3.9	2.1
Income and social tax	12.3	15.1	17.0	16.2	17.6	16.4
Taxes on goods and services	6.5	8.7	11.8	11.5	12.0	11.7
Expenditure	28.2	34.8	38.0	37.1	38.8	39.1
Wages and salaries	6.2	7.6	8.8	9.2	8.5	9.7
Transfers to households	9.6	14.0	16.1	16.5	15.8	16.2
Interest	0.1	0.9	0.7	0.4	0.9	1.0
Other current	10.8	11.2	11.3	10.1	12.3	11.4
Investment 2/	1.5	1.1	1.1	0.9	1.3	0.8
Financial surplus(+)/deficit(-)	-0.0	1.0	-1.7	-1.5	-1.8	-3.4
Net lending	-0.8	-0.4	-2.5	-3.2	-1.9	-0.3
Fiscal surplus(+)/deficit(-)	-0.8	0.6	-4.2	-4.7	-3.7	-3.7

Sources: Latvian authorities; and staff estimates.

1/ The 1995 Budget includes around 20 special funds not previously included in the data. These boost revenues and expenditures by around 1 percent of GDP in 1995.

2/ Excludes extrabudgetary investment in the PIP financed through net lending and other sources.

Table 10. Latvia: Central Government Operations and Social Security

	1992	1993	1994	1994 1st. half	1994 2nd. half	1995 1st. half
(In millions of lats)						
Total Revenue	237.6	432.1	617.9	275.1	342.9	303.1
Revenue – basic budget	...	...	...	...	...	174.9
Current revenue	198.0	431.9	615.3	275.1	340.2	302.9
Taxes on income, profits and property	40.8	123.5	115.6	49.9	65.7	24.5
Tax on profits	29.0	88.2	73.3	31.7	41.6	23.3
Income tax 1/	11.7	35.1	42.2	18.0	24.2	0.6
Social security taxes	93.5	167.8	236.1	104.6	131.5	128.2
Taxes on goods and services	54.1	112.9	226.5	99.7	126.8	133.0
Taxes on domestic transactions	51.1	92.2	203.3	87.1	116.1	123.3
Turnover/VAT	31.0	80.1	174.1	77.5	96.5	103.4
Excises	20.0	12.1	29.2	9.6	19.6	19.9
Taxes on international trade	3.1	20.6	23.2	12.5	10.7	9.7
Other taxes	7.3	25.4	22.8	11.5	11.2	13.4
Other current revenue	2.3	2.3	14.3	9.4	4.9	3.7
Capital revenue	0.0	0.2	2.7	0.0	2.7	0.2
Revenue from foreign currency budget	39.5	...	...	...	...	...
Total Expenditure	238.8	424.2	640.4	285.9	354.6	345.5
Expenditure – basic budget	...	...	...	...	...	216.8
Current expenditure	203.5	411.8	626.9	280.5	346.4	340.4
Wages and salaries	25.9	84.7	135.0	65.7	69.4	88.6
Supplies and maintenance	28.7	47.9	85.5	36.4	49.2	35.9
Interest payments	1.4	13.6	13.1	3.5	9.6	11.1
Subsidies	1.9	0.0	3.0	1.0	2.0	1.8
Transfers	130.7	225.2	363.2	165.8	197.4	188.6
To enterprises	0.8	3.7	0.0	0.0	0.0	0.0
To individuals	96.3	195.4	271.1	125.6	145.5	156.4
Social budget	...	...	...	...	...	128.6
Basic budget	...	...	...	...	...	27.8
To local government 1/	33.5	26.1	92.1	40.2	51.9	32.2
Other current expenditure	14.9	40.4	27.0	8.2	18.8	14.4
Capital expenditure	9.2	12.4	13.6	5.4	8.2	5.1
Investment	9.2	12.4	13.6	5.4	8.2	5.1
Expenditure in foreign currency budget	26.1	...	...	...	...	...
Financial Surplus (+) /Deficit (-)	-1.2	7.9	-22.5	-10.8	-11.7	-42.4
Basic budget	...	...	...	...	...	-42.0
Social budget	...	...	...	...	...	-0.4
Net Lending	-8.0	-6.1	-47.8	-28.2	-19.6	-6.1
Fiscal Surplus (+) /Deficit (-)	-9.3	1.8	-70.2	-39.0	-31.3	-48.5
(In percent of GDP)						
Revenue	23.7	29.0	31.9	31.3	32.4	26.7
Expenditure	23.8	28.5	33.1	32.5	33.5	30.4
Financial balance	-0.1	0.5	-1.2	-1.2	-1.1	-3.7
Net lending	-0.8	-0.4	-2.5	-3.2	-1.9	-0.5
Balance	-0.9	0.1	-3.7	-4.4	-3.0	-4.2

Source: Statistical authorities and staff estimates.

1/ Data for 1994 include income tax revenues collected by the central government and transferred to local

Table 11. Latvia: Local Government Operations

	1992	1993	1994	1994 1st. half	1994 2nd. half	1995 1st. half
Revenue	78.1	126.2	179.3	78.2	101.1	118.5
Current revenue	77.9	125.6	177.7	77.5	100.2	118.2
Taxes on income, profits and property	32.8	68.4	73.3	31.0	42.3	70.6
Tax on profits	12.9	28.3	0.8	0.8	--	--
Income tax ^{1/}	14.9	22.3	50.5	19.9	30.6	57.3
Property tax	1.8	10.7	12.4	6.0	6.4	8.3
Land tax	3.1	7.1	9.5	4.3	5.3	5.0
Taxes on goods and services	2.5	16.7	1.5	1.6	--	--
Turnover/VAT	2.5	16.7	1.5	1.6	--	--
Other taxes	3.8	13.6	9.6	4.2	5.4	4.8
Other current revenue	34.0	27.0	93.3	40.7	52.6	42.8
Transfers from central government ^{1/}	33.5	24.4	93.3	40.9	52.4	32.2
Other revenue	0.5	2.6	0.0	-0.2	0.2	10.6
Capital revenue	0.3	0.6	1.6	0.7	0.8	0.3
Expenditure	71.8	123.7	185.5	74.5	110.9	116.4
Economic classification:	71.8	123.7	187.9	80.1	107.8	116.4
Current expenditure	66.3	119.1	179.9	77.6	102.2	112.6
Wages and salaries	35.9	28.2	34.9	14.8	20.1	22.0
Interest payments	---	---	---	---	---	---
Supplies and maintenance	19.9	32.7	54.8	21.7	33.0	33.3
Subsidies	1.3	--	--	--	--	--
Transfers	1.0	12.5	41.1	19.5	21.5	27.4
To enterprises	0.9	0.0	0.0	0.0	0.0	0.0
To individuals	0.0	12.5	41.1	19.5	21.5	27.4
Other current expenditure	8.2	45.8	49.1	21.6	27.5	29.8
Capital expenditure	5.5	4.6	8.1	2.5	5.6	3.9
Investment	5.5	4.6	8.1	2.5	5.6	3.9
Fiscal surplus(+)/deficit(-)	6.3	2.5	-6.2	3.7	-9.9	2.1
(In percent of GDP)						
Revenue	7.8	8.5	9.3	8.9	9.5	10.4
Expenditure	7.2	8.3	9.6	8.5	10.5	10.2
Fiscal balance	0.6	0.2	-0.3	0.4	-0.9	0.2

Sources: Latvian authorities; and staff estimates.

^{1/} The share of income tax revenues received by local governments was increased in 1995 and transfers from the central government were reduced accordingly.

Table 12. Latvia: Treasury Bill Auctions
(Millions of lats, face value)

	Sales of Treasury bills				Outstanding stock (end-month) 1/			
	28-day	91-day	182-day	Total	28-day	91-day	182-day	Total
1993 December	1.6	--	--	1.6	1.6	--	--	1.6
1994 January	6.0	--	--	6.0	6.0	--	--	6.0
February	5.2	--	--	5.2	5.2	--	--	5.2
March	10.0	--	--	10.0	8.0	--	--	8.0
April	11.9	--	--	11.9	11.9	--	--	11.9
May	14.0	2.7	--	16.7	14.0	2.7	--	16.7
June	13.0	3.0	--	16.0	13.0	5.7	--	18.7
July	10.6	0.0	--	10.6	10.6	5.7	--	16.3
August	22.3	0.2	--	22.5	13.7	3.2	--	16.9
September	19.2	0.0	--	19.2	19.2	0.2	--	19.4
October	23.4	1.1	--	24.5	23.4	1.3	--	24.7
November	22.9	12.6	--	35.5	16.9	13.7	--	30.6
December	11.2	14.1	--	25.3	11.2	27.8	--	39.0
1995 January	8.8	7.5	--	16.3	8.8	34.2	--	43.0
February	12.4	21.6	--	34.0	12.4	44.9	--	57.3
March	9.2	11.2	0.7	21.1	6.5	40.3	0.7	47.5
April	4.7	3.0	1.2	8.9	4.7	35.8	1.9	42.4
May	12.2	3.7	2.1	18.0	11.2	15.1	4.0	30.3
June	14.1	0.9	0.1	15.2	14.1	7.6	4.1	25.9
July	17.8	0.5	0.3	18.6	17.8	5.1	4.4	27.3
August	29.1	3.2	1.0	33.3	22.1	4.6	4.9	31.6

Sources: Ministry of Finance; and staff calculations.

1/ Dates refer to date of auctions rather than settlement.

Table 13. Latvia: Government Expenditure for Selected Countries 1/

	Latvia (1994)		High income 2/		Middle income 3/		Low income 4/	
	Percent of GDP	Percent of total	Percent of GDP	Percent of total	Percent of GDP	Percent of total	Percent of GDP	Percent of total
Expenditure by economic type	38.0	100.0	39.1	100.0	23.9	100.0	24.0	100.0
Current expenditures	36.9	97.1	36.2	92.5	19.0	79.6	17.8	74.4
Goods and services	19.9	52.5	18.0	46.0	8.5	35.4	9.3	38.9
Wages	8.8	23.1	8.9	22.7	2.9	12.3	5.6	23.5
Other goods and services	11.1	29.4	8.5	21.8	4.1	17.1	3.7	15.4
Interest	0.7	1.8	4.4	11.2	1.0	4.3	3.2	13.2
Transfers and subsidies	16.3	42.8	13.8	35.3	9.5	39.8	5.3	22.2
Capital expenditures	1.1	2.9	2.9	7.4	4.4	18.2	5.6	23.4
Expenditure by economic type	38.0	100.0	39.1	100.0	23.9	100.0	28.5	100.0
Defense and public order	3.3	8.7	4.7	12.0	3.1	12.8	2.2	7.9
Education	6.5	17.0	4.9	12.5	3.3	13.7	4.3	14.8
Health	4.1	10.9	5.1	13.1	0.8	3.5	1.9	6.2
Social security, welfare and housing	15.6	41.1	11.3	28.8	2.0	8.2	1.5	5.7
Other 5/	8.5	22.3	13.1	33.6	14.7	61.8	18.6	65.4

Sources: Latvian authorities; "Unproductive Public Expenditures", Pamphlet No. 48, Fiscal Affairs Department, IMF, 1995; and staff estimates.

1/ For Latvia, includes both central and local government. Data for other countries are for 1983–90. The sums of components do not necessarily equal the totals because some minor components are not shown and because of classification differences.

2/ Weighted average of Australia, Canada, Denmark, Germany, Israel, Luxembourg, United Kingdom, and United States.

3/ Weighted average of Argentina, Chile, Hungary, Panama, Romania, Swaziland, and Zimbabwe.

4/ Weighted average of India, Indonesia, and Malawi.

5/ Includes "other government services", interest, and unclassified expenditures.

Table 14. Latvia: Pension System

	1992	1993	1994	1995 ^{1/}
(In thousands)				
Number of pensioners	654	657	654	664
Old age	497	500	496	500
Disability	102	104	104	106
Survivors	28	26	29	28
Social	19	20	19	20
Other	8	7	6	10
(In lats per month)				
Average benefit	7.9	14.8	24.8	29.1
Old age	7.4	14.8	24.8	29.0
Disability	...	15.6	27.6	32.2
Survivors	...	17.3	24.4	28.0
Social	...	11.3	16.5	21.2
Other	...	...	...	...
(In millions of lats)				
Expenditure ^{2/}	62.2	141.0	199.5	232.1
Old age	44.3	90.1	150.2	173.6
Disability	12.4	19.8	34.8	40.8
Survivors	2.9	5.5	8.4	9.4
Social	...	2.8	3.8	5.0
Other	2.6	1.4	2.3	3.3
Heating allowance ^{3/}	--	21.4	--	--
Memorandum item:				
Total expenditure (percent of GDP)	6.2	9.5	10.3	9.8

Sources: Ministry of Labor, Welfare and Health; and staff estimates.

^{1/} Budget estimate; does not include the effect of pension increases in 1995.

^{2/} From 1995, all pensions except social pension are paid by the social budget rather than by the basic budget.

^{3/} Heating allowance in 1993 is not included in calculation of average pensions.

Table 15. Latvia: Family Benefits

	1992	1993	1994	1995 1/
(In thousands)				
Number of beneficiaries				
Birth grant	32	26	24	28
Maternity leave	23	15	11	10
Child care allowances	85	77	68	74
Ages 0–1.5	43	38	32	36
Ages 1.5–3	42	39	36	39
Family allowances	564	551	552	559
Ages 0–8	286	272	261	267
Ages 8–15	250	246	253	252
In higher education	29	33	38	40
Others	92	...	...	...
(In lats per month)				
Average benefit				
Birth grant	7.0	14.5	34.8	...
Maternity leave	11.7	27.9	46.4	51.3
Child care allowances	4.6	9.7	9.6	9.7
Ages 0–1.5	5.5	11.8	11.9	12.0
Ages 1.5–3	3.9	7.6	7.5	7.5
Family allowances	2.2	4.2	4.2	4.1
Ages 0–8	2.0	3.0	3.8	3.8
Ages 8–15	2.5	4.6	4.5	4.5
In higher education	2.5	4.8	4.6	4.5
Others	0.5	...	...	...
(In millions of lats)				
Expenditure				
Birth grant	21.5	38.9	38.2	40.7
Maternity leave	0.2	0.4	0.8	2.1
Child care allowances	1.1	1.7	2.0	2.1
Ages 0–1.5	4.7	8.9	7.8	8.6
Ages 1.5–3	2.7	5.4	4.6	5.1
Ages 1.5–3	2.0	3.6	3.2	3.5
Family allowances	15.0	27.9	27.5	27.8
Ages 0–8	7.1	12.5	11.8	12.0
Ages 8–15	7.1	13.5	13.6	13.6
In higher education	0.8	1.9	2.1	2.2
Others	0.5	...	...	...
Memorandum Item:				
Total expenditure (percent of GDP)	2.1	2.6	2.0	1.7

Sources: Ministry of Labor, Welfare and Health; and staff estimates.

1/ Estimate at time of approval of budget.

Table 16. Latvia: Reserve Money and Net Domestic Assets of the Bank of Latvia

	1993	1994				1995	
	Dec.	March	June	Sept.	Dec.	March	June
	(In millions of lats)						
Reserve money	224.9	223.0	226.9	253.6	269.4	270.3	257.9
Currency issued	179.1	177.8	194.6	203.3	232.1	233.8	218.9
Bank deposits	45.8	45.1	32.3	50.3	37.3	36.4	39.0
Net foreign assets	233.4	213.0	196.3	224.2	249.5	227.4	183.1
Convertible net international reserves 1/	239.6	218.9	200.9	229.6	255.2	233.2	188.8
Correspondent accounts 1/ 2/	-6.2	-5.9	-4.6	-5.4	-5.7	-5.8	-5.7
Net domestic assets	-8.5	9.9	30.6	29.4	19.9	42.9	74.8
Domestic credit	52.2	59.6	68.7	67.3	60.0	71.9	106.0
Banks	44.8	42.3	57.2	55.4	54.5	49.8	48.2
BoP assistance	38.7	39.8	55.4	53.4	53.0	46.8	44.6
Refinance credits	6.1	2.5	1.9	2.1	1.4	3.1	3.6
Government, net 3/	0.2	10.1	4.9	11.8	5.5	22.1	57.8
BoP assistance	2.4	2.3	3.2	2.1	13.1	12.5	24.9
Other government, net 4/	-2.1	7.8	1.7	9.7	-7.6	9.6	32.9
Others 5/	7.2	7.2	6.5	0.0	0.0	0.0	0.0
Other items, net	-60.7	-49.6	-38.1	-37.8	-40.1	-29.0	-31.2
Of which:							
Balance of payments assistance 5/	-41.8	-40.3	-40.5	-40.6	-40.6	-40.2	-39.9
Memorandum items:							
	(Percentage change from previous 12 months)						
Reserve money	107.7	73.8	33.1	35.5	19.8	21.2	13.7
Domestic credit	-12.2	18.2	-10.5	20.3	14.9	20.7	54.2
Banks	-20.2	-6.5	-7.2	43.3	21.7	17.7	-15.9
Government, net 3/	-93.1	97.1	-67.2	25.8	2,241.1	119.4	1,068.5
Exchange rate (LVL/US\$)	0.595	0.567	0.551	0.545	0.548	0.517	0.512
Convertible NFA (US\$mn)	402.7	386.1	364.5	421.3	465.7	451.1	368.8

Sources: Bank of Latvia; and staff estimates.

1/ Valued at current exchange rates.

2/ Sum of net balances in the correspondent accounts opened since January 1, 1992 with former republics of the Soviet Union, and technical credits.

3/ Excluding proceeds from foreign loans for balance of payments support.

4/ Includes purchase of Treasury bills.

5/ Loans to the Privatization Fund.

6/ G-24 loans and other loans intermediated by the Bank of Latvia, and which are not included in net foreign assets.

Table 17. Latvia: Monetary Survey and Net Domestic Assets of the Banking System
(In millions of lats)

	1993	1994				1995	
	Dec.	March	June	Sept.	Dec.	March	June
Broad money (M2X)	462.4	487.7	555.0	601.3	687.4	688.6	652.6
Currency held by public	152.8	150.5	168.3	184.5	213.1	215.8	204.1
Household deposits	104.4	134.1	160.6	174.6	190.9	190.9	169.6
Enterprise deposits	84.0	71.4	77.3	78.8	93.3	93.2	82.0
Residents' FC deposits	121.3	131.7	148.8	163.4	190.1	188.7	196.9
Total deposits	309.6	337.1	386.7	416.7	474.3	472.8	448.6
Of which: blocked deposits	--	--	0.9	0.9	6.0	5.9	143.9
Net foreign assets	312.8	299.2	287.5	313.9	370.4	287.8	240.0
Convertible net international reserves 1/	314.6	298.8	286.4	310.2	370.8	292.3	244.1
Correspondent accounts 1/ 2/	-1.8	0.4	1.1	3.7	-0.4	-4.5	-4.0
Net domestic assets	149.6	188.5	267.5	287.3	317.0	400.9	412.6
Domestic credit	270.8	285.4	363.5	385.0	447.6	487.4	506.9
Households	17.2	21.4	26.0	31.2	31.9	35.0	39.3
Enterprises	250.7	262.2	289.6	303.7	337.2	353.2	350.9
Government, net 3/	2.9	1.8	47.8	50.0	78.6	99.2	116.8
Restructuring Bonds	23.4	23.4	57.1	56.7	63.0	62.6	62.0
Other credit to Government	-20.5	-21.6	-9.3	-6.7	15.5	36.6	54.7
Other items, net	-121.2	-96.9	-95.9	-97.6	-130.7	-86.5	-94.3
Of which:							
Balance of payments assistance 4/	-41.8	-40.3	-40.5	-40.6	-40.6	-40.2	-39.9
Memorandum items:							
		(Percentage change from the previous 12 months)					
Broad money(M2X)	84.1	81.9	65.4	49.4	48.7	41.2	17.6
Domestic credit	150.3	84.5	123.1	59.1	65.3	70.8	39.5
Households	912.6	205.9	221.0	155.7	85.4	63.5	51.1
Enterprises	113.2	90.0	94.1	30.8	34.5	34.7	21.2
Exchange rate (LVL/US\$)	0.595	0.567	0.551	0.545	0.548	0.517	0.512
Convertible NFA (US\$m)							
Total	528.7	526.9	519.7	569.2	676.7	565.3	476.7
Commercial banks	125.9	140.8	155.2	148.0	211.0	114.2	107.9

Sources: Bank of Latvia; and staff estimates.

1/ Valued at current exchange rates.

2/ Sum of net balances in the correspondent accounts opened since January 1, 1992 with former republics of the Soviet Union, and technical credits

3/ Excluding proceeds from foreign loans for balance of payments support.

4/ G-24 loans and other loans intermediated by the Bank of Latvia, and which are not included in net foreign assets.

Table 18. Latvia: Enterprise and Household Credits

	1992	1993				1994				1995	
	Dec.	March	June	Sept.	Dec.	March	June	Sept.	Dec.	March	June
	(In millions of lats)										
Enterprise Credit	117.4	138.0	193.5	232.2	250.7	262.2	289.6	303.7	337.2	353.2	350.9
Bank of Latvia Branches	82.1	80.5	83.0	64.4	--	--	--	--	--	--	--
Commercial Banks	27.4	48.4	100.1	155.3	236.7	248.0	279.9	294.1	328.0	344.6	341.6
Latvian Savings Bank	8.0	9.0	10.5	12.5	14.0	14.1	9.7	9.6	9.2	8.6	9.3
Household Credit	1.7	7.0	8.1	12.2	17.2	21.4	26.0	31.2	31.9	35.0	39.3
Bank of Latvia Branches	1.0	0.4	0.7	0.7	--	--	--	--	--	--	--
Commercial Banks	0.1	5.3	5.4	8.6	13.9	17.4	21.2	26.0	25.4	27.3	29.6
Latvian Savings Bank	0.5	1.3	2.0	3.0	3.4	4.0	4.8	5.3	6.5	7.7	9.7
Total Credit to Private Sector	119.1	144.9	201.7	244.4	267.9	283.6	315.6	334.9	369.1	388.2	390.1
Bank of Latvia Branches	83.1	81.0	83.7	65.0	--	--	--	--	--	--	--
Commercial Banks	27.5	53.6	105.5	163.8	250.6	265.4	301.1	320.0	353.4	371.9	371.2
Latvian Savings Bank	8.5	10.4	12.5	15.5	17.3	18.1	14.5	14.9	15.7	16.3	18.9
Memorandum item:	(In percent)										
Enterprise Credit/Total	98.6	95.2	96.0	95.0	93.6	92.4	91.8	90.7	91.4	91.0	90.0

Sources: Bank of Latvia; and staff calculations.

Table 19. Latvia: Enterprise and Household Deposits

	1992	1993				1994				1995	
	Dec.	March	June	Sept.	Dec.	March	June	Sept.	Dec.	March	June
(In millions of lats)											
Enterprise Deposits	133.1	117.6	144.9	153.8	156.3	145.9	160.3	163.4	197.7	190.9	200.1
Bank of Latvia Branches	46.4	46.1	53.9	37.7	--	--	--	--	--	--	--
Commercial Banks	83.8	64.7	84.9	110.9	147.9	143.5	158.3	161.6	196.0	189.2	197.7
Latvian Savings Bank	2.9	6.8	6.2	5.3	8.5	2.4	2.0	1.8	1.7	1.7	2.4
Household Deposits	43.5	73.4	85.9	122.8	153.2	191.2	226.4	253.3	276.6	281.9	248.5
Bank of Latvia Branches	2.3	2.2	2.8	3.0	--	--	--	--	--	--	--
Commercial Banks	6.8	32.7	39.5	73.2	105.1	143.0	177.3	201.8	220.4	215.0	184.6
Latvian Savings Bank	34.4	38.5	43.7	46.7	48.2	48.2	49.1	51.5	56.3	66.9	63.9
Total Deposits from Private Sector	176.5	191.0	230.9	276.6	309.6	337.1	386.7	416.7	474.3	472.9	448.6
Bank of Latvia Branches	48.7	48.3	56.6	40.7	--	--	--	--	--	--	--
Commercial Banks	90.6	97.4	124.3	184.0	253.0	286.5	335.6	363.4	416.4	404.2	382.3
Latvian Savings Bank	37.3	45.3	49.9	51.9	56.6	50.7	51.1	53.3	57.9	68.7	66.3
Memorandum item:	(In percent)										
Enterprise Deposits/Total	75.4	61.6	62.8	55.6	50.5	43.3	41.4	39.2	41.7	40.4	44.6

Sources: Bank of Latvia; and staff calculations.

Table 20. Latvia: Banking System

Banking Institution	Total Assets 1/					Capital and Reserves					Credit to Private Sector					Deposits from Private Sector				
	1992	1993	1994	1995		1992	1993	1994	1995		1992	1993	1994	1995		1992	1993	1994	1995	
				Q1	Q2				Q1	Q2				Q1	Q2				Q1	Q2
(In millions of lats)																				
Bank of Latvia	233.4	394.4	444.4	434.5	396.2	1.6	3.1	3.1	7.3		--	--	--	--	--	--	--	--	--	--
Branches of Bank of Latvia	112.9	--	--	--	--	2.0	--	--	--	--	83.1	--	--	--	--	48.7	--	--	--	--
Commercial Banks and other credit institutions	73.1	574.8	1071.5	1050.3	1025.2	7.4	61.0	140.2	151.6	156.3	36.1	269.0	365.3	382.7	367.6	128.7	309.6	468.0	464.7	433.9
Five largest banks	55.6	322.4	542.7	552.6	566.7	1.5	24.9	59.6	64.2	65.2	18.8	148.3	184.7	207.5	205.9	86.5	197.7	287.3	304.5	301.9
Other commercial banks and credit institutions of which:	17.5	252.4	528.8	497.7	458.5	5.9	36.1	80.6	87.4	91.1	17.3	120.7	180.6	175.2	161.7	42.2	111.9	180.7	160.2	132.0
Latvia Investment Bank	0.3	4.0	6.2	6.4	7.6	0.2	3.7	5.6	5.6	5.6	--	0.9	1.3	1.6	1.6	--	--	--	--	1.0
Pawnshops	--	0.3	0.5	0.8	0.8	--	0.2	0.3	0.5	0.5	--	0.2	0.3	0.5	0.5	--	--	--	--	--
Credit Unions	--	0.1	0.3	0.3	0.3	--	0.02	0.1	0.1	0.1	--	0.04	0.2	0.2	0.1	--	0.03	0.3	0.2	0.2
Memorandum items:																				
(As a percent of total assets)																				
Commercial banks																				
Capital plus reserves	0.05	0.11	0.13	0.14	0.16 2/															
Credit to private sector	0.64	0.47	0.34	0.36	0.34 2/															
(As a percent of GDP)																				
Capital plus reserves	0.01	0.04	0.07	0.06	0.05 2/															
Credit to private sector	0.09	0.16	0.19	0.16	0.11 2/															

Source: Bank of Latvia

1/ Computed on the basis of the net asset position of the Government.

2/ Excludes Bank Baltija

Table 21. Latvia: Regulatory Framework for Commercial Banks

Prudential Regulations	
Capital adequacy ratio	10% (risk-weighted)
Limits on lending (as a % of own capital)	
Credit concentration	50% (July 31, 1995) 35% (Sept.1,1995) 1/ 25% (Jan 1, 1996) 1/
Insider lending	50% (July 31, 1995) 25% (Sept.1,1995) 1/ 15% (Jan 1, 1996) 1/
Limit on foreign exchange exposure (as a % of own capital)	
July 31, 1995:	50% (overall) 25% (any one currency)
From September 1, 1995: 1/	40% (overall) 20% (any one currency)
From January 1, 1996: 1/	20% (overall) 10% (any one currency)
Loan classification	
Provisioning	
Licensing requirements	
Minimum capital requirement	LVL 100,000 (July 31, 1995) LVL 1 million (March 1996) LVL 2 million (March 1998)
Minimum registered capital (for new banks)	LVL 2 million
Competence of bank management	
Other requirements	
Audited annual reports	by international audit companies if assets are above LVL 2 million
Quarterly audited assessment	required for "core" banks

Source: Bank of Latvia

1/ According to Bank of Latvia regulations, provisions in the credit law institutions may change the scheduled dates.

Table 22. Baltic Countries: Key Prudential Ratios
(As of July 31, 1995)

	<u>Latvia</u>	<u>Estonia</u>	<u>Lithuania</u>
Capital adequacy ratio	10%	8%	13%
Limit on credit concentration	50%	25%	30%
Limit on insider lending	50%	25%	10%
Limit on foreign exchange exposure			
Overall open position	50%	30%	30%
Any one currency	25%	10% ^{1/}	20% ^{2/}
Minimum capital requirement	LVL 100,000	EEK 15 million	Lts. 10 million
	(US\$200,000)	(US\$1.3 million)	(US\$2.5 million)
Minimum registered capital	LVL 2 million	EEK 15 million	Lts. 10 million
(for new banks)	(US\$4 million)	(US\$1.3 million)	(US\$2.5 million)

Source: Country authorities.

^{1/} Excluding the deutsche mark.

^{2/} Excluding the U.S. dollar.

**Table 23. Latvia: Sectoral Distribution of Credit
(In percent)**

	1994				1995	
	Q1	Q2	Q3	Q4	Q1	Q2
Agriculture	13.3	11.3	9.6	8.5	7.7	7.6
Manufacturing	14.1	17.7	13.9	15.3	14.6	15.8
Electricity, water supply	3.2	2.8	3.0	4.9	4.2	5.5
Construction	5.8	6.4	7.9	8.2	7.3	6.3
Trade	39.0	43.2	46.3	37.5	41.5	36.1
Transport and Communication	2.9	4.4	5.7	6.1	5.1	6.3
Financial intermediation	4.2	3.3	2.0	5.7	6.4	6.8
Other services	15.9	9.6	10.2	11.5	10.0	11.7
Other	1.5	1.3	1.5	2.2	3.3	3.8
Total	100.0	100.0	100.0	100.0	100.0	100.0
In domestic currency	43.4	34.2	34.6	37.5	38.3	35.8
In foreign currency ^{1/}	56.6	65.8	65.4	62.5	61.7	64.2
Short-term credits (up to 1 year)	81.3	76.9	76.9	74.2	73.5	68.9

Sources: Bank of Latvia; and staff calculations.

^{1/} Includes EU/G-24 credits and credits in nonconvertible currency (the latter is less than 1 percent of total).

Table 24. Latvia: Balance of Payments

(In millions of U.S. dollars)

	1992	1993	1994 Prel.	1995 Prel. First Half
Current account balance ^{1/}	25	151	-86	-79
excluding official transfers	-49	103	-125	-93
Trade balance ^{1/}	-215	-160	-378	-185
Exports, f.o.b.	831	998	997	611
Baltics, Russia and OFSU	396	541	503	289
Other countries	435	457	494	322
Imports, f.o.b. ^{1/}	-1,046	-1,158	-1,375	-796
Energy	503	-525	-407	-224
Non-energy	-543	-633	-968	-572
Baltics, Russia and OFSU	-203	-237	-245	-110
Other countries	-340	-396	-722	-462
Services, income and transfers balance ^{1/}	240	311	292	106
Of which:				
Transport sector, net	188	247	270	122
Interest, net	5	11	7	-7
Current transfers, net	73	78	64	26
Capital account balance ^{1/}	76	186	274	-93
Foreign investment, net	43	51	155	100
Other medium- and long-term capital	33	98	87	7
Disbursements	33	105	107	12
Repayments	--	-7	-20	-5
Other capital, net ^{1/}	--	37	32	-200
Errors and omissions	34	-15	-49	-12
Overall balance	135	322	139	-184
Financing items:				
Change in NFA, total	-135	-293	-150	200
NFA of DMBs	-80	-38	-87	103
Convertible (increase, -)	-82	-38	-85	103
Nonconvertible (increase, -)	2	--	-2	--
Official NIR (increase, -)	-17	-282	-63	97
Gross convertible reserves	-52	-356	-110	97
Use of Fund credit net	35	74	47	--
Nonconvertible NFA, BoL	-38	27	--	--
Natural gas arrears	--	-29	11	-16
Memorandum Items: ^{2/}				
Current account balance	1.8	6.8	-2.5	-3.6
Current account balance (excluding official transfers)	-3.6	4.7	-3.6	-4.3
Gross reserves, months of GNFS ^{3/}	1.5	4.4	4.5	3.3
External debt stock, (US\$ millions)	43	225	359	373
External debt stock, (as a percent of GDP)	3	10	10	9
Debt service, (as a percent of exports)	--	2	5	6

Sources: Data provided by the Latvian authorities; and staff estimates.

^{1/} Information on capital flows suggests that imports may be underestimated and that services data in the current account may include some capital inflows.

^{2/} In percent of GDP, unless otherwise specified.

^{3/} Gross reserves in months of imports of goods and nonfactor services.

Table 25. Latvia: Trade Outside the Baltics, Russia, and Other Countries of the FSU

(In percent of total)

	1993 Exports	1994 Exports	1995 <u>Exports</u> First Half	1993 Imports	1994 Imports	1995 <u>Imports</u> First Half
Europe 1/	83.4	84.5	94.4	91.3	93.4	91.0
Belgium	3.6	0.8	2.0	1.6	1.8	2.2
Denmark	1.6	2.7	2.9	3.6	3.7	5.3
Finland	4.5	4.2	5.2	8.7	13.1	17.7
France	1.9	2.5	2.8	1.9	1.9	2.1
Germany	14.4	18.4	25.6	20.4	19.7	25.6
Italy	2.9	1.7	2.0	1.7	2.1	3.5
The Netherlands	17.9	3.3	3.5	2.2	3.3	5.3
Poland	6.4	2.8	1.7	1.6	2.3	2.7
Sweden	13.7	12.0	17.8	11.3	9.7	13.7
United Kingdom	9.9	17.0	20.8	3.8	4.0	4.2
Africa	3.6	1.0	1.3	2.0	0.2	0.2
Asia and Middle East 1/	10.1	11.3	1.6	2.8	3.3	3.8
China	2.3	0.9	--	0.1	0.1	0.1
Thailand	3.8	1.2	--	--	--	--
Western Hemisphere	2.9	3.1	2.7	3.9	2.9	4.9
United States	1.5	2.1	2.5	2.9	1.8	3.1
Australia	--	--	--	--	0.2	0.1
Total	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>

Source: Central Statistical Bureau.

1/ Excluding the Baltics, Russia, and other countries of the FSU.

Table 26. Latvia: Trade with the Baltics, Russia, and Other Countries of the Former Soviet Union

(In percent of total)

	1993	1994	<u>1995</u> First Half
Exports			
Estonia	3.8	5.1	5.8
Lithuania	8.0	10.9	11.4
Russia	55.2	55.3	56.9
Ukraine	11.0	11.6	10.4
Other FSU	22.0	17.0	15.6
Total	<u>100</u>	<u>100</u>	<u>100</u>
Imports 1/			
Estonia	5.9	7.4	12.1
Lithuania	14.6	12.5	15.1
Russia	43.3	49.8	54.6
Ukraine	4.5	6.4	6.1
Other FSU	10.2	8.0	12.0
Energy import adjustment	21.6	15.8	--
Total	<u>100</u>	<u>100</u>	<u>100</u>

Source: Central Statistical Bureau; and staff estimates.

1/ Import figures for 1993 and 1994 are based on upwardly-adjusted estimates of energy imports. A large share of these imports are from Russia.

Table 27. Latvia: Trade by Commodity
(In percent of total)

	1993	1994	1995 First Half
Exports			
Live animals, animal products	6.3	2.9	4.6
Vegetable products	1.7	1.0	0.5
Animal, vegetable fats and oils	0.3	0.1	0.1
Food, drink, and tobacco	6.7	8.8	9.1
Mineral products	14.3	2.2	2.6
Chemicals	6.9	7.4	6.5
Plastic and rubber products	0.6	0.9	1.3
Hide, skin, and leather	1.5	1.8	1.4
Wood and wood products	8.8	20.3	28.0
Pulp and paper products	0.8	0.8	1.0
Textiles and textile articles	12.7	13.2	14.0
Footwear; feather/down products	2.3	1.8	0.7
Stone, cement, and ceramic products	1.4	1.3	1.9
Precious metals	0.8	0.2	0.1
Base metals, and base metal products	8.4	10.1	8.0
Machinery and electrical equipment	7.1	9.2	8.2
Rail/tram vehicles and parts; vessels	12.6	10.0	6.8
Optical and musical instruments	0.6	0.6	0.6
Arms and ammunition	--	--	--
Furniture; miscellaneous manufactured goods	3.4	4.5	4.7
Works of art and antiques	--	--	--
Other	2.9	2.7	--
Total	100.0	100.0	100.0
Imports			
Live animals, animal products	0.9	2.3	1.5
Vegetable products	1.8	2.9	3.5
Animal, vegetable fats and oils	0.4	0.4	0.6
Food, drink, and tobacco	3.3	5.1	4.8
Mineral products	45.6	29.4	21.0
Chemicals	7.1	10.2	11.8
Plastic and rubber products	1.8	2.9	3.4
Hide, skin, and leather	0.4	0.4	0.3
Wood and wood products	0.3	0.5	1.1
Pulp and paper products	1.4	3.0	4.4
Textiles and textile articles	4.6	5.9	8.3
Footwear; feather/down products	1.1	0.9	0.7
Stone, cement, and ceramic products	1.1	1.4	1.6
Precious metals	0.1	0.1	0.1
Base metals, and base metal products	4.4	5.0	6.5
Machinery and electrical equipment	9.9	16.1	17.9
Rail/tram vehicles and parts; vessels	9.3	6.7	8.0
Optical and musical instruments	1.0	2.4	2.3
Arms and ammunition	0.1	0.1	0.1
Furniture; miscellaneous manufactured goods	1.3	1.8	2.0
Works of art and antiques	--	--	--
Other	4.2	2.6	--
Total	100.0	100.0	100.0

Source: Central Statistical Bureau.

**Table 28. Comparative Average Monthly Wages 1/
(In U.S. dollars)**

	1992	1993	1994	1995 <u>2/</u>
Latvia	30	78	140	192
Estonia	46	83	131	202
Lithuania	35	44	92	125
Russia	27	63	98	88
Ukraine	26	15	28	48
Belarus	44	22	24	64
Bulgaria	85	109	88	93
Czech Republic	170	205	240	288
Hungary	356	301	320	323
Poland	178	179	249	305
Romania	69	78	84	105

Sources: Latvian authorities, and staff calculations.

1/ Data generally are for the state sector only and may contain breaks in the series.

2/ May 1995, or latest available.

Table 29. Latvia: Domestic Arrears in the Energy Sector
(In millions of lats)

	Natural gas	Electricity	Heating and hot water	Total
Dec. 1993	37.1	20.9	26.9	84.9
Mar. 1994	47.2	21.3	42.4	110.9
June 1994	46.9	18.9	40.7	106.5
Sept. 1994	44.5	15.9	39.3	99.7
Dec. 1994	44.6	14.8	45.1	104.5
Mar. 1995	57.9	15.1	52.8	125.8
June 1995	50.2	14.9	50.6	115.7

Source: Latvian authorities.

Tax Summary
(as of July 1, 1995)

I. Taxes on Income, Profits and Property

1. The Corporate Income Tax

a. Nature of the tax

The Law on the Corporate Income Tax replaced the Law on the Profit Tax effective April 1, 1995. Together with the Law on the Personal Income Tax, the laws forms a unified system of taxation on all forms of income in Latvia unless otherwise stipulated by acts of legislation. The tax applies both to residents and "permanent establishments" of non-residents. Taxable income is defined as the profit or loss as determined by Law on Annual Reports of Enterprises, adjusted according to provisions of the Law. The annual depreciation amount for fixed assets is set at twice the depreciation rate under the law (rates between 5 percent and 25 percent, with a standard rate of 20 percent) multiplied by the remaining balance: the standard depreciation rate is therefore 40 percent per year. Tax losses can be carried forward for 5 years. Thin capitalization rules limit the amount of interest payments that can be deducted in any year.

b. Tax rates

The standard tax rate is 25 percent, compared with rates of 25 percent-65 percent under the profit tax. There are withholding rates of 5 percent-25 percent on income paid to non-residents, with a rate of 10 percent applying to dividends and interest payments. Tax credits apply to charitable deductions, small enterprises, income from agricultural activity, and on tax paid in foreign countries. Small enterprises are defined as those satisfying requirements on the value of fixed assets, net turnover or the number of employees.

c. Tax exemptions

Exempt entities include enterprises that use prisoners' labor and enterprises run by associations for the handicapped, charities, and health foundations. Amendments to the Law on Foreign Investment provide for the abolition of tax reductions for enterprises with foreign capital participation.

2. The Personal Income Tax (PIT)

a. Nature of the tax

The personal income tax is assessed on salary, income from self-employment, property income, as well as on all other remuneration, bonuses,

compensation for unused vacation time, disability assistance payments, and all other kinds of payments which have not been exempted from the income tax. Tax levied on salaries and wages is withheld at source. Persons whose only source of income is labor income and whose annual income does not exceed 20 times the minimum nontaxable income do not submit declarations. Other taxpayers must file an annual income declaration by April 1 of the following year for taxes owed during the previous calendar year. The following do not file declarations: persons under 16 years of age; persons who have received income for fewer than 183 days during the year; persons whose income does not exceed the yearly nontaxable income.

b. Tax rates

The basic rate is 25 percent of taxable income. A marginal tax rate of 35 percent applies to income exceeding 20 times the nontaxable minimum.

c. Exemptions and deductions

The income tax is imposed on taxpayers' income for the calendar year, except for nontaxable activities. The following are deducted from taxpayer income: (a) a general deduction for each taxpayer (LVL 25/month effective May 1, 1994) and for each dependent (LVL 15/month effective May 1, 1994); (b) the sum of social tax and state social insurance payments; (c) expenses for the education and health care of the taxpayer or family members; (d) donations to charity; and (e) benefits for handicapped or politically repressed persons.

Income tax is not assessed on: agricultural income of individual farmers if it does not exceed LVL 3,000; dividends or profits from a business operation subject to the Corporate Income Tax; interest income; grants or payments from the social insurance fund including unemployment compensation and social maintenance, except for temporary disability payments; scholarships; child support; alimony; worker's compensation and long-term disability payments; insurance compensation and payments; and income from the sale of personal property.

3. Social Security tax

a. Nature of the tax

The social security tax (social tax) is a tax on salaries, wages, fees, royalties, and other rewards for work.

b. Tax rates

The tax is payable in the following proportions by employers and employees:

1. General tax rate: 37 percent for employers, and 1 percent for employees.
2. Agricultural activities: one half of the general rates.

3. Handicapped employees: rate paid by employers is 8 percent.
4. Workers in dangerous or unhealthy working conditions: 50 percent-70 percent for employers, and 1 percent for employees.

c. Exemptions

The tax is not assessed on: pensions and social benefits; certain types of compensation determined by the Government; compensation for health problems; scholarships; wages of pupils at trade schools; allowances for accidents; donations/rewards; and royalties earned by foreigners.

4. Property tax

a. Nature of the tax

The property tax is paid by physical persons and legal entities on fixed assets and unfinished construction located in the Republic of Latvia. The tax on leased property is paid by the owner of the property unless otherwise provided in the lease agreement. The tax on government property is paid by the manager of the property.

b. Tax rates

The tax imposed depends on the value of property as follows. Property worth less than LVL 1,500 is not taxed. A tax of 0.5 percent is imposed on property valued at LVL 1,500 or more. A maximum rate of 4 percent is applied when the value of property exceeds LVL 2.5 million. The tax is to be paid entirely to the local governments.

If a taxpayer owns several items of property, the tax is computed for the total value of the property, and if a taxpayer's property is located in different jurisdictions, the share to be paid to the local budget is proportional to the value of taxable property in each administrative or territorial unit.

c. Exemptions

1. Property of individuals, if not used for business purposes.
2. Property used or meant to be used solely for agricultural purposes.
3. Government property used for health care, sports, education, and cultural purposes, except for cinemas, etc.
4. Roads and roadside property as well as road service facilities, bridges, and viaducts; communication lines and stretches of land beneath them; and buildings of post offices and telephone exchanges in rural areas.
5. Property used for environmental protection and fire safety.

6. Property of religious organizations, national culture societies, and other public organizations approved by Parliament.

7. Residences and property used in municipal services.

II. Taxes on Goods and Services

1. Value-Added tax

a. Nature of the tax

This is a tax on value added, which uses the credit system and is levied on goods and services at the manufacturing/import, wholesale and retail stages. The new law is effective May 1, 1995 and replaces the old Turnover Tax Law which had, however, been administered as a VAT.

b. Tax rates

The standard tax rate is 18 percent of taxable value of supplies of goods (including imports), services and supplies for internal consumption. No tax applies to exports, international transportation, as well as for services connected with export supplies of goods.

c. Exemptions

The VAT is not charged on: educational services; school books, scientific literature, and certain Latvian language literature; public library services; scientific research; services of nursing homes, day-care centers and kindergartens; banking, financial and insurance services; betting, lotteries and other types of gambling; registered mass media; real estate sales and rent payments by individuals; movies (except video), concerts, cultural and amateur sporting events, etc.; certain approved medical services, supplies and goods; certain approved baby-foods; funerals and religious services; humanitarian aid and approved gifts; consular services; certain services provided by agricultural companies to farmers; fire-fighting services; supplies of imported goods not subject to customs duties; certain approved fixed assets; catering in penitentiaries; and certain services at agricultural educational establishments.

2. Excise taxes

a. Nature of the tax

Excise taxes are payable by individuals and enterprises that produce or import the products listed below.

b. Tax rates

<u>Item to be taxed</u>	<u>Unit tax (LVL) or general rate in percent of price</u>
Passenger cars	10%
Alcohol or alcoholic drinks (per liter of 200-proof equivalent)	LVL 3.00
Champagne and wines (per liter)	LVL 0.25
Tobacco (per 100 cigarettes)	LVL 0.35
Cigars and cigarillos (per 100)	LVL 1.00
Other tobacco products	100%
Precious metals and jewelry with precious and semi-precious stones	30%
Gasoline and substitutes (per liter)	LVL 0.04
Diesel and substitutes (per liter)	LVL 0.02

c. Exemptions

Excise taxes are not imposed on exports, on ethyl alcohol used for medical, pharmaceutical and scientific purposes, and certain automobiles with small engines or more than seven years old. Diesel excises, on up to 80 liters per hectare of land, paid by agricultural producers are refunded.

3. Customs duties

A new tariff law became effective December 1, 1994. A general import duty of 20 percent (15 percent for countries with most favored nation status) applies on non-agricultural final goods. The tariff on raw materials and component parts is 1 percent (0.5 percent). A rate of 55 percent applies to 6 agricultural commodities. However, some final goods are exempt from tariffs, while others are subject to a rate of 1 percent (0.5 percent). Specific tariffs apply to certain grains, seeds and cereals, flour, sugar, and certain confectionery and bakery products. Individuals may import goods up to LVL 300 (LVL 15 for food products) in value without payment of customs or VAT. Export duties are levied on gypsum and limestone, waste and scrap metals, round logs, and certain art and antiques.

III. Other Taxes

1. Land tax

a. Nature of the tax

A tax on the use of land is paid by individuals and enterprises. The tax is paid directly to the respective district, village, city, or municipal district budget.

b. Tax rates

Land tax rates in rural districts are determined by the rating of the land for agricultural uses and its location. Local governments set their own tax rates for land within their jurisdiction. Individual tax rates for different types of land may not deviate by more than 50 percent from the average tax rate. Tracts of brush land are taxed at 50 percent of the average land tax rates.

c. Exemptions and deductions

Exemptions

The following are exempt from the land tax:

1. Land used for collective transportation routes; lines of communication and strips of land allocated to these functions; land that has been banned from commercial use; land that is used for local government institutions, as well as residences, communal dwellings, educational, cultural, health, social services, and sports facilities belonging to local governments.

2. Individual farms up to the first five years if the starting conditions are unsatisfactory.

Deductions

Local governments may exempt or reduce the tax for the following land users: those suffering material losses due to a natural accident; retired and handicapped persons; newly founded families; poor families; families with many children; land users on whose land the scope of commercial activity is limited by law; religious and charitable organizations; land used for social purposes; and government organizations.

2. Natural resource tax

a. Nature of the tax

The objective of the natural resource tax is to encourage the efficient use of natural resources and to accumulate the means for funding environmental protection measures. The tax consists of three parts: a tax

on the use of natural resources; a tax on pollution; and punitive fines for excessive use of natural resources and pollution.

b. Tax rates

The types of environmental pollution and the list of natural resources which are taxable as well as the respective limits of pollution and utilization of resources are determined by the Environmental Protection Committee.

3. State duties

These are duties levied on the delivery of various official documents and acts, including emigration permits, notarial services, and recognition of inheritance rights.

Exchange and Trade Systems

1. Exchange arrangements

The currency of Latvia is the lats (LVL). On July 20, 1992, the Latvian ruble replaced the Russian ruble as legal tender in Latvia, and in March 1993, the lats began to be issued as permanent currency at the conversion rate of one lats per 200 Latvian rubles. At this conversion rate, the exchange rate of the lats for the U.S. dollar was LVL 0.75 per US\$1. Conversion of all accounts and prices into lats was made mandatory as of June 28, 1993. The lats became the sole legal tender effective October 18, 1993. The use of other currencies has, however, remained legal.

The exchange rate has been pegged to the SDR since February 1994 at a rate of SDR 1 = LVL 0.7997. The Bank of Latvia reviews domestic and international exchange markets on a daily basis and announces buying and selling rates for the lats against a number of currencies. The Bank stands ready to transact with commercial banks at these rates. The exchange rates for the lats against convertible currencies other than the U.S. dollar are quoted on the basis of the cross rates between the U.S. dollar and the currencies concerned in the international market. A margin of 2 percent is applied in the quotations of the buying and selling rates for the above currencies. Banks and other authorized exchange dealers also trade in these currencies, and their buying and selling rates may deviate from the quoted rates. Since November 1, 1993, the Bank of Latvia also quotes daily the midpoint of the buying and selling rates of the lats against convertible currencies. These rates are used for various accounting purposes, including customs duties, taxation, and other valuations; they are valid through the next day and are communicated to all commercial banks. On June 30, 1995, the official exchange rate of the lats was LVL 0.512 per US\$1.

The Bank of Latvia also quotes weekly the accounting rates of the lats vis-à-vis the currencies of Estonia, Lithuania, Russia, and other countries of the former Soviet Union which participate in the system of correspondent accounts. These rates are determined as cross rates based on rates against the U.S. dollar or Deutsche mark.

Government decisions adopted by the Cabinet of Ministers and approved by Parliament have ultimate authority over foreign exchange and trade matters, but authority to issue regulations governing foreign exchange transactions has been delegated to the Bank of Latvia. All foreign exchange transactions must be effected through authorized banks and enterprises licensed by the Bank of Latvia. There are no regulations governing international trade in gold, but a license is required to deal in gold in the domestic market. Foreign exchange is transacted freely in Latvia.

Export proceeds are not subject to repatriation or surrender requirements, nor are there any exchange control regulations governing capital transactions. No exchange controls or restrictions are imposed on payments for or proceeds from invisibles.

Resident natural persons and enterprises are allowed to hold foreign currencies in cash or in domestic or foreign bank accounts and to use these funds for domestic payments. Non-resident natural persons and enterprises are permitted to hold bank accounts in Latvia denominated in either foreign or domestic currency. Foreign direct and portfolio investment in Latvia by non-residents are governed by the Law on Foreign Investment which was revised last in March 1995. There are no restrictions on the repatriation of investments or profits thereon.

Latvia has accepted the obligation of Article VIII, Sections 2,3, and 4 of the Fund Agreement, as of June 10, 1994.

2. Trade system and trade reform

a. Exports and imports practices

Latvia has an open trade system supported by a low uniform import tariff regime. However, agricultural tariffs are high, with an average production-weighted tariff rate of more than 50 percent. Table 30 provides a summary of the main features of the trade system. Under Latvia's Free Trade Agreement with the European Union, it is estimated that the production-weighted average agricultural tariff applying to EU imports would be reduced to 38 percent by the year 2000.

A new tariff law became effective on December 1, 1994. It replaced most specific tariffs with ad valorem rates, and established basic tariff rates of 20 percent (15 percent for countries with most favored nation (MFN) status) for nonagricultural final goods. Excluding agricultural goods, in 1994, 67 percent of Latvia's imports were assessed MFN duties. Duties on an additional 23 percent of Latvia's imports were assessed based on free trade agreements, and only 10 percent of Latvia's imports were assessed basic tariff rates.

A high ad valorem tariff rate of 55 percent applies to six agricultural commodities. However, most raw material and spare parts are assessed an import tariff duty of 1 percent (0.5 percent of the countries with which MFN relations are maintained). A number of final goods are also exempt from import tariff, and certain goods such as fruits and nuts, coffee and tea, were subject to reduced tariffs of 1 percent (0.5 percent of the countries with which MFN relations are maintained). Specific tariff rates are levied on seed and animal feed, certain grains, flour, bread, sugar, certain confectionery products, including chocolate, alcohol, cigarettes and cars.

The Ministry of Foreign Affairs has recently proposed introducing changes in the tariff law to ensure a uniform customs valuation procedure which is in accordance to WTO agreements. Currently, custom values are

determined on the basis of a list of reference prices provided by the EU on a quarterly basis. Custom values for certain agricultural goods are established on the basis of the value of identical or similar goods in world markets or local wholesale prices if world market prices are not available.

There are virtually no licensing requirements for imports except imports of sugar, grains, cereals, tobacco and tobacco products, and alcoholic beverages. For national health and safety reasons, there are licensing requirements for pyrotechnic products, arms and ammunition, fighting vehicles and prepared explosives.

Physical persons entering Latvia are entitled to import, without any customs payments, goods intended for other than commercial purposes, provided their import is not forbidden by law and their customs value does not exceed LVL 300. A total customs value of foodstuff not exceeding LVL 15 per person is exempted from taxes. A person over 18 is exempt from taxes on alcoholic drinks up to one liter, or one measure unit in original packing not exceeding three liters, and not more than 200 cigarettes, or 20 cigars or 200 grams of tobacco. The importation of certain goods, such as firearms, is prohibited.

There are no export quotas in Latvia. Export duties are levied on waste and scrap metals, certain categories of round logs, and some mineral products, work of art, antiques and certain printed books.

b. Trade and payments arrangements

At end-June 1995, Latvia maintained Intergovernmental Trade and Cooperation Agreements providing for most-favored-nation status with Armenia, Australia, Azerbaijan, Belarus, Canada, People's Republic of China, Cuba, the Czech Republic, Hungary, Iceland, India, Kazakhstan, the Kyrgyz Republic, Moldova, Poland, Romania, the Russian Federation, Tajikistan, Turkmenistan, Ukraine, United States, and Uzbekistan. Agreements with Argentina, Cyprus, Georgia, Iran and Turkey are in preparation.

Latvia has free trade agreements with Norway, Switzerland, Estonia and Lithuania, and the European Union. Free trade agreements with EFTA, Bulgaria, the Czech Republic, Hungary, Poland, the Slovak Republic, Slovenia, and Ukraine are under consideration. A free trade agreement with Iceland is expected to be signed soon.

Working groups have been set up to undertake negotiations to settle outstanding balances of inoperative bilateral payments agreements which Latvia maintained with Armenia, Azerbaijan, Kazakhstan, Moldova, the Russian Federation, Tajikistan, Ukraine, and Uzbekistan. Outstanding balances from similar accounts with Estonia, Lithuania, Georgia, and the Kyrgyz Republic have been cleared.

In June 1995, Latvia signed an Association Agreement with the EU. The agreement stipulates the gradual implementation of free movement of goods, services, capital and workforce between Latvia and the EU member countries.

It envisages a gradual reduction in tariffs and eventual removal of nontariff barriers, and the harmonization of Latvian laws with EU standards. The Free Trade Agreement with the EU, which was initiated on June 20, 1994 and became effective on January 1, 1995, operates within the framework of the Association Agreement and covers substantially all trade in goods with the EU. According to this agreement, free trade areas will be gradually established within a maximum of 4 years starting from January 1, 1995. In particular, for the majority of industrial products tariff reductions to zero have been achieved from January 1, 1995. A 50 percent reduction of all tariffs of certain products is expected within two years after entry into force of the Agreement. Tariffs for these products are expected to be eliminated four years after the entry into force of the Agreement. A 50 percent reduction of tariffs for most non-agricultural goods is expected to take place by end-1996; elimination of tariffs is expected in 1997. Tariff reductions for agricultural products are expected to be implemented during 1995-2000 with annual equal reductions which are higher than 1 percent, or alternatively, eliminated in one step in the year 2000.

Multilateral accession negotiations for WTO were initiated at end-March 1995. In the context of these negotiations, no discussions to bind tariffs (agricultural and industrial) took place. The issue is expected to be discussed in the context of bilateral negotiations for market access.

Table 30. Latvia: Summary Overview of the Trade System

Trade policy instrument	Status as at June 30, 1995
1. Import customs tariffs	
Ad valorem tariff rate for raw materials and component parts:	
Basic rate:	1 percent
MFN rate:	0.5 percent
Ad valorem tariff rate for final non-agricultural goods:	
Basic rate:	20 percent
MFN rate:	15 percent
Tariff rates (ad valorem and some specific) for agricultural goods:	
Basic rate:	53 percent ^{1/}
MFN rate:	46 percent ^{1/}
2. Goods subject to specific import tariffs:	Certain grain, seed, cereal, flour, sugar, confectionary, bakery, beverage and tobacco items and cars
3. Goods subject to quantitative restrictions	Sugar, grains, alcohol
Import quotas:	Only in the case of goods for which Latvia's international agreements specify tariff quotas
Tariff quotas:	
4. Goods subject to import licensing	Tobacco, sugar, grains, spirits and alcohol, weapons, explosives.
5. Anti-dumping and countervailing provisions:	Broadly consistent with WTO provisions
6. Other non tariff barriers	
Import valuation:	Wherever available international prices are used for valuation of imports
7. Goods subject to export taxes:	Gypsum and limestone (to be abolished by January 1, 1996), waste/scrap metals and round logs (to be abolished by end-1998), and art works/antiques
8. Goods subject to export quotas:	Only in the case of goods for which Latvia's international agreements specify export quotas (e.g., textiles under the EU FTA)

Sources: Information supplied by the authorities; and staff estimates.

^{1/} Estimated production-weighted average tariff rates.