While the investment ratio is projected to gradually increase to 32 percent of GDP over time (Table 5), staff projects a slightly declining trend in the FDI/GDP ratio from the high levels of recent years, implying that an increasing share of investment will be generated domestically. However, this would not significantly reduce projected TFP growth, as FDI flows as a share of GDP in Latvia would still be above the levels recorded in Ireland, Spain, and Portugal following their EU accession in 1970s and 1980s, which enabled them to close between 10 and 20 percentage points of their income gap in the two decades following their respective accession. It would also exceed the projected medium-term FDI flows for other Eastern and Central European accession countries, with the exception of Estonia. Moreover, the ratio of the stock of FDI to GDP would still be rising, from 32.7 percent in 2002 to 36.2 percent in 2007. If, however, stronger FDI inflows were to materialize in Latvia, the Irish convergence experience in the second half of the 1990s offers an example of how quickly sustained and large FDI inflows, coupled with prudent macroeconomic policies and a deregulation of the economy, could contribute to an acceleration of real convergence; while the Irish income gap narrowed by 11 percentage points in the two decades before 1994, it was eliminated by 1998, and income stood at 16 percent above the EU average by 2000.[7]

While the necessary conditions for sustained economic growth are in place, much will depend on the Latvian authorities' macroeconomic and structural policy stance over the next few years. Macroeconomic stability will be critical. A prudent fiscal and monetary policy mix within the context of the SGP should enable Latvia to maintain a low-inflation environment and contain the risk stemming from its persistently large current account deficit.

The deepening of structural reforms should also help maintain the current favorable investment climate and attract FDI. Key areas where progress still needs to be made are: (i) the battle against corruption; (ii) the privatization of the remaining state enterprises; (iii) the deregulation of the energy and telecommunications markets; (iv) the promotion of labor market policies channeling employment to high value-added sectors; (v) the promotion of small- and medium-sized enterprises, including their access to financing; and (vi) efforts to foster the diversification of exports. The government has a good tradition of working very closely with the business community to improve the business climate, as evidenced by the constant updating and good implementation record of the *Action Plan to Improve the Business Environment*.

In conclusion, international experience and key features of the Latvian economy suggest that Latvia is poised to sustain an annual growth rate of 5 ½ to 6 percent in the next few years. This should help Latvia make headway in catching up with the EU income average. Productivity growth should be the main source driving growth, aided by capital and human capital accumulation. Prudent macroeconomic policy and deepening structural reforms are required to turn this favorable outlook into reality.

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[7] See Chapter IV in IMF Occasional Paper 213.

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