INTERNATIONAL MONETARY FUND

Staff Country Reports

April 2001
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Republic of Latvia: Request for Stand-By Arrangement—Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement on Behalf of the Authorities of the Republic of Latvia

In the context of the Republic of Latvia's request for a Stand-By Arrangement, the following documents have been released and are included in this package:

- the staff report for the request for a Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on **February 7, 2001,** with the officials of the Republic of Latvia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on March 23, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **April 20, 2001**, updating information on recent economic developments.

- a Press Release summarizing the **views of the Executive Board as expressed during its April 20, 2001 discussion** of the staff report that completed the request.

- a statement by the Executive Director for the Republic of Latvia on behalf of the authorities.

The documents listed below have been separately released.

Letter of Intent by the authorities of the member country*
Memorandum of Economic and Financial Policies by the authorities of the member country*

*Also included in Staff Report.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

Request for Stand-By Arrangement

Prepared by European II and Policy Development and Review Departments

Approved by Thomas Wolf and Liam P. Ebrill

March 23, 2001

- Discussions were held in Riga during October 26-November 6, 2000 and January 31-February 7, 2001.
- The staff representatives comprised Messrs. Schiff (head), Mueller, Beddies, and Lundbäck (all EU2). Mr. Knöbl, the Fund's resident representative in Riga, assisted the mission. Mr. Lehmussaari, Executive Director for Latvia, attended the policy meetings.
- The mission met with Prime Minister Bērziņš, Minister of Finance Bērziņš, Minister of the Economy Kalvitis, Minister of Welfare Pozarnovs, as well as Bank of Latvia (BoL) Governor Mr. Repše, other senior government officials, and members of Parliament and of the financial and diplomatic communities.
- On December 10, 1999, the Executive Board approved a 16-month precautionary Stand-By Arrangement (SBA) in an amount of SDR 33 million (equivalent to 19.5 percent of quota on an annual basis). The arrangement will expire on April 9, 2001, without any purchases having been made.
- In the attached letter dated March 21, 2001 (Attachment II), the Minister of Finance and BoL Governor request approval of a successor stand-by arrangement in the amount of SDR 33 million (equivalent to 16 percent of quota on an annual basis) covering a 20-month period. The authorities have indicated that they do not intend to make any purchases under the arrangement. The requested arrangement supports the policies and measures outlined in the accompanying Memorandum of Economic Policies (MEP), which the authorities intend to publish.
- The first program review and the Article IV consultation are expected to be completed by November 30, 2001.
- Relations with the Fund and the World Bank are summarized in Appendices I and II, respectively; technical assistance by the Fund in Appendix III; and statistical issues in Appendix IV.

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Latvia: Basic Data

Social and demographic indicators	
Area	64,589 sq. km.
Population	2.4 million
Urban	69 percent
Rate of population growth	-0.6 percent per year
Life expectancy at birth	
Male	64.9 years
Female	76.2 years
Infant mortality rate (per 1,000 births)	11.4
Hospital beds (per 10,000 inhabitants)	88.5
Physicians (per 10,000 inhabitants)	33.0

	1996	1997	1998	1999	2000
Shares of gross domestic product					
Agriculture and hunting	7.8	4.6	2.9	2.6	...
Fishing	0.3	0.2	0.3	0.4	...
Forestry and logging	0.9	1.0	1.2	1.5	...
Mining and quarrying	0.2	0.2	0.2	0.2	...
Manufacturing	20.9	22.2	17.9	15.3	...
Electricity, gas, and water	5.3	5.0	5.3	4.5	...
Construction	4.7	4.8	6.8	7.1	...
Services	59.9	62.0	65.4	68.5	...
GDP					
Nominal GDP (in millions of lats)	2,829	3,276	3,590	3,897	4,317
GDP per capita (in lats)	1,136	1,327	1,466	1,506	1,781
Real GDP (percentage change)	3.3	8.6	3.9	1.1	5.5
Consumer prices (percentage change, end-period)	13.1	7.0	2.8	3.2	1.8
General government finances					
Total revenue	1,057	1,352	1,529	1,561	1,620
(in percent of GDP)	37.4	41.3	42.6	40.0	37.5
Total expenditure	1,104	1,332	1,554	1,707	1,764
(in percent of GDP)	39.0	40.7	43.3	43.8	40.9
Financial balance	-47	20	-25	-146	-144
(in percent of GDP)	-1.7	0.6	-0.7	-3.8	-3.3
Net lending	5	10	3	7	0
(in percent of GDP)	0.2	0.3	0.1	0.2	0.0
Fiscal balance	-52	10	-27	-153	-143
(in percent of GDP)	-1.8	0.3	-0.8	-3.9	-3.3
	(in millions of lats, unless stated otherwise)				
Money and credit (end-period)					
Net foreign assets	445	619	415	364	538
Broad money	628	871	923	997	1,275
Domestic credit	366	479	647	745	1,063
Velocity (level)	4.5	3.8	3.9	4.0	3.6
	(in millions of US dollars, unless stated otherwise)				
Balance of payments					
Total exports (GNFS)	2,678	2,929	3,174	2,914	3,276
Total imports (GNFS)	3,028	3,348	3,947	3,605	3,876
Current account balance	-215	-287	-595	-646	-512
Official reserves (in months of imports of goods and nonfactor services)	3.1	3.0	2.7	3.1	2.8
Exchange rate, lats per US$, period average	0.551	0.581	0.590	0.585	0.607

Sources: Latvian authorities; and Fund staff estimates.

EXECUTIVE SUMMARY

The Latvian economy has fully recovered from the recession triggered by the Russian crisis. Despite the adverse effect of higher oil prices and the appreciation of the lats vis-à-vis the euro, **real GDP** is estimated to have grown by 5½ percent in 2000, while **inflation** was 1¾ percent in the 12 months through December. The **external current account deficit** is estimated to have declined significantly in 2000, to 7¼ percent of GDP, covered to a large extent by FDI which helped contain Latvia's moderate external debt indicators.

Slippage in fiscal policy has put these encouraging developments at some risk. The **fiscal deficit**—while declining by about half a percentage point of GDP in 2000 compared to 1999—remained substantially above the ceiling under the previous SBA, preventing the completion of the discussions for the second review. **Monetary policy** in 2000 was appropriate in supporting the BoL's exchange rate peg, while the strengthening of the financial sector continues and the modernization of the prudential framework is fully on track. Progress in **trade reform** has been excellent, while on the **structural front** the uncertainties surrounding the divestiture of the remaining large public enterprises have caused some delays, although some momentum was gained toward year-end.

The foundation has been laid for sustainable and strong **growth in a low-inflation environment,** and Latvia's **vulnerability to external shocks** seems to have diminished. The **external position** is expected to remain sustainable in view of continued buoyant FDI and a projected improvement of the government's saving-investment balance, which will help to further reduce the external current account deficit. Against this background, a **return to a prudent fiscal policy stance** is the centerpiece of the requested precautionary SBA. The key objective will be to provide a credible medium-term fiscal framework that, while aiming at **budget balance** over the medium term, incorporates increased expenditure for EU and NATO accession and, possibly, selective tax cuts. To this end, the **fiscal deficit** will be contained to no more than 1¾ percent of GDP in 2001 and 1 percent of GDP in 2002, essentially on account of expenditure restraint. To achieve these goals, the **structural component of the program** will focus on measures aimed at enhancing public expenditure policy and management, including pension reform, as well as tax and customs administration.

The **exchange rate peg** to the SDR has served Latvia well, and no change is envisaged during the program period. The **monetary program** will be sufficiently tight to support the peg, while allowing appropriate expansion of private sector credit. Intensive efforts to ensure a smooth transition to **unified financial sector supervision,** and steps to ensure full compliance with the Basle Core Principles for Effective Banking Supervision are underway.

The program's prudent macroeconomic policy stance is complemented by key **structural reforms** that constitute a vital building block in supporting durable growth and Latvia's attractiveness to foreign investors. Measures include concerted efforts to expedite privatization and further improve the business climate.

I. Recent Economic Developments and Performance Under The Previous Program

1. **Latvia has fully recovered from the recession induced by the Russia crisis, with the resumption of strong growth in a low-inflation environment** (Table 1; Figure 1). Nevertheless, slippage in fiscal policy in the second half of 2000 prevented the completion of the discussions for the second review under the previous stand-by arrangement (Table 2).

2. **Real GDP is estimated to have increased by 5½ percent in 2000, despite the adverse impact of higher oil prices and the depreciated euro.**[1] Growth has been broad-based, with especially forestry, business services, financial intermediation, and, to a lesser extent, manufacturing showing strong gains. The CPI rose by 1¾ percent in the twelve months through December, mirroring the appreciation of the lats vis-à-vis the euro and moderate growth in consumer demand; abstracting from the impact of increases in administrative and fuel prices, annual inflation was 0.6 percent for the period. The low core inflation is also reflected in the PPI, which increased by 1 percent year-on-year by end-2000. The official unemployment rate has continued to decline, falling to 7¾ percent by end-2000, 2¼ percentage points below its peak in April 1999, although employment remained relatively flat throughout 2000.[2]

3. **Latvia's external position and outlook have improved as well, as evidenced by developments in the external current account and FDI inflows, while competitiveness and debt indicators remain comfortable** (Box 1; Table 3; Figure 2).[3] In addition, the authorities are fully on track in harmonizing their trade legislation with WTO rules and EU requirements, and have implemented all tariff measures under the previous SBA.

4. **However, slippages in fiscal policy have put these benign developments at some risk.** While the general government fiscal deficit declined by about half a percentage point

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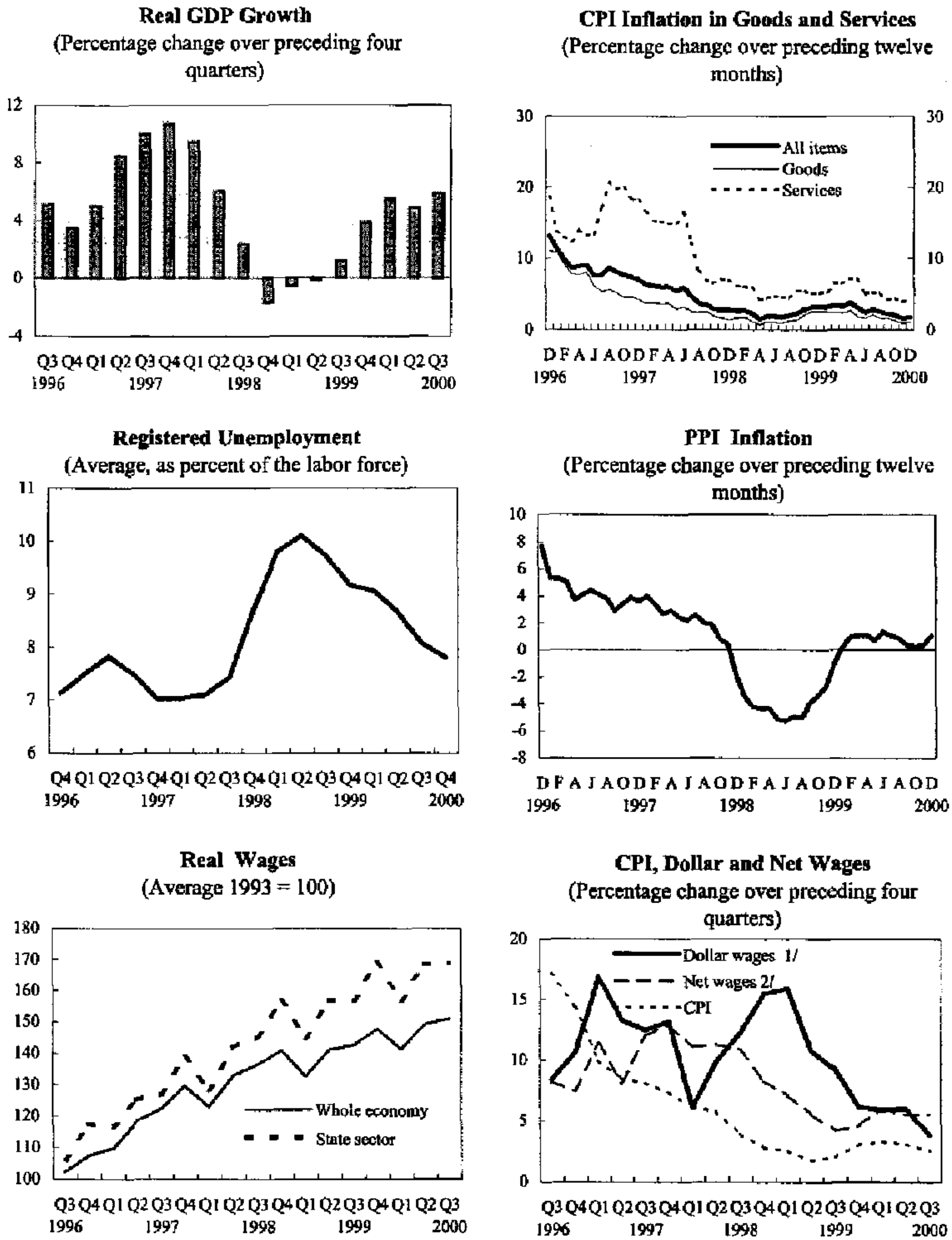
[1] In late 2000, the authorities presented revised national accounts data for 1999, raising real GDP growth from 0.1 percent to 1.1 percent and the deflator by 5.4 percentage points to 7.4 percent. The authorities explained the high deflator relative to the more moderate increase in the CPI (2.4 percent) by the relatively large increase in prices of services, which account for about 60 percent of GDP, but only 25 percent of the CPI basket. While the mission raised some doubts regarding this discrepancy, it nevertheless accepted the revision partly in view of the ongoing technical assistance in national accounts provided to Latvia by Eurostat as an integral part of Latvia's EU accession process.

[2] However, according to the ILO definition, unemployment is significantly higher, at an estimated 14 percent in 1999 (see Box 3).

[3] See also SM/99/282 and EBS/00/109 for further discussion of competitiveness issues.

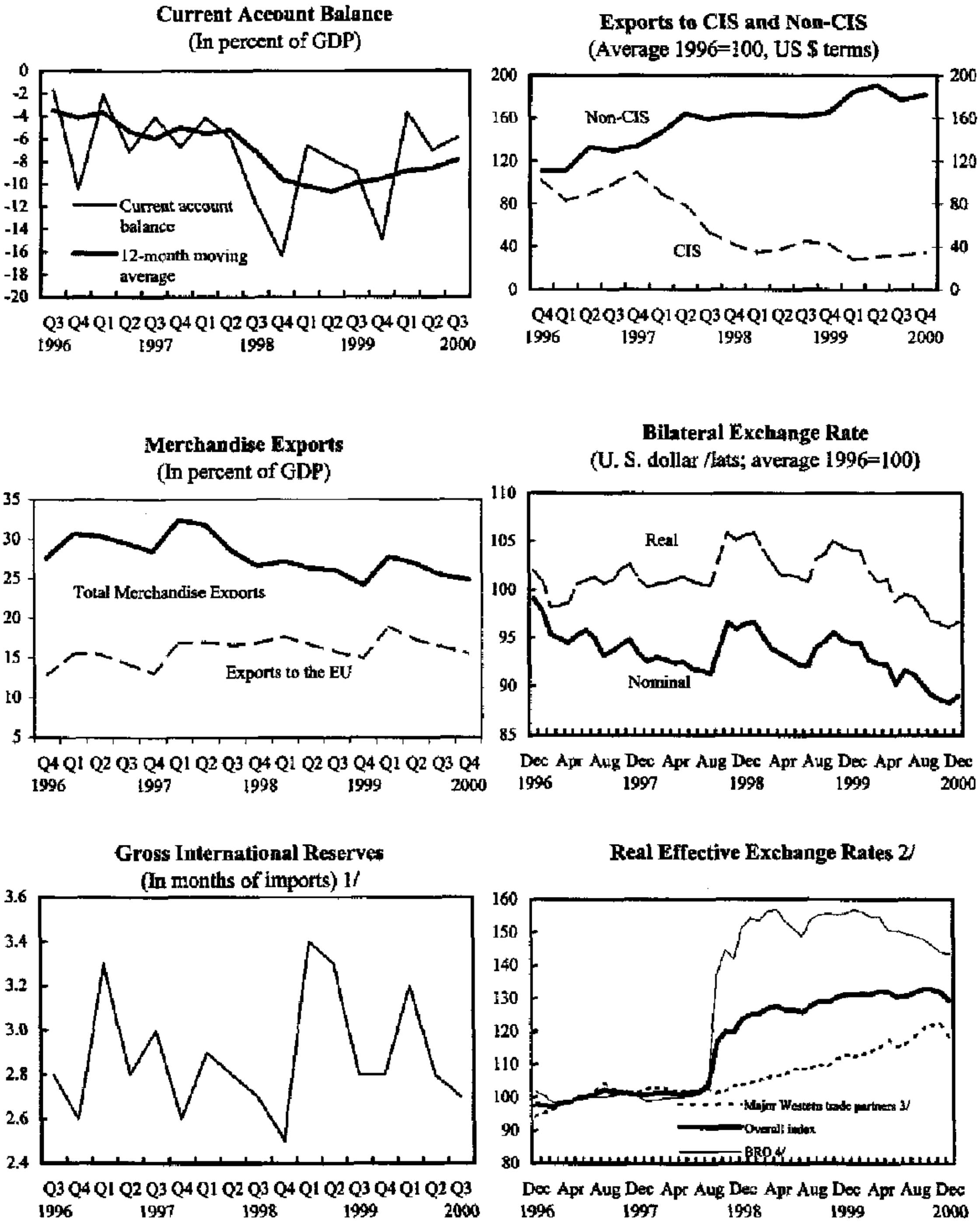
Figure 1. Latvia: Macroeconomic Indicators, 1996-2000



Sources: Latvian authorities; and Fund staff estimates.

1/ Average monthly wage in the public sector, including public enterprises.
2/ Wages net of social taxes.

Figure 2. Latvia: Exchange Rates and External Indicators, 1996-2000



Sources: Latvian authorities; and Fund staff estimates.
1/ Imports of goods and non-factor services.
2/ Trade-weighted, using INS-adjusted weights for 1997, to reflect recent changes in shares of trading partners.
3/ Comprising Denmark, Finland, Germany, the Netherlands, Sweden, United Kingdom, and United States.
4/ Comprising Belarus, Estonia, Lithuania, the Russian Federation, and Ukraine.

in 2000, to 3¼ percent of GDP, it remained about 1¼ percentage points of GDP above the ceiling under the previous SBA. This slippage led to the nonobservance of the fiscal performance criteria under the previous SBA for end-June, end-September, and end-December 2000. On the revenue side, tax revenues rose by only 3 percent in 2000, despite a rise in nominal GDP of more than 10 percent, reflecting, in part, the export-led nature of growth. In addition, excise tax collections suffered from the impact of higher oil prices on consumption and continued problems with smuggling of petroleum products, although improved tax and customs administration contributed to a strengthening of excise tax receipts in the second half of the year. Further, corporate income tax collections were adversely affected during the third quarter by unexpectedly large repayments, reflecting depressed profit levels in 1999, especially for a few large taxpayers. VAT performance was also

Box 1. Latvia's External Position and Outlook

The external sector outlook has improved compared to the previous staff report (EBS/00/109), as evidenced by the following developments:

• The **external current account deficit** for the first nine months of 2000 stood at 5½ percent of GDP, compared with initial projections of 7½ percent of GDP. For the year as a whole, the current account deficit is estimated to have fallen to about 7 percent of GDP—1½ percentage points better than previously envisaged and 2½ percentage points better than in 1999—and is projected to decline further to below 6½ percent of GDP in 2001. This improvement reflects (i) strong transport receipts as a result of sharply increased oil transit; (ii) somewhat lower-than-expected growth of imports of consumption goods; (iii) buoyant exports to the EU, which grew by 13 percent in dollar terms in 2000, despite the significant appreciation of the lats vis-à-vis the euro; and (iv) a strengthening of the income balance due to higher interest and investment income received from abroad and low profit remittances as a result of depressed profit levels in 1999. Exports to the EU rose to close to 65 percent of all exports, after 62 percent in 1999. The recent appreciation of the euro and the moderation in oil prices would, if sustained, further improve the external outlook. However, exports of wood and wood products still account for more than one-third of all exports, presenting some vulnerability to external shocks.

• During the first three quarters of 2000, nearly 100 percent of the current account deficit was financed by **foreign direct investment** despite delays in the program of large-scale privatization; such cover is conservatively projected at close to 75 percent for the year as a whole, compared to initial projections of 60 percent. Large-scale privatization, the auctioning of mobile phone licenses, and continued strong reinvestment of earnings and greenfield investments are expected to increase FDI in 2001 and beyond. The approach of EU accession should also provide a significant boost to FDI over the medium term.

• The weakness of the euro during 2000 gave rise to some concerns regarding Latvia's **external competitiveness**, in particular in the EU market. However, the trade-weighted real effective exchange rate depreciated by 1 percent year-on-year by end-December 2000, although it appreciated by about 5 percent vis-à-vis Western trading partners during the period. Further, wage growth has dampened considerably, with real wages rising by 3 percent in 2000. Reflecting these moderate wage gains and continued improvements in productivity, unit labor costs have decreased economy-wide, including in manufacturing. However, as unit labor costs in Latvia's Western trading partners are estimated to have declined substantially in 2000, Latvia's *relative* unit labor costs vis-à-vis these countries are estimated to have appreciated by about 8¾ percent.

• Latvia's **external debt** indicators continue to be moderate. External public debt amounted to 10 percent of GDP at end-2000. While total external debt stood at about 64 percent of GDP, on a net basis such debt represented only 15 percent of GDP, while net short-term debt was negative.

• **The yield spread on Latvia's Eurobond**, at about 80 basis points over the German benchmark bond, is very low by emerging markets standards.

disappointing in November and December as timber exporters claimed larger-than-anticipated reimbursements. Meanwhile, unplanned spending out of privatization receipts outside of the budget of about ½ percent of GDP in the first half of the year, and additional spending of about 0.1 percent of GDP provided for by the supplementary budget passed in November, were only partially offset by expenditure restraint elsewhere (Table 4; Figure 3).[4]

5. **The budget for 2001, envisaging a deficit of 1¾ percent of GDP, was approved by Parliament in late November 2000, with the government resisting firmly the many proposals to increase spending during the parliamentary deliberations.** Latvia's expenditure-to-GDP ratio is projected to decline by some 2 percentage points, to 39 percent of GDP, following a decline of 3 percentage points of GDP in 2000. The budget is based on conservative revenue assumptions, with nominal tax receipts projected to grow by 8½ percent, somewhat slower than nominal GDP. Further, the budget does not incorporate the potential impact of the amendments to the pension law (see below), but reflects the loss in social tax revenue equivalent to 0.1 percent of GDP, which will be directed to the new second pillar of the pension system.[5]

6. **Monetary policy in 2000 was appropriate in supporting the BoL's exchange rate peg, and all quarterly monetary targets under the program were observed comfortably.** Monetary developments reflected both the deepening of financial markets and increased confidence in the banking system and the economy more generally. In the absence of pressure on the exchange rate, reserve and broad money rose by 8 percent and 28 percent, respectively, broadly in line with expectations. Credit to the private sector grew robustly, by 37 percent, from still-low levels, deposits in the banking system rose sharply (including from non-residents), and lending rates exhibited a declining trend (Tables 5 and 6; Figure 4).

7. **Monetary policy was complicated during the course of the year by the need to alleviate the liquidity impact of several large issues of medium-term government bonds.** These issues, well in excess of financing needs, were aimed at financial market development, especially in longer maturities, but had the impact of significantly tightening monetary conditions. The BoL initially responded through large purchases of these bonds on the secondary market, which gave rise to the perception among some market participants that the

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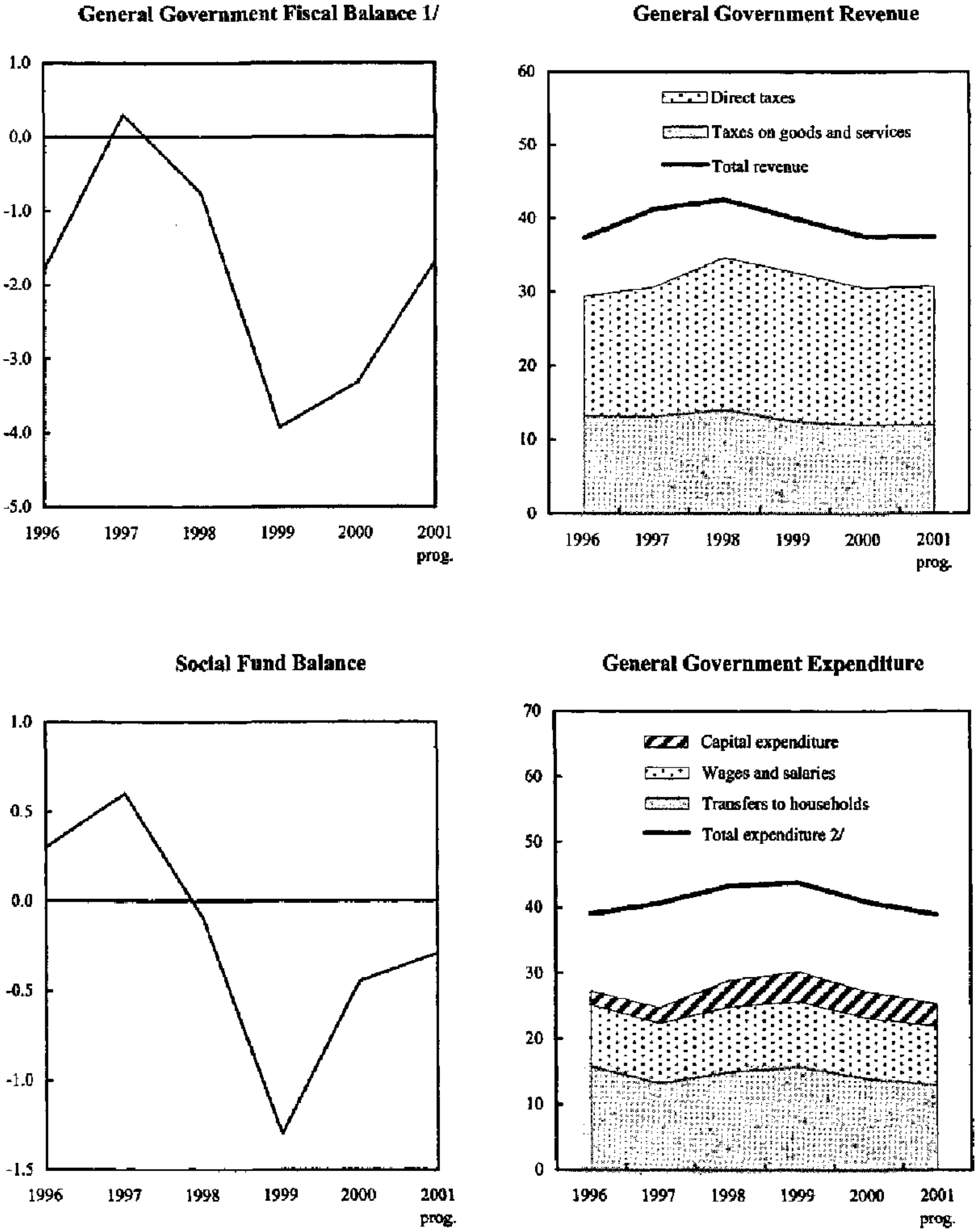
[4] The authorities were informed at the time of the discussion for the first review that such unplanned spending—which is generally authorized through resolutions from the Cabinet of Ministers—would also need to be brought into the budget and included under the program ceiling. Language to this effect was included in the supplementary MEP (EBS/00/109). Nevertheless, some new Cabinet resolutions were adopted in late 2000 and early 2001 amounting to LVL 2.7 million, which will be counted under the program ceilings for the fiscal deficit.

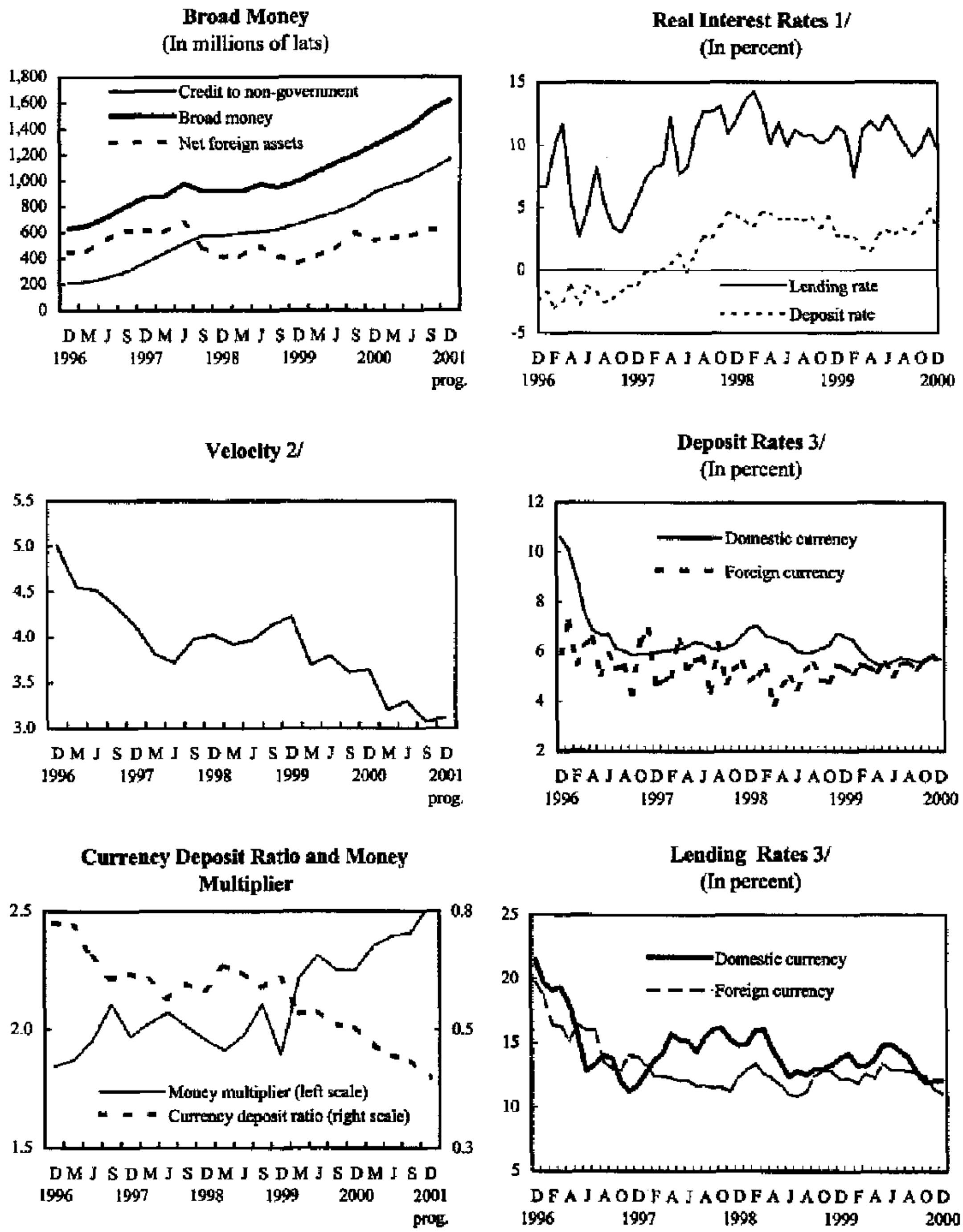
[5] For an overview on pension reform in Latvia, see SM/00/117 and Box 4 in EBS/00/109.

Figure 3. Latvia: Fiscal Developments, 1996-2001
(In percent of GDP)



Sources: Latvian Ministry of Finance; and Fund staff estimates.
1/ Revenue excludes privatization receipts.
2/ Including interest payments and other current expenditures.

Figure 4. Latvia: Monetary Developments, 1996-2001



Sources: Latvian authorities; and Fund staff estimates.

1/ Three-month average; computed using domestic 3-6 month interest rates and twelve month past inflation rate.
2/ Velocity is defined as nominal GDP over broad money.
3/ Three-month average; 3-6 months' maturity.

BoL was facilitating financing of the government. The BoL sharply reversed course in mid-June by curtailing the provision of liquidity through repo auctions and introducing reverse repurchase operations for the first time. The BoL operations surprised market participants and led to a noticeable rise in interest rates in the money market, which, however, abated in the fall as a result of the return to a more balanced and predictable policy conduct.

8. **Reliance on foreign exchange swaps for conducting monetary policy and fostering financial market development intensified during 2000.** During the second half of 2000, the BoL provided liquidity to commercial banks primarily via short-term foreign exchange swaps, leading to a significant rise in the outstanding stock of such swaps which almost gave the swaps the character of a standing facility.[6] [7] In addition, since their inception in May 2000, demand for the BoL's controversial long-term foreign exchange swaps, with a maturity of two years, has risen sharply. The subscriptions to these swaps, which have been subject to criticism by Fund staff and Executive Directors, reached US$ 84 million by year-end, about 8 percent of the BoL's net international reserves. In addition, a new proposal for five-year foreign exchange swaps with the involvement of the Treasury has been advocated by some foreign investors and members of the government.[8]

9. **The strengthening of the financial sector continues, as evidenced by key financial sector indicators, and improvements to financial sector regulation are fully on track** (Table 7 and Figure 5). All banks have capital adequacy ratios above the BoL-prescribed 10 percent, nonperforming loans are declining, and banks' profits tripled in 2000 compared to 1999. Foreign investors have recently either increased or acquired majority stakes in three of the six largest banks, including in PirmaKomercBanka, the successor of RigasKomercBanka, which was subject to a BoL-led rescue operation in 1999. In addition, further banking sector consolidation appears likely, as several mergers of larger banks are being pursued. The BoL is fully on track in modernizing its prudential framework, which is

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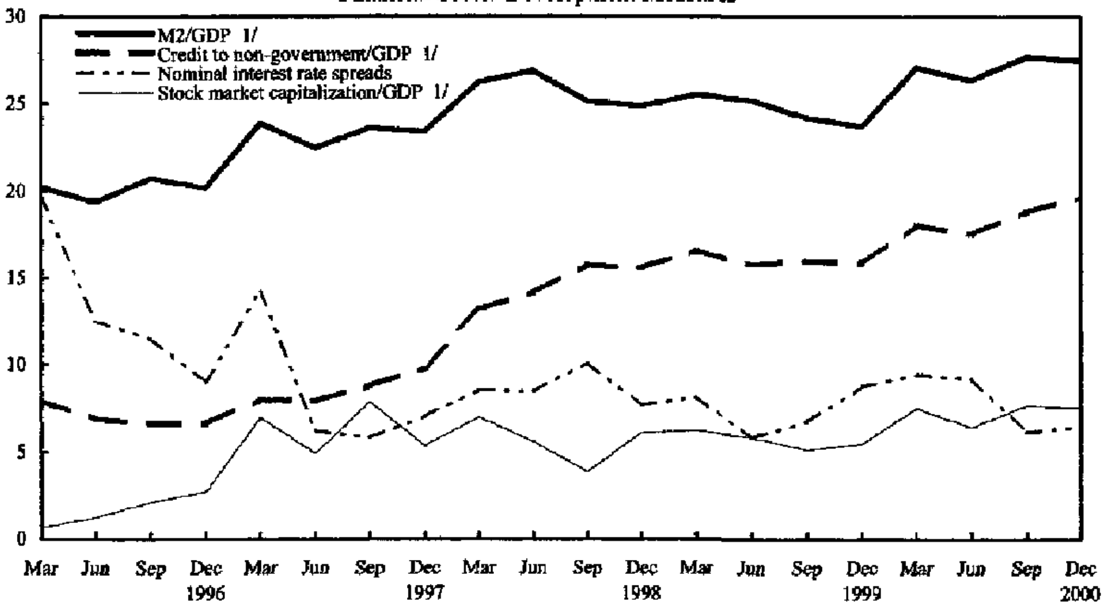
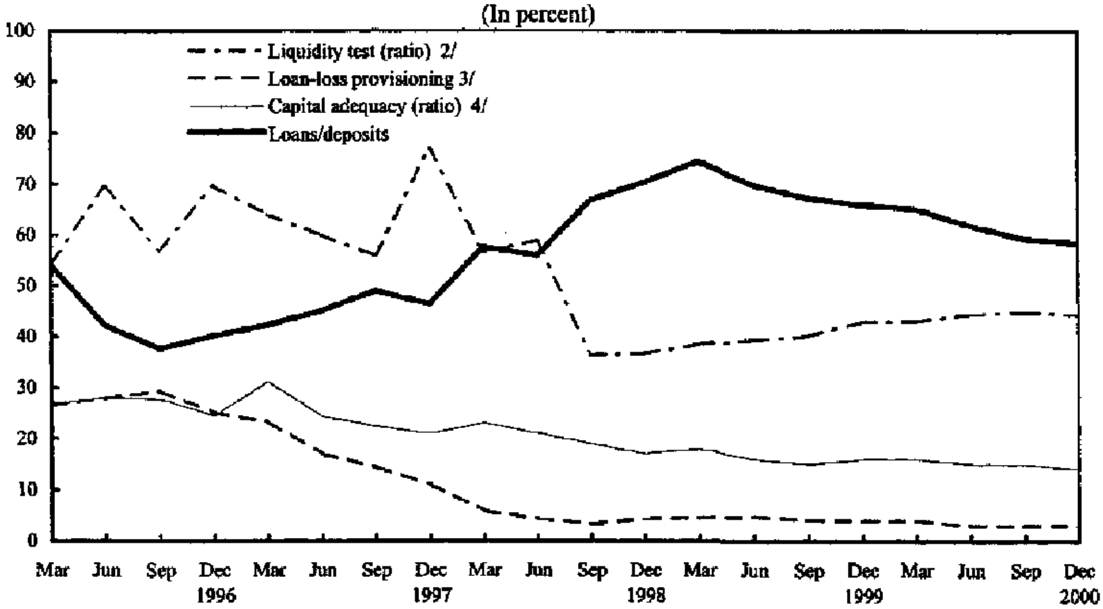
[6] The stock averaged US$86 million during the first half of 2000 but rose to US$118 million during the second half, with a peak of US$148 million at end-July 2000.

[7] In addition, in December 2000, the BoL reduced reserve requirements from 7 to 6 percent, while lowering the share of cash balances that can be counted toward reserve requirements from 50 to 40 percent. Both decisions are part of the BoL's intention to gradually reduce reserve requirements to the ECB level of 2 percent and the counting of cash balances to 0 percent.

[8] Under the proposed swap, an investor would provide foreign exchange for a bank loan in lats for an investment project approved by the Ministry of Economy. The Treasury would act as an intermediary, providing the lats to the bank via a swap facility at a subsidized rate, with the BoL serving as the Treasury's agent. The operation would also entail potential exchange rate and interest rate risks to the Treasury.

Figure 5. Latvia: Financial Sector Developments, 1996-2000





Sources: Bank of Latvia, Riga Stock Exchange, and Fund staff estimates.

1/ Annualized GDP.

2/ Liquidity test is defined as (cash+claims on the cental bank + claims on other credit institutions + fixed income government bonds - liabilities to the central bank - liabilities to other credit institutions) / deposits.

3/ In percent of total loans.

4/ For end-December, based on auditors' reports. Otherwise as reported by banks.

now close to full compliance with Basel Core Principles.[9] Preparations are proceeding well to ensure that unified financial sector supervision can begin as scheduled in July 2001. An FSAP mission visited Latvia in February 2001.

10. **Progress has been mixed on the structural front, although some momentum was gained toward year-end.** Public sector reforms—a focus of the World Bank PSAL and promoted through technical assistance from the Fund and the EU—and steps to enhance the business climate and enhance governance—derived in close consultation with foreign investors—are proceeding broadly as planned, albeit with delays in some areas. The privatization of large enterprises has lagged behind schedule, leading to the non-observance of most related structural benchmarks under the previous SBA. However, a number of important steps have been taken to restart the privatization process and help ensure its transparency. The government succeeded in hiring international advisors and in adopting the guidelines for the divestiture of the Latvian Shipping Company (LASCO),[10] which allowed the bidding process for potential strategic investors to begin in February 2001, with completion of the divestiture expected in the third quarter of 2001.[11] Similarly, international advisors were selected for the privatization of the government's remaining 38 percent stake in Ventspils Nafta (the Ventspils oil terminal) and for the negotiations with the foreign investor in Lattelekom on the relinquishing of monopoly rights in accordance with the WTO access document.[12] However, faced with the threat of a public referendum, Parliament adopted an amendment to the energy law in August 2000, prohibiting the privatization of Latvenergo. The government is pursuing other ways to liberalize the energy market and increase competition until a more favorable political climate may allow putting the privatization of Latvenergo back on the agenda.

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[9] The BoL has met the structural benchmark under the previous program for end-June 2000 to implement prudential regulations to cover the market risk, beginning with the introduction of capital requirements for the foreign exchange risk, while the Securities Market Commission (SMC) met the end-September 2000 structural benchmark on the adoption of the directive on capital adequacy and the draft law on investor protection.

[10] The guidelines envisage the sale of 68 percent of LASCO's registered capital to a foreign strategic investor; 15 percent to the general public against privatization vouchers; and 6 percent to current and retired LASCO employees against privatization vouchers. The remaining shares will be transferred to the Social Fund (10 percent) and kept as a privatization reserve (1 percent).

[11] Transparency International is, at the government's invitation, monitoring the LASCO privatization.

[12] The foreign investor has in the meantime sued the Latvian government at the International Court of Arbitration in Paris, followed by a countersuit brought by the Latvian government.

II. Program Objectives and Policies

A. Overview

11. **Following its recovery from the impact of the Russia crisis, Latvia has rejoined the path toward high and sustainable growth in a low-inflation environment reflecting, in large part, a generally appropriate mix of macroeconomic policies.** Nevertheless, the slippage in fiscal policy during the second half of 2000 gives rise to some concern, given that fiscal policy is the main instrument at the disposal of the Latvian authorities to rein in the still large external current account deficit—notwithstanding its impressive decline and its improved financing during 2000—and to reinforce Latvia's ability to withstand potential external shocks in the future. The burden on fiscal policy is compounded by the medium-term spending pressures associated with Latvia's intention to accede to the EU and NATO, as well as by the desire to reduce tax rates, including the social (payroll) tax, which is high by international standards.

12. **Against this background, the main focus of the new program will be on fiscal policy in 2001 and over the medium term, underpinned by a continuation of the successful exchange rate peg to the SDR.** The key objective will be to provide a credible framework within which the authorities' medium-term fiscal goals—a broadly balanced fiscal stance, increased expenditure for EU and NATO accession, and selective tax rate cuts—can be achieved. Such a medium-term framework would also play an important role as a signal to potential domestic and international investors of the government's intentions and is fully in line with the EU requirement to derive, and annually update, a Pre-accession Economic Programme (PEP) (Box 2).[13]

13. **The structural component under the new program will focus on three areas which are key to medium-term macroeconomic stability and growth: public expenditure policy and management, including pension reform; improvements in tax and customs administration; and financial sector supervision.** The emphasis on expenditure policy and management is critical for ensuring the necessary fiscal adjustment in the near term by improving the setting of expenditure priorities, and for bringing about durable spending reductions over the medium term. Improvements in tax administration will be instrumental in shoring up the revenue base. Further strengthening of financial sector supervision is key for limiting Latvia's vulnerability to shocks, and takes on particular importance in light of the planned move toward unified financial sector supervision in 2001.

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[13] Latvia will have to submit a PEP in May 2001 for the first time.

Box 2: Medium-Term Fiscal Challenges

The EU-mandated preparation of a Pre-Accession Economic Program (PEP) has already contributed to a more medium-term focus in the Latvian authorities' budgetary framework and the initiation of a forward-looking analysis of the budgetary trade-offs and tensions in the period ahead. The challenges facing the Latvian authorities in this regard are formidable, and the new program to be supported under the proposed stand-by arrangement is based on responding to these challenges:

- From a macroeconomic point of view, given the exchange rate regime, fiscal policy represents the only macroeconomic instrument at the disposal of the authorities to reign in the still large external current account deficit, mandating the pursuit of a tight fiscal stance aimed at achieving broad fiscal balance over the medium term.
- Private saving is expected to level off over the medium-term (see Section II.B), requiring that strong government savings are available to help finance (i) the large private sector investment needs to sustain macroeconomic growth, and (ii) the government's investment program to comply with EU accession requirements.
- Investment to comply with the EU *acquis communautaire* will be sizable—costs of meeting environmental requirements alone could amount to 2 to 5 percent of GDP annually—with the extent and timing of such spending depending heavily on the length of the transition phase being accorded to Latvia. Transfers from the EU to finance such spending could exceed 1 percent of GDP in 2001 but at best rise only moderately over the medium term, implying a significant domestic co-financing share.
- In its quest for rapid NATO membership, the Latvian government has announced its intention—in an annex to the 2001 budget law—to raise military expenditure from 1.1 percent of GDP in 2001 to 2 percent of GDP in 2003.
- At the same time, Latvia's relatively high tax burden precludes reliance on rate increases to strengthen the revenue base. To the contrary, Latvia aims to lower its taxes, especially on labor income. Such efforts have already begun—the social tax was reduced by 1 percentage point, to 35 percent, effective January 1, 2001, and a further reduction by 2 percentage points is envisaged next year—but further efforts would be desirable. Similarly, Latvia's corporate income tax, with a standard rate of 25 percent, could be detrimental to attracting foreign investors if compared to Estonia, where such tax on retained profits was abolished in 2000.
- As a result of the EU- and NATO-related spending pressures and the possible implementation of selective tax rate cuts, a further rationalization and curtailment of current spending appears unavoidable. This would keep expenditure slightly below the current level of about 40 percent of GDP over the medium term, which is still large by international standards. To address this need, Latvia is moving forward with a number of key measures to improve budgeting, expenditure management and fiscal transparency. In addition, Latvia will need to continue to improve its tax administration and broaden its tax base, including by limiting tax exemptions.

B. Macroeconomic Framework and External Sector Prospects

14. **With the unexpectedly strong resumption of growth and improvement in Latvia's external position, as well as a clearer formulation of the authorities' medium-term fiscal priorities, Latvia's medium-term macroeconomic outlook has strengthened compared to EBS/00/109** (Table 8). It is expected that the Latvian economy will continue to grow strongly and sustainably, at about 6 percent annually, over the next five years or so. This growth will be driven by exports and investment by both the private sector and the government in the run-up to EU accession. On the supply side, continued efficiency gains are expected in line with progress made on the structural front. The large investment needs in the years to come, coupled with a catch-up in private sector consumption will, however, necessitate a leveling off in the improvement of the external current account deficit, as imports will continue to grow strongly and FDI-related profit remittances are expected to rise. On the other hand, a continued strengthening of Latvia's exports to the EU, together with a diversification in the export base resulting from broad-based FDI, is projected to materialize

during the period. As FDI is projected to remain buoyant—not the least because of the forthcoming privatization of large public enterprises and the sale of new telecommunication licenses—the external current account deficit is expected to be close to fully covered by non-debt creating flows, thereby containing Latvia's already favorable external debt indicators. As pointed out in Box 1, Latvia remains competitive, but external competitiveness indicators need to be monitored carefully.

15. **The improvement in the external current account deficit over the medium term largely mirrors the expected considerable strengthening of the government's saving-investment balance, while the private sector's balance is projected to worsen slightly during the period.** In this regard, the medium-term framework is more conservative than that presented in EBS/00/109. Given developments in 2000, including the significant strengthening of private savings—following the successful rehabilitation of the banking system, the rapid development of domestic financial markets, and the improved economic environment—it might be expected that private consumption will begin to increase somewhat more rapidly.[14] However, rising incomes and the further development and sophistication of financial markets, including with the implementation of the second pillar of the pension system, should still allow private savings to rise moderately.

16. **Latvia's indicators of external and financial vulnerabilities are largely at comfortable levels** (Table 9). Nevertheless, the authorities need to carefully monitor their reserve coverage of imports so as to ensure an adequate level of reserves to support the exchange rate regime. In addition, while the ratio of gross reserves to gross short-term debt could pose a source of concern, Latvia is a net creditor to the rest of the world regarding short-term debt. With respect to financial vulnerability, the authorities need to carefully monitor the sustainability of the rapid growth in credit to the non-government sector.

17. **Sensitivity analysis suggests that Latvia's medium-term external outlook would remain sustainable in the face of moderate shocks or somewhat worse export performance, but that further fiscal consolidation remains key** (Table 10). For example, a reduction in export growth in 2001 by 4 percentage points—consistent with a decline in wood export prices by 7 percent—would imply a widening of the current account deficit by 1 percentage point of GDP and a rise of 2 percentage points in the debt-to-GDP ratio over the medium term, maintaining the debt burden at a moderate level. A permanently lower growth rate of exports, by 2 percentage points, would raise the medium-term current account deficit by 1¼ percentage points of GDP and increase debt by 3½ percentage points. However, a failure to undertake fiscal adjustment, maintaining the expenditure-to-GDP ratio at its 2000 level, would have more significant effects: the current account deficit would rise to about 8 percent of GDP, while external debt would increase from 63 percent to 77 percent of GDP

[14] The recent sharp increases in bank loans to households and in leasing contracts for consumption goods indicate that private consumption may indeed have started to accelerate.

in order to keep reserves at adequate levels. This illustrates the risk of failing to successfully reform public expenditure policy and management in the face of considerable medium-term spending pressures.

18. **With a view to sustaining growth, containing poverty, and preparing for eventual EU accession, Latvia faces the challenge of reducing unemployment.** The reasons for the persistently high, albeit declining, unemployment appear to be related to skill mismatches and lack of geographic mobility, rather than labor policy rigidities. This suggests that a continuation of policies aimed at growth and job creation, supplemented by an adequate and well-targeted social safety net and selective well-designed active labor market policies, would be appropriate (Box 3).

Box 3: Labor Market Developments

Latvia's transformation from a centrally-planned to a market economy has been associated with a dramatic reallocation of resources, from public to private as well as from industry and agriculture to services. In the initial years of transition, this restructuring, combined with a dramatic economic contraction, led to a decline in employment and labor force participation, and a sharp rise in unemployment, to a peak of 22 percent in 1995 (ILO definition). While such a rise was not unexpected, it is perhaps surprising that, despite an economic recovery—with positive growth since 1996—unemployment has remained relatively high, at around 14 percent. (Official unemployment increased gradually from virtually zero at the beginning of the transition to levels above 10 percent in April 1999, with a recent decline to less than 8 percent.) In this regard, Latvia's experience has been quite similar to that of its Baltic neighbors.

The persistently high unemployment cannot, however, be easily explained by Latvia's labor market policies and institutions—employers have considerable latitude regarding hiring, firing and work conditions, minimum wages are fairly low, and unemployment insurance is not overly generous. The economy as a whole has also proven to be quite flexible, as evidenced by the decline in public sector employment by about 60 percent between 1992 and 1999, and sizeable reallocations of labor from declining to expanding sectors.

Thus, the persistently high unemployment rate alongside a fairly dynamic economy and labor market would appear to present a puzzle. Several possible explanations suggest themselves. First, there appears to be a mismatch between the skills of a large number of unemployed, acquired prior to transition, and those required by the growing private sector. This is reflected in the large share, about 55 percent, of unemployed who are long-term unemployed. Besides the obvious impact on the well-being of the population, significant long-term unemployment could threaten political support for economic reforms, and lead to an erosion of work skills, thereby resulting in a higher natural rate of unemployment. Second, unemployment is geographically concentrated, with a number of rural regions experiencing an official unemployment rate as high as 30 percent, and regional mobility is very low. Net migration to low unemployment regions like Riga and Ventspils, was negligible during 1994-1998, and was actually negative in the latter. By contrast, several of the regions with the highest rates of unemployment, such as Rezekne, have experienced net inflows over the period. The lack of labor mobility may well reflect a social norm developed during years of central planning, and might be expected to increase over the long term. Labor mobility is also constrained, however, by the poor available housing stock, and very limited turnover, in particular in Riga.

As the high unemployment rate does not primarily reflect rigid labor policies, further reductions are likely to be only gradual. In addition, as the transformation of the economy continues, including through the completion of privatization and further restructuring on both the macroeconomic and enterprise levels, there will be continued pressure on the labor market. Therefore, it is imperative that Latvia continue to implement policies to attract investment and encourage job creation, while implementing well-targeted active labor market policies and ensuring an adequate social safety net for the poorest members of society.

C. Fiscal Policies and Public Sector Reform

19. **Fiscal adjustment is the centerpiece of the new program.** The program envisages implementation of the approved 2001 budget aiming at a fiscal deficit of 1¾ percent of GDP, which implies an adjustment of 1½ percentage points compared to 2000. The authorities plan to reduce the deficit further to around 1 percent of GDP in 2002, and move toward a balanced budget over the medium term. This fiscal stance is somewhat less tight than envisaged under the previous SBA—a deficit of 1 percent of GDP was initially planned for this year—but appears appropriate in light of the better external position and prospects and the rapid progress toward EU accession, requiring substantial expenditure.

20. **While the targeted fiscal adjustment currently appears appropriate, the authorities stand ready to further tighten fiscal policy should external or revenue developments prove adverse during the course of the year.** Accordingly, the program envisages the adoption of a negative supplementary budget, with further cuts in non-priority spending, should external risks become apparent or shortfalls in revenue occur. Further, the authorities have committed themselves to fully dedicate any central government tax revenues above those projected under the 2001 budget to further deficit reduction.

21. **The program ensures that any spending from privatization receipts or the sale of mobile phone (UMTS and GSM) licenses are undertaken within the budget process and in line with the program's deficit targets for this year and next and the authorities' medium-term fiscal plan.** The receipts from both sources could be significant, and, following last year's experience, pressure could arise that they be spent outside of the budget, for example, for large investment projects. The program envisages that all spending of any such receipts beyond the amounts budgeted are to be brought into the budget process through a supplementary budget and will count under the program ceilings for the fiscal deficit. The authorities will discuss with staff during the first review their plans for the use of these resources, including infrastructure investment projects with high social returns, with a view to ensuring that adequate resources would be available to cover future recurrent costs.

22. **The brunt of the envisaged fiscal adjustment will be on the expenditure side.** The expenditure-to-GDP ratio is projected to decline from 41 percent of GDP in 2000 to less than 39 percent of GDP in 2002. Key elements of this strategy are a freeze in civil servant wages this year, coupled with implementation of civil service reform in 2002; restraint in non-priority current spending; and moderate pension increases in line with inflation. With regard to pensions, the impact of the 1999 pension amendments will also help contain transfer payments to households. Notwithstanding the decline in overall spending, capital expenditure are projected to accelerate during the second half of 2001 and in 2002, as the inflow of EU grants gains steam in line with an expansion of Latvia's institutional capacity to implement projects related to EU accession.

23. **The envisaged reduction in the expenditure-to-GDP ratio hinges on the authorities' efforts to rationalize and better prioritize expenditure.** To this end, an array

of policies to improve the budget process and enhance expenditure management have been made part of the program (paragraphs 14 to 21).[15] This area is also a focus of the proposed World Bank PSAL II. A few key measures were defined as structural benchmarks, including steps aimed at containing the proliferation of public sector agencies and the transfer of all accounts of institutions directly financed from the budget from commercial banks to the Treasury (see Table 2 attached to the MEP).

24. **With respect to improving fiscal transparency, following a request from the authorities, a fiscal ROSC mission visited Riga in January 2001.** The authorities authorized the publication of the main findings and recommendations of the fiscal ROSC in this staff report (Box 4).

25. **Given the authorities' intention to lower labor income taxation over the medium term, efforts to improve the tax and customs administration are crucial to shoring up the revenue base.** To this end, particular efforts will be devoted to enhance the collection of excise taxes on petroleum products. Some of the most damaging loopholes for avoiding such taxation will be closed through amendments to the excise tax law (paragraph 23); adoption of such amendments by Parliament constitutes a structural benchmark under the program for end-June 2001. In addition, the State Revenue Service (SRS) will continue its program of modernization and computerization (aimed at enhancing its audit and control functions), as well as the development of Eastern border posts, regional offices, and taxpayer service centers (paragraph 22).

26. **The tax base for the corporate income tax has been eroded through a number of tax holidays and exemptions, as well as the creation of free economic zones and ports.** The program stipulates that no new exemptions be granted. In addition, it is envisaged that existing exemptions would be repealed, should shortfalls in corporate income tax receipts endanger the achievement of the overall revenue objectives under the 2001 budget. In addition, the current number of free economic zones and ports will be frozen and the tax benefits granted to these zones and ports brought in line with EU regulations.

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[15] Paragraph numbers refer to the attached Memorandum of Economic Policies.

Box 4: The Fiscal ROSC—Key Findings and Recommendations

A fiscal ROSC mission visited Latvia in January/February 2001 to help the authorities to assess compliance with the fiscal transparency module of the Report on the Observance of Standards and Codes (ROSC). The related report has been finalized, incorporating comments from the Latvian authorities, and is being circulated separately to the Executive Board.

The ROSC notes that Latvia has established many elements of a sound and transparent fiscal management system. It was one of the first transition economies to establish a treasury system, which is now considered to provide effective, reliable, and timely reporting on the state budget. Budget preparation and control are conducted in a transparent way within an annual budget framework. However, coverage of the state budget, albeit extensive, is incomplete, to a large extent because of the creation of numerous public agencies whose roles in budget-decision making are not well defined. Moreover, some spending of privatization receipts has occurred on the basis of decisions by the Cabinet of Ministers instead of being authorized under the budget law, and some fiscal activities are promoted by off-budget means, including the issuance of guarantees, tax expenditures, and quasi-fiscal activities. Information is available on some aspects of the latter type of activity, but reporting is incomplete and not well linked to the budget. In addition, the medium- and long-term implications of policy changes are not clearly explained in the budget presentation, although steps are being taken to establish a medium-term budget framework that will be required for EU accession.

The authorities recognize these weaknesses and are taking steps to address many of them through their public administration reform program. The staff commentary of the ROSC highlighted a number of possible improvements in fiscal transparency that could help achieve fiscal management goals. First, clear boundaries on government activity must be established. The adoption of the Law on Public Agencies and supporting implementation regulation is crucial in containing the proliferation of public agencies. Second, state budget coverage should be improved. All budget-financed agencies should transfer their accounts to the Treasury and be made subject to treasury reporting standards. Third, more extensive analytical information should be provided with budget and accounts documents. It was suggested that the 2002 budget should be prepared providing (i) more complete data and analysis on the sources of financing of the deficit; (ii) a more comprehensive presentation of fiscal forecasting assumptions and fiscal risks; and (iii) annexes covering contingent liabilities, tax expenditures, and quasi-fiscal activities. Fourth, although reconciliation of fiscal and monetary data were soundly based, some minor technical improvements could be made and the reconciliation included in the published reports (which has largely been addressed in the meantime). Fifth, medium-term fiscal policies need to be clearly described and monitored. The medium-term fiscal framework needs to be enhanced and, in this context, an interministerial working group was proposed to (i) prepare estimates of resources available over the medium-term and the costs of continuing existing government programs; and (ii) review all new proposed policies and make recommendations to the Cabinet of Ministers. Finally, the staff commentary emphasized the need to build up capacity in the internal and external audit system to maintain the current fiscal data quality and integrity.

27. **Notwithstanding the positive impact of the 1999 pension law amendments which sought to strengthen the financial situation of the Social Fund, additional steps need to be taken to eliminate the structural deficit of the Social Fund over the medium to long term and eliminate some actuarially unfair features of the current system.** Completion of these steps would represent a major policy achievement by the authorities. The Social Fund deficit is projected to decline from 1.3 percent of GDP in 1999 to 0.3 percent of GDP this year and to be broadly eliminated in 2002. However, demographic trends will make it necessary, over the long term, to further raise the retirement age for men and women to 65 years, following the current gradual rise in the retirement age to 62 years, which is to be completed in 2003 for men and 2008 for women.[16] The authorities intend to address this issue by late 2002. In the short run, current incentives for early retirement will be

[16] As of January 1, 2001, the retirement age for men is 61 years and for women 58.5 years.

eliminated;[17] submission of this amendment to Parliament constitutes a structural benchmark for end-June 2001. The authorities also intend to submit to Parliament amendments to allow working pensioners to keep their full pensions, which, while desirable on labor market efficiency grounds, may impose some short-term net fiscal costs. The exact modalities of both measures will be subject to discussions between the authorities and the World Bank in the context of the PSAL, which are expected to be completed by end-April 2001.

D. Exchange Rate and Monetary Policies

28. **The SDR peg continues to be appropriate, in particular given that Latvia has maintained its external competitiveness, notwithstanding the appreciation of the lats against the euro** (see Box 1). This is also confirmed by the absence of any significant pressure on the exchange rate during last year. However, the maintenance of the exchange rate peg until EU accession[18] is predicated on the conduct of sufficiently tight macroeconomic policies, and a continued close monitoring of key indicators of external competitiveness.

29. **The quarterly monetary program for 2001 is aimed at supporting the exchange rate peg.** The monetary program is based on a moderate inflation projection, as well as a continued rise in money demand and the money multiplier in view of a further gradual strengthening of the banking system and the economy more generally. The BoL will contain the expansion of its net domestic assets, implying a growth rate for reserve money of no more than 13 percent in 2001.[19] Broad money is projected to rise by 27 percent, with growth of credit to the nongovernment sector abating somewhat to about 29 percent compared to the rapid 37 percent expansion in 2000. These broad trends are expected to continue in 2002.

30. **In its conduct of monetary policy, the BoL will rely increasingly on open market operations for the provision of liquidity while curtailing its use of short-term foreign exchange swaps.** This move will be facilitated by the availability of suitable collateral for repo and other refinance operations, as the government now regularly issues medium-term

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[17] At present, it is possible to claim early retirement up to two years prior to reaching the official retirement age. The early retiree receives a pension that is reduced by 20 percent but raised to the normal pension level once the official retirement age is reached.

[18] As discussed in EBS/00/109, Latvia intends to shift to a euro peg at the time of its accession to the EU. The EU considers the existing institutional framework leading to the eventual adoption of the euro sufficiently flexible to accommodate different exchange rate regimes prior to accession, including Latvia's current peg to the SDR.

[19] While such reserve money growth may appear large compared to the respective growth rate in 2000, the latter is somewhat distorted by the end-1999 liquidity injection to accommodate banks' demands for lats to guard against potential Y2K-related problems (see EBS/00/109).

bonds, in addition to short-term debt instruments.[20] In addition, the role of the two-year foreign exchange swaps in creating liquidity will be contained by the BoL's commitment to phase out this instrument before end-March 2002, reflecting its assessment that the swaps have served their intended function of contributing to the broader availability of long-term credits in lats.[21] As a first step in this direction, the BoL will reduce the monthly auction volume by half, to LVL 5 million, in April 2001. In the same vein, the authorities agreed not to pursue further any proposals to introduce five-year foreign exchange swaps with participation of the Treasury. With a view to containing the growth of NDA and reducing past volatility in monetary expansion, the BoL and the Treasury will closely coordinate with respect to the government's plans to issue securities in excess of its immediate financing needs. The BoL will purchase only the limited amounts of such securities in the secondary market required to ensure a sufficient reserve for potential open market operations—thereby avoiding the perception that it is artificially lowering the government's borrowing costs—while the government will keep most of its excess financing in its central bank accounts.

31. **The monetary program will be monitored based on performance criteria on NIR and NDA of the BoL, as well as indicative ceilings for reserve money and NDA of the banking system.** However, in view of practical considerations and the special role played by foreign exchange swaps, the definition of performance criteria is altered compared to the previous SBA and brought in line with the practice in other Fund programs, such as with Korea.[22] The new treatment is intended to fully capture the liquidity-creating effect of the

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[20] The government intends to pursue a reliable schedule in its issuance of bonds so as to further foster the deepening of domestic financial markets and provide a benchmark for the emergence of private debt instruments, although such issuance will be in excess of its immediate financing needs. To this end, it intends to generally auction five-year bonds in January and three-year bonds in November each year.

[21] This can be observed, for example, in the emergence of 20-year mortgages with a fixed interest rate of up to 5 years.

[22] The quarterly monetary program (Table 5) includes a projected quarterly increase of US$15 million in foreign exchange swaps. However, the performance criteria on NIR and NDA of the Bank of Latvia are set on the basis of a scenario in which NIR is lower and NDA higher by the assumed cumulative quarterly increase of swaps under the monetary program. Any accumulation or decumulation of swaps compared to the outstanding stock of such swaps at end-December 2000 will result in an upward/downward adjustment of the NIR target and a downward/upward adjustment of the NDA target. Following past practice, the NIR targets also entail a cushion of US$100 million to allow for short-run interventions. The approach ensures balance sheet consistency (excluding the cushion) and leaves the BoL with a cushion of US$100 million as long as it does not increase swaps beyond the projected amounts under the monetary program.

foreign exchange swaps and provide an incentive for the BoL to curtail its reliance on this policy instrument in the provision of liquidity in favor of open market operations.

E. Financial Sector Reform

32. **The authorities will take the few remaining steps to bring their prudential framework for financial sector supervision fully in line with best international practices.**[23] To this end, they will ensure that the Financial and Capital Markets Commission (FCMC) will be fully operational by July 1, 2001 (Box 5). They will also adopt a variety of changes to the Law on Credit Institutions (LCI) regulating the so-called "close links" of banks with domestic and overseas third parties (including affiliated companies), as well as transactions with such parties, and embark on an overhaul of the LCI during the program period (paragraph 30). Based on the findings of the FSAP mission that visited Riga in February 2001, additional measures to enhance the prudential framework may be identified that could be integrated into the program at the time of the first review.

33. **It is crucial that the authorities continue monitoring closely commercial banks and rigorously applying the existing prudential framework.** While the rapid expansion of credit to the non-government sector in 2000 appears to have been accompanied by the adequate use of collateral and an appropriate level of loan loss provisioning, and non-performing loans as a share of total loans have declined by 1½ percentage points to 4.6 percent during 2000, continued vigilance is key. Staff also impressed on the authorities the need to continuously monitor the large inflows of deposits from non-residents, whose share has risen to 51 percent of all deposits. While it appears that these inflows as such do not threaten the stability of the banking system—they are primarily invested in liquid OECD country papers—the authorities need to ensure that anti-money laundering laws and regulations (including the recently adopted "know your customer rules") are strictly enforced so as to not jeopardize the reputation of Latvia's banking system.

[23] See EBS/00/109 for a preliminary assessment of the BoL's compliance with the Basle Core Principles for Effective Banking Supervision; and SM/00/123 for a preliminary assessment of deficiencies in the supervision of nonbank financial institutions.

Box 5: Unified Financial Sector Supervision

After several years of preparatory work to create a unified financial sector regulatory authority—supported by technical assistance from the World Bank and the Government of Sweden—the law on the creation of the Financial and Capital Markets Commission (FCMC) was passed in June 2000. The FCMC, which will begin operations on July 1, 2001, will unify the supervision of the banking sector with that of securities markets, insurance companies, and pension funds, and also manage the deposit guarantee fund.

The amalgamated supervisory agency is intended to provide valuable synergies in monitoring the activities of the entire financial sector, thereby improving the effectiveness of the regulatory framework and the efficiency of consolidated supervision. Fund staff's concerns in the past focused on ensuring that (i) adequate safeguards against interference from outside are put in place by guaranteeing the FCMC's political and operational independence; and (ii) the existing high quality standards established by the BoL in supervising the banking system are not diluted. In addition, Fund staff pointed to the possibility of a potential conflict of interest in the administration of the deposit insurance fund by the FCMC.

These concerns appear to have been largely taken into account. The Law on the FCMC largely ensures the agency's political independence through a variety of strict provisions on the appointment and dismissal of its leadership. A first test of such independence occurred during the selection process of the agency's first chairman. When the first nominee was rejected by Parliament, the former chairman of the Riga Stock Exchange—who enjoys a solid reputation in the industry—was nominated and, in the end, appointed. The FCMC's operational independence is guaranteed through an adequate definition of its regulatory objectives; the availability of regulatory powers, such as regarding licensing; and self-sufficiency in its financing. Nevertheless, reaching an appropriate balance between operational independence and accountability, as well as setting the short- and long-term objectives of the new agency, are important challenges facing the FCMC leadership.

Concerns that high quality staff from the BoL's banking supervision department would leave in view of the uncertainties related to the transition phase, appear to have been unfounded, as—with only a few exceptions—BoL staff are moving to the new agency. Nevertheless, the first few months after the new regulator begins operations will prove crucial in establishing a track record with the various arms of the industries to be regulated.

To ensure a smooth transition in the unification process, a strategic plan is being implemented, outlining measures to achieve operational efficiency and a rapid integration of supervisory functions, which will be instrumental in ensuring that the relevant international supervision standards are being met. The authorities decided to follow a functional rather than industry-based organization model to ensure that synergies in the operational work of the agency can be fully utilized. As a result, they envisage setting up a supervision department, a legal and licensing department, and a methodology and statistics department. It needs to be pointed out, though, that starting with a functional organization from the beginning may prove difficult; other countries needed quite some time to merge the industry pillars of the unified agency into a properly working functional organization.

In the next few months, it is imperative that key decisions be taken on the staffing (especially at the senior level), the decision-making processes, crisis management strategies, and public relations aspects. In addition, the relationship between the BoL and the FCMC and the role and responsibilities of the FCMC with regard to deposit insurance need to be defined.

F. Structural and Trade Policies

34. **Further progress in structural reforms and improvements in governance and in the business climate are instrumental to ensuring an environment conducive to private sector activity and attracting FDI.** A number of important measures not subject to conditionality under the program[25] are being undertaken by the authorities in these areas, notably the privatization of the remaining large public enterprises; improvements in the legal and regulatory framework for utilities; enhancement of competition in the energy sector; and a wide array of steps aimed at removing barriers for business activity, improving the judicial system, cutting red tape, and fighting corruption (paragraphs 32 to 38).

35. **Latvia maintains a very liberal trade system and has received the highest ranking in the Fund's Index of Trade Restrictiveness.** The authorities will ensure that their trade legislation continues to follow WTO rules and agreements (paragraph 39). Latvia has concluded its negotiations with the EU on trade policy and is currently considered to fully comply with EU requirements, with no need for a further change in tariffs until it accedes to the EU. The authorities intend to keep their tariffs at or below EU levels[26] and refrain from increasing any *ad valorem* tariffs and introducing any new specific tariffs or export subsidies during the program period.

III. Access Under the SBA and Capacity to Repay the Fund

36. **As stated above, access under the successor arrangement is proposed at SDR 33 million (equivalent to 16 percent of quota on an annual basis).** While in the absence of a financing need the authorities have indicated that they will treat the new SBA as precautionary, a financing need could emerge if the growth of exports to the EU were to slow substantially, e.g., as a result of a renewed depreciation of the euro, or the recent surge in FDI were to be reversed. While larger access could be justified, the authorities indicated that they want to keep access at the same low level as under the previous SBA because of cost considerations. The proposed schedule of disbursements can be found in Table 11.

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[25] Some of these measures would be subject to conditionality under the proposed World Bank PSAL II.

[26] Currently, all tariffs are at or below EU levels if tariffs on product groups at the 4-digit level under Latvia's Combined Commodity Nomenclature are considered, but at more disaggregated levels, there are a few Latvian tariffs above EU levels. However, it should be noted that a comparison of such tariffs with EU levels is difficult since Latvia, with one exception, applies *ad valorem* tariffs, while EU tariffs, in general, are a combination of specific and *ad valorem* tariff rates.

37. **In view of Latvia's good record in servicing its obligations to the Fund, it can be expected that all future payments will be made according to schedule.** Debt service to the Fund is expected to peak in 2004, but will account for less than ½ percent of exports through 2006 (Table 12). This reflects in part the very low access relative to overall financing requirements (less than 3 percent) envisaged in the program (Table 13).

IV. Program Monitoring

38. Implementation of the program will be monitored through a set of quantitative performance criteria, as specified for 2001 in Table 1 of Attachment II, and a set of structural benchmarks, as specified in Table 2 of Attachment II. Progress with program implementation will be assessed through two reviews. The first review, during which quantitative performance criteria and possible additional structural benchmarks for end-March and end-June 2002 will be established, is expected to coincide with the 2001 Article IV consultation discussion and to be concluded by end-November 2001. Performance criteria for end-September 2002 and possible additional structural benchmarks will be specified at the time of the second program review, which is scheduled to be completed by end-May 2002.

V. Staff Appraisal

39. **Latvia's economy has emerged from the economic recession triggered by the Russian crisis with positive prospects for the future.** Strong economic growth has resumed and is broad-based, driven by private investment and a buoyant export performance, notwithstanding the appreciation of the lats vis-à-vis the euro. Inflation is close to the levels prevailing in the EU. In addition, the banking system has impressively regained its soundness and, helped by the acquisition of major banks by strong foreign partners, is playing an increasingly important role as a true financial intermediary for the domestic economy. The prudential framework was brought in line with international standards, and financial markets in general are deepening and expanding rapidly. Progress has been made toward completing the structural reform agenda and reinforcing Latvia's capacity to weather the competitive pressures once it accedes to the EU.

40. **In addition, Latvia's vulnerability to external shocks has lessened.** The doubling of the external current account deficit in the wake of the Russian crisis was substantially reversed in 2000, and prospects are such that a further gradual lowering of the deficit over the medium term is likely to materialize, provided that appropriate macroeconomic policies are pursued. In addition, the recent surge in FDI bodes well for ensuring that the external current account deficit will continue to be covered, to a very large extent, by non-debt creating flows, thereby maintaining Latvia's external debt indicators at moderate levels. Such excellent performance is particularly noteworthy in view of the difficult external environment marked by the appreciation of the lats vis-à-vis the euro and rising oil prices, as well as the delays experienced in divesting of the large-scale public enterprises to foreign investors. Nevertheless, there is no room for complacency, given that the external current account

deficit is still quite large. Further, export diversification is still insufficient, with timber exports accounting for more than one-third of all exports.

41. **While macroeconomic policies have been generally appropriate over the last two years, the fiscal slippage in the second half of 2000 gives rise to some concern.** This slippage prevented completion of the discussions for the second review under the previous stand-by arrangement. While some of the fiscal underperformance was due to unexpected revenue shortfalls, the additional spending undertaken last year represented an unwarranted loosening of fiscal policy, and the expenditure taken outside of the budget was particularly troubling. Staff calls on the authorities to keep spending within the budget authorizations so as to not jeopardize the economic recovery and the external prospects, as well as to maintain Latvia's credibility with international investors. In addition, continuing spending outside of the budget process would raise increased concerns about a lack of fiscal transparency.

42. **Latvia's medium-term fiscal challenges are formidable, and nowhere is the government's role in ensuring macroeconomic stability and external sustainability more critical than in the area of fiscal policy.** Staff, therefore, welcomes the authorities' intention to move toward a broadly balanced budget over the medium-term, beginning with a sizable fiscal adjustment in 2001. Adherence to the approved budget for 2001 and the quarterly fiscal targets under the program, as well as adoption of a budget for 2002 with a deficit of no more than 1 percent of GDP, are crucial to reigning in the still-large external current account deficit. In addition, the envisaged curtailing of low-priority spending will generate an improvement in government savings needed to cope with the investments mandated by the EU *acquis communautaire* and expenditure related to NATO accession over the medium term, and to provide sufficient room for the private sector's investment demands. The authorities' recent heightened attention to these medium-term budgetary trade-offs and tensions—including also their intention to possibly implement selective tax rate cuts—has raised their awareness of the need to critically assess all current spending programs and reprioritize their future spending decisions.

43. **In this context, staff urges the authorities to implement the public sector reforms under the program.** Such measures are key to bringing about durable spending reductions over the medium term, thereby allowing the government to pursue its intended fiscal adjustment path. But they will also be instrumental in enhancing the transparency and efficiency of the budget process; strengthening expenditure management and procurement practices; restricting the role of public sector agencies; streamlining the role of subnational governments; and modernizing the civil service.

44. **In the same vein, efforts to improve tax and customs administration, close tax loopholes, and broaden the tax base need to be intensified.** Such endeavor will safeguard the tax base, and gains increased importance in light of the authorities' intention to lower taxes on labor income, especially the social tax. In particular, tax benefits to special economic zones and free ports need to be streamlined and the revenue impact of the new exemptions granted under corporate income tax law closely monitored. Staff strongly urges the

authorities not to grant any new exemptions and to repeal existing exemptions if their impact jeopardizes the revenue targets under the program. A broader corporate income tax base would also facilitate a lowering of the standard 25 percent tax rate should such a step be envisaged to respond to tax competition from neighboring countries.

45. **Pension reform has succeeded in placing the financial position of the Social Fund on a more solid footing, at least over the short- to medium-term.** Staff calls on the authorities to complete this reform project expeditiously so as to ensure the long-term viability of the pension system and adequate pension income. To this end, staff urges the authorities to eliminate as planned the current incentives for early retirement. In addition, further raising the retirement age will be a key task which the authorities should embark upon no later than 2002 to allow workers adequate time to adjust their labor and savings decisions. Finally, staff commends the authorities for being on track in ensuring that the second fully-funded pension pillar will become operational in July of this year.

46. **The exchange rate peg to the SDR has provided Latvia with a reliable anchor for the past seven years and continues to be appropriate in the current external environment.** Staff and the authorities agree that such peg could be maintained until Latvia accedes to the EU in a few years' time provided that macroeconomic policies are kept sufficiently tight. Staff encourages the authorities to continue to monitor the key indicators of external competitiveness so as to ensure that the current peg remains sustainable.

47. **The BoL's monetary policy has been successful in supporting the exchange rate peg and should be continued.** Staff welcomes the BoL's return to a more predictable and less volatile conduct of monetary policy in the second half of last year and the enhanced coordination between the BoL and the Treasury in projecting the government's cash flow, including from the issuance of medium-term government securities in excess of the government's immediate financing needs. Staff strongly supports the BoL's decision to reduce its reliance on short-term foreign exchange swaps in controlling commercial banks' liquidity and to take more recourse to repo and other refinance operations instead. In the same vein, staff is pleased with the BoL's commitment to phase out long-term foreign exchange swaps within a year's time and the authorities' decision to refrain from introducing the proposed five-year swaps with participation of the Treasury.

48. **Key financial indicators point toward a considerable strengthening of the Latvian financial sector.** The entry of strategic foreign investors in several of the major banks and possible mergers among key players in the market are likely to further strengthen the banking system and make it more resilient to exogenous shocks. Staff commends the BoL for having almost completed its efforts in bringing its prudential framework into full compliance with international supervisory standards. Nevertheless, continued vigilance is crucial in enforcing this framework, monitoring the inflow of non-resident deposits, and ensuring that the rapid expansion of credit to the non-government sector remains sustainable. Staff is satisfied that its earlier concerns on safeguarding the independence of the FCMC and

maintaining adequate staff quality have been taken into consideration, which bodes well for ensuring a smooth transition period.

49. **Building on the progress so far, structural reforms remain essential to achieve Latvia's medium-term goals and reduce further its vulnerability to external shocks.** Staff calls on the authorities to persevere in the implementation of these reforms, most notably in the area of large-scale privatization and regarding measures aimed at improving governance and the business climate. Such efforts will foster an environment conducive to private sector activity and help attract FDI.

50. **Latvia has a stellar record in maintaining an open and liberal trade system, bringing its trade legislation in line with WTO and EU rules and agreements, and keeping its tariffs at or below EU levels.** Staff commends the authorities for their reaffirmation not to deviate from this path.

51. **While the program targets are achievable, the program is subject to several risks.** First, fiscal adjustment is at the core of the program, and any deviation from the targeted path may undermine Latvia's external prospects and give rise to increased external vulnerability. In this context, delays in the implementation of public sector reforms may make the necessary reprioritization of expenditure—in the face of newly emerging spending pressures mandated by EU and NATO accession—difficult to achieve. Second, adverse external developments, such as a renewed depreciation of the euro, or sharply falling export prices for Latvia's key export products, could erode Latvia's external competitiveness and growth prospects, which may pose additional challenges for economic policy-making. Third, with the strong resumption of economic growth, a consumption boom could materialize, which may require more fiscal adjustment than currently envisaged under the program. Finally, while systemic risks in the banking system appear unlikely, some current developments, such as the rapid credit growth and the large share of non-resident deposits, should be carefully monitored.

52. **Overall, the staff supports the authorities' request for a new stand-by arrangement.**

Table 1. Latvia: Selected Economic and Financial Indicators, 1996–2001

	1996	1997	1998	1999	2000 Est.	2001 Proj.
(Annual percentage changes unless otherwise specified)						
National income						
Nominal GDP (millions of lats, estimates for 2000)	2,829	3,276	3,590	3,897	4,317	4,700
GDP (millions of $US)	5,137	5,639	6,086	6,662	7,118	7,681
Real GDP	3.3	8.6	3.9	1.1	5.5	6.0
Registered unemployed (in '000, end of period)	90.8	84.9	111.4	109.5	92.3	...
Unemployment rate (end of period)	7.2	7	9.2	9.1	7.8	...
Prices and wages (annual change)						
Consumer price index (period average)	17.6	8.4	4.7	2.4	2.7	2.3
Consumer price index (end-period)	13.1	7.0	2.8	3.2	1.8	3.0
Producer price index (end-period)	13.7	4.1	1.9	-1.1	1.1	...
Real wage (growth rate)	-5.3	11.2	6.2	3.5	...	...
Average monthly wage (in lats)	99	120	133	141	...	...
General government (in percent of GDP)						
Revenue 1/	37.4	41.3	42.6	40.0	37.5	37.5
Expenditure	39.0	40.7	43.3	43.8	40.9	38.9
Net lending	0.2	0.3	0.1	0.2	0.0	0.3
Fiscal balance 1/	-1.8	0.3	-0.8	-3.9	-3.3	-1.7
Gross government debt (millions of lats)	408	392	377	505	570	...
Gross debt as percentage of GDP (in percent)	14.4	12.0	10.5	13.0	13.2	...
Foreign debt (millions of lats)	227	218	232	358	347	...
External sector						
Current acct. balance (incl. official transfers, percent of GDP)	-4.2	-5.1	-9.8	-9.7	-7.2	-6.3
External trade balance (percent of GDP) 2/	-15.5	-15.0	-18.6	-15.4	-15.0	-14.5
Exports						
Value	8.8	23.6	9.4	-6.1	9.4	11.7
Imports						
Value	17.4	17.5	17.0	-7.2	7.5	9.3
CPI-based real exchange rate indices (1994=100)						
INS weights	101.4	105.9	134.2	141.6	...	...
International reserves (in months of imports of goods and nonfactor services, end-of-period)	3.1	3.0	2.7	3.1	2.8	2.9
Exchange rate (lats per $US; end-of-period)	0.56	0.59	0.57	0.58	0.61	...
Exchange rate (lats per $US; period average)	0.55	0.58	0.59	0.59	0.61	...
Money and credit (end-period, change in percent)						
Reserve money	25	30	7	12	8	13
Domestic credit (non-government)	1	76	59	15	37	29
Broad money	20	39	6	8	28	27
Ratio of broad money to NFA of the BoL	1.8	2.0	1.7	1.9	2.4	2.6
Riga Stock Exchange Price Index, RICI, (end-of-period)	417	741	186	171	176	...
Interest rates (in percent, per annum, end-period)						
Deposit 3/	11.0	6.0	7.0	6.0	4.9	...
Credit 3/	20.0	13.0	15.0	15.0	11.3	...
Three-month treasury bill auction rate	10.8	4.0	7.9	5.1	4.5	...

Sources: Latvian authorities and Fund staff estimates and projections.

1/ Privatization receipts are classified as a deficit financing component, i.e. they are excluded from revenues.

2/ Goods only.

3/ Average volume-weighted commercial bank interest rates on 3-6 month domestic currency transactions.

Table 2. Latvia: Quantitative Performance Criteria and Structural Benchmarks Under the Previous Stand-By Arrangement, 1999-2000 1/

Variable and Periods		Adjusted		Outcome (Prel.)
				(In millions of lats)
I. Limits on the general government fiscal deficit 2/				
January 1, 1999-September 30, 1999: Indicative		114		88
January 1, 1999-December 31, 1999: Performance criterion		159		153
January 1, 2000-March 31, 2000: Performance criterion		26		11
January 1, 2000-June 30, 2000: Performance criterion		49		57
January 1, 2000-September 30, 2000: Performance criterion		56		83
January 1, 2000-December 31, 2000: Performance criterion		75		143
II. Limits on net domestic assets of the Bank of Latvia 3/				
September 30, 1999: Indicative		-28		-28
December 31, 1999: Performance criterion		-24		3
March 31, 2000: Performance criterion		-7		-42
June 30, 2000: Performance criterion		17		-27
September 30, 2000: Performance criterion		22		12
December 31, 2000: Performance criterion		37		25
				(In millions of US$)
III. Floor on convertible net international reserves of the Bank of Latvia 4/				
September 30, 1999: Indicative		724		824
December 31, 1999: Performance criterion		804		898
March 31, 2000: Performance criterion		815		881
June 30, 2000: Performance criterion		803		864
September 30, 2000: Performance criterion 5/		671		729
December 31, 2000: Performance criterion		687		700
IV. Cumulative limits on contracting and guaranteeing of medium- and long-term nonconcessional external debt 6/	Total	Of which: 1-5 year maturity	Total	Of which: 1-5 year maturity
From June 30, 1999 to:				
September 30, 1999: Indicative	150	100	30	0
December 31, 1999: Performance criterion	285	200	114	80
March 31, 2000: Performance criterion	435	200	155	80
June 30, 2000: Performance criterion	565	200	155	80
September 30, 2000: Performance criterion	565	200	164	80
December 31, 2000: Performance criterion	565	200	195	80
V. Limits on external government debt of up to one year 7/				
September 30, 1999: Indicative		0		0
December 31, 1999: Performance criterion		0		0
March 31, 2000: Performance criterion		0		0
June 30, 2000: Performance criterion		0		0
September 30, 2000: Performance criterion		0		0
December 31, 2000: Performance criterion		0		0

Table 2. Latvia: Quantitative Performance Criteria and Structural Benchmarks Under the Previous Stand-By Arrangement, 1999-2000 1/

Variable and Periods	Adjusted	Outcome (Prel.)
	(In millions of lats)	
VI. Indicative limits on reserve money		
September 30, 1999:	450	450
December 31, 1999:	499	526
March 31, 2000:	523	483
June 30, 2000:	539	491
September 30, 2000:	555	534
December 31, 2000:	579	567
VII. Indicative limits on net domestic assets of the banking system 3/		
September 30, 1999:	531	531
December 31, 1999:	564	633
March 31, 2000:	594	653
June 30, 2000:	639	668
September 30, 2000: 8/	660	604
December 31, 2000:	696	737
VIII. Indicative floors on central government revenue 9/		
January 1, 1999-September 30, 1999:	894	887
January 1, 1999-December 31, 1999:	1235	1209
January 1, 2000-March 31, 2000:	290	291
January 1, 2000-June 30, 2000:	605	607
January 1, 2000-September 30, 2000:	943	908
January 1, 2000-December 31, 2000:	1290	1225

IX. Structural benchmarks under the program

By end-December 1999:	
1. Cabinet of Ministers to approve the method of privatization and timetable for Latvenergo.	Met on February 15, 2000
2. Enact the Law on Concerns, as described in paragraph 23 of the MEP dated November 10, 1999.	Met on March 24, 2000
3. Complete functional reviews for two ministries, as described in paragraph 11 of the MEP dated November 10, 1999.	Met
By end-January 2000:	
1. Implement the prudential regulations on loan classification and loan-loss provisioning.	Met
2. Complete the sale of 44 percent of government-owned shares in the Latvian Shipping Company to a strategic investor.	Not met

Table 2. Latvia: Quantitative Performance Criteria and Structural Benchmarks Under the Previous Stand-By Arrangement, 1999-2000 1/

By end-March 2000:	
1. Enact legislation providing the basis for the implementation of the second pillar of the pension system.	Met
2. Approve prudential regulations to cover the market risk, in line with the Basle Core Principles of Effective Banking Supervision and the relevant EU Directive.	Met
3. Sell additional government-owned shares in the Latvian Shipping Company to make the government a minority shareholder.	Not met
4. Enact the new Commercial Code, as described in paragraph 24 of the MEP dated November 10, 1999.	Met on April 13, 2000
5. Amend legislation to eliminate tax benefits to special economic zones and free ports that are inconsistent with EU regulations.	Not met
By end-June 2000:	
1. Enact the Civil Service Law and adopt a new public sector wage scale, as described in paragraph 11 of the MEP dated November 10, 1999.	Partially met
2. Submit to Parliament the Law on Public Sector Agencies, as described in paragraph 11 of the MEP dated November 10, 1999.	Met
3. Make effective the law reducing agricultural tariffs as described in paragraph 21 of the MEP dated November 10, 1999.	Met
4. Implement the prudential regulations to cover the market risk.	Met
5. Enact a telecommunications law, as described in paragraph 23 of the MEP dated November 10, 1999.	Not Met
By end-September 2000:	
1. The Bank of Latvia to divest its investment in Rīgas Komerc Banka (RKB).	Met
2. Reduce all tariff rates above EU levels to EU levels or below, to become effective January 1, 2001.	Met
3. Hire international advisors for the divestiture of the Latvian Shipping Company (LASCO) and Latvenergo, as agreed with the World Bank.	Partially met
4 . The Securities Market Commission to adopt the directives on capital adequacy and investor protection, for implementation by January 1, 2001.	Met
By end-December 2000:	
1. Complete the restructuring of Latvenergo, as described in paragraph 17.	Not met
2. Submit to parliament amendments to the pension law, as described in paragraph 12.	Not met

Table 2. Latvia: Quantitative Performance Criteria and Structural Benchmarks Under the Previous Stand-By Arrangement, 1999-2000 1/

1/ *Definitions of the performance criteria and indicative targets are included in the Annexes to the Supplementary* Memorandum of Economic Policies. In addition to the performance criteria specified in the table, a continuous performance criterion on the non-accumulation of external arrears by the government applies. The performance criteria for end-September and end-December 2000 were established at the time of the first review.

2/ The limits on the general government fiscal deficit will be adjusted upward (downward) for any excess (shortfall) of disbursements of foreign project financing from programmed levels, and downward by the amount by which the central government revenue exceeds the indicative targets mentioned under VIII (see Annex I of MEP).

3/ The limits will be adjusted upward (downward) for any shortfall (excess) of disbursements of foreign balance of payments assistance from programmed levels (see Annex II of MEP). The shortfall was US$ 45 million for end-June 2000.

4/ The floors will be adjusted downward (upward) for any shortfall (excess) in disbursements of foreign balance of payments assistance from programmed levels (see Annex III of MEP). The shortfall was US$ 45 million for end-June 2000.

5/ As of September 30, 2000, the program definition excludes gross international reserves generated from foreign exchange swaps (see Annex III of MEP).

6/ Applies to the government, the Bank of Latvia, or any other agencies acting on behalf of the government.

7/ Excluding normal import-related trade credits.

8/ As of September 30, 2000, the program definition includes foreign equity of commercial banks, which is recorded in "other net assets" (see Annex III of MEP).

9/ Includes all central government revenues from the basic and social budgets, excluding fee and service revenue that can be spent by ministries without assignation (see Annex I of MEP).

Table 3. Latvia - Balance of Payments, 1999-2006

	1999	2000	2001	2002	2003	2004	2005	2006
		Est.			Projections			
				(In millions of U.S. dollars)				
Current Account	-646	-512	-487	-484	-514	-535	-549	-575
excluding official transfers	-707	-539	-554	-577	-626	-671	-712	-763
Goods	-1,027	-1,068	-1,115	-1,205	-1,309	-1,402	1,482	-1,602
Exports	1,889	2,067	2,309	2,608	2,893	3,211	3,571	3,904
Imports	-2,916	-3,135	-3,425	-3,812	-4,201	-4,613	-5,054	-5,507
Services	336	467	526	603	669	736	817	905
Transportation	522	573	609	658	716	771	836	911
Travel	-151	-111	-116	-117	-118	-119	-118	-116
Other	-35	5	34	62	71	83	99	110
Income	-48	-3	-31	-43	-57	-78	-122	-142
Current transfers	93	92	134	162	183	208	238	205
Official	61	27	67	93	113	136	163	138
Private	32	65	67	69	71	73	75	77
Capital and Financial Account	806	507	607	594	635	691	751	712
Capital Account	13	22	24	26	29	31	34	37
Financial Account	794	485	583	568	606	660	717	675
Direct Investment	331	380	411	442	432	467	504	460
Portfolio investment	284	-128	-96	-106	-116	-125	-141	-155
of which General government	201	0	0	0	0	3	0	0
Other Investment	179	233	267	232	290	318	354	369
of which General government	29	17	74	-4	20	17	21	13
Errors and omissions	5	15	0	0	0	0	0	0
Overall Balance, Net reserve assets	165	10	120	111	121	156	202	137
				(In percent of GDP, unless otherwise indicated)				
Memorandum items:								
Current account balance	-9.7	-7.2	-6.3	-5.8	-5.7	-5.4	5.1	-4.9
excluding official transfers	10.6	-7.6	-7.2	-6.9	-6.9	-6.8	-6.6	-6.6
Trade balance	-15.4	-15.0	-14.5	-14.4	-14.4	-14.2	-13.8	-13.6
Merchandise exports	28.4	29.0	30.1	31.2	31.9	32.6	33.3	33.6
Merchandise imports	-43.8	-44.0	-44.6	-45.6	-46.3	-46.8	-47.2	-47.3
Services, income & transfers balance	5.7	7.8	8.2	8.6	8.8	8.8	8.7	8.8
Gross official reserves (millions of US$)	944	919	1,029	1,130	1,241	1,392	1,594	1,732
in months of GNFS imports	3.1	2.8	2.9	2.9	2.9	3.0	3.1	3.1
Value growth of merchandise exports (percent)	-6.1	9.4	11.7	12.9	10.9	11.0	11.2	9.3
Value growth of merchandise imports (percent)	-7.2	7.5	9.3	11.3	10.2	9.8	9.5	9.0
Terms of Trade (percent)	1.8	-2.4	0.8	1.1	-0.3	0.0	-0.4	-2.2
Net FDI / Current Account, percent	51	74	85	91	84	87	92	80
External public debt (millions of US$) 1/	708	704	768	755	765	780	801	814
in percent of GDP	10.6	9.9	10.0	9.0	8.4	7.9	7.5	7.0
Public debt service (in percent of exports) 1/	4.2	7.4	4.2	4.2	4.0	10.1	3.2	3.2
External debt								
in millions of US$	3,850	4,520	4,998	5,455	5,992	6,577	7,216	7,877
in percent of GDP	57.8	63.5	65.1	65.3	66.0	66.7	67.4	67.7
of which: short-term (in millions of US$)	2,080	2,495	2,640	2,831	3,076	3,349	3,652	3,977
gross official reserves / short-term debt	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Net debt								
total in millions of US$	815	1,036	1,196	1,328	1,495	1,649	1,781	1,971
total in percent of GDP	12.2	14.6	15.6	15.9	16.5	16.7	16.6	16.9
short-term in millions of US$	-171	-63	-140	-163	-167	-195	-258	-249
short-term in percent of GDP	-2.6	-0.9	-1.8	-2.0	-1.8	-2.0	-2.4	-2.1

Source: Data provided by Latvian authorities and staff estimates.

1/ Includes publicly guaranteed debt.

Table 4. Latvia: Consolidated General Government, 1999-2002
(in millions of lats, unless otherwise indicated)

	1999	2000			2001						2002
		Prog.	Supp. Budget	Act.	Approved Budget	Prog. Annual	Q1	Q2	Q3	Q4	Proj.
Revenue 1/	1,560.6	1,676.1	1,632.0	1,620.1	1,760.5	1,760.5	398.6	442.0	447.7	472.2	1,942.7
Tax revenue	1,321.7	1,409.8	1,380.3	1,361.6	1,481.0	1,481.0	342.4	371.6	375.8	391.2	1,615.5
Direct taxes	785.7	836.4	812.9	801.3	877.6	877.6	205.4	219.1	222.2	230.9	940.0
Corporate income tax	92.2	95.0	74.7	73.7	98.0	98.0	25.0	26.6	23.9	23.6	109.0
Personal income tax	240.8	261.4	261.2	261.2	283.9	283.9	64.0	69.5	72.8	77.6	334.6
Social taxes 2/	452.6	480.0	477.0	466.4	495.6	495.6	116.4	123.0	125.6	130.6	496.3
Indirect taxes	534.0	573.4	563.9	560.4	603.5	603.5	137.0	152.5	153.7	160.3	675.6
Taxes on goods & services	487.4	533.4	524.3	516.3	565.6	565.6	128.4	141.2	144.9	151.1	634.2
VAT	316.2	335.1	346.7	337.9	368.9	368.9	89.1	91.8	92.7	95.4	412.8
Excises	155.1	185.3	163.8	164.0	184.7	184.7	37.5	46.6	48.5	52.0	208.6
Customs duty	16.1	13.0	13.8	14.4	11.9	11.9	1.8	2.8	3.7	3.7	12.8
Property taxes	46.6	40.0	39.6	44.1	37.9	37.9	8.6	11.3	8.8	9.2	41.4
Other (incl. taxes in transit)	2.0	0.0	3.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Non-tax revenue	238.9	266.3	251.8	258.4	279.5	279.5	56.2	70.4	71.8	81.0	327.2
of which: EU grants	...	37.9	21.9	20.8	47.3	47.3	8.8	11.8	12.8	13.8	63.3
Expenditure	1,706.9	1,740.7	1,753.5	1,763.7	1,827.3	1,827.4	412.5	464.5	461.3	489.2	1,965.6
Current expenditure	1,529.7	1,589.9	1,597.9	1,590.7	1,664.7	1,664.8	388.5	419.2	403.6	453.5	1,756.2
Wages & salaries	386.1	386.2	401.2	396.5	417.4	417.4	98.4	109.3	92.4	117.3	455.7
of which: Social security contributions	82.2	80.6	83.8	82.4	88.7	88.7	20.9	21.9	21.1	24.7	96.8
Goods & services	300.8	328.0	292.2	305.1	315.0	317.4	60.8	77.4	78.6	100.6	347.3
Interest	25.3	38.8	41.1	48.8	44.1	39.0	7.8	14.9	10.6	5.8	47.2
Subsidies & transfers	817.4	836.9	842.7	820.1	888.2	888.2	218.7	217.6	222.0	229.9	906.0
Transfers to households	615.8	619.2	609.9	603.8	610.0	610.0	152.1	148.7	150.4	158.8	602.2
Other	201.6	217.7	232.8	216.3	278.3	278.3	66.7	68.9	71.6	71.1	303.8
Other expenditure	0.0	0.0	20.7	20.2	0.0	2.7	2.7	0.0	0.0	0.0	0.0
Capital expenditure	177.2	150.8	155.6	173.0	162.6	162.6	23.9	45.3	57.7	35.7	209.4
Financial balance	-146.3	-64.6	-121.5	-143.6	-66.9	-66.9	-13.8	-22.5	-13.6	-17.0	-22.9
Net lending (+)	6.9	16.0	14.6	-0.2	12.4	12.4	3.1	3.1	3.1	3.1	25.7
Fiscal balance	-153.2	-80.6	-136.0	-143.4	-79.3	-79.3	-16.9	-25.6	-16.7	-20.1	-48.5
Financing	153.2	80.6	136.0	143.4	79.3	79.3	16.9	25.6	16.7	20.1	48.5
Privatization receipts	6.2	50.5	22.7	25.2	15.0	15.0	3.8	3.8	3.8	3.8	15.0
Domestic	36.2	3.7	123.9	129.3	39.5	34.9	9.6	20.9	-11.0	15.5	37.0
Banks	34.7	-0.3	93.6	99.4	9.1	20.3	0.2	12.5	-0.9	8.5	20.5
BOL	-31.0	...	21.4	49.2	...	-17.6	-35.0	9.1	7.0	1.3	12.0
Commercial banks	65.7	...	72.2	50.2	...	37.9	35.2	3.4	-7.9	7.2	8.5
Other domestic	1.5	4.0	30.2	29.8	30.4	14.6	9.4	8.4	-10.1	7.0	16.5
Foreign	110.8	26.4	-10.6	-11.0	24.8	29.4	3.6	0.9	24.0	0.8	-3.5
Memorandum items:						(in percent of GDP)					
Revenue	40.0	40.1	37.8	37.5	40.7	37.5	37.0	37.6	37.8	37.4	37.9
Direct taxes	20.2	20.0	18.8	18.6	20.3	18.7	19.1	18.6	18.8	18.3	18.3
Taxes on goods & services	12.5	12.8	12.1	12.0	13.1	12.0	11.9	12.0	12.2	12.0	12.4
Expenditure, *of which:*	43.8	41.7	40.6	40.9	42.2	38.9	38.3	39.5	39.0	38.7	38.3
Expenditure financed by EU grants	0.0	0.9	1.1	0.5	1.1	1.0	0.8	1.0	1.1	1.1	1.2
Wages & salaries *(net of social taxes)*	7.8	7.3	7.4	7.3	7.6	7.0	7.2	7.4	6.0	7.3	7.0
Transfers to households	15.8	14.8	14.1	14.0	14.1	13.0	14.1	12.7	12.7	12.6	11.7
Capital expenditure	4.5	3.6	3.6	4.0	3.8	3.5	2.2	3.9	4.9	2.8	4.1
Net lending	0.2	0.4	0.3	0.0	0.3	0.3	0.3	0.3	0.3	0.2	0.5
Fiscal balance	-3.9	-1.9	-3.2	-3.3	-1.8	-1.7	-1.6	-2.2	-1.4	-1.6	-0.9
						(in millions of lats)					
Social Budget											
Revenues (social taxes)	452.6	480.0	477.0	466.4	495.6	495.6	116.4	123.0	125.6	130.6	496.3
Transfers from basic budget	7.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Transfers to individuals	499.8	502.5	505.8	485.6	509.4	509.4	129.0	123.3	127.2	129.9	492.4
Pensions	445.2	461.2	466.4	445.0	447.5	447.5	106.7	110.6	113.7	116.6	420.2
Balance	-47.2	-22.5	-28.8	-19.2	-13.8	-13.8	-12.5	-0.3	-1.7	0.7	3.9
In percent of GDP	-1.2	-0.5	-0.7	-0.4	-0.3	-0.3	-1.2	0.0	-0.1	0.1	0.1
Nominal GDP	3,897	4,178	4,317	4,317	4,326	4,700	1,077	1,175	1,183	1,264	5,131

Sources: Ministry of Finance; and Fund staff estimates.
1/ Revenues exclude receipts from privatization.
2/ Excluding social tax revenue amounting to LVL 5.9 million that will be channeled to the second pension pillar.

Table 5. Latvia: Reserve Money and Net Domestic Assets of the Bank of Latvia, 1999-2002
(in millions of lats)

	1999	2000				2001				2002
	Dec	Mar	Jun	Sep	Dec Act.	Mar Prog.	Jun Prog.	Sep Prog.	Dec Prog.	Dec Prog.
Reserve money	526.3	482.6	491.4	534.2	566.7	571.9	594.7	639.8	641.0	723.0
Currency in circulation	426.1	411.1	442.1	452.9	482.3	480.4	493.6	524.7	519.2	571.1
Bank deposits	100.2	71.6	49.3	81.3	84.4	91.5	101.1	115.2	121.8	151.8
Foreign currency deposits	--	--	--	--	--	--	--	--	--	--
Other	100.2	71.6	49.3	81.3	84.4	91.5	101.1	115.2	121.8	151.8
of which: Time deposits 1/	4.0	3.0	2.9	3.7	6.0	--	--	--	--	--
Net foreign assets 2/ 3/	523.4	524.9	518.5	522.0	542.0	559.9	578.6	627.0	615.7	683.4
Net International Reserves	523.1	524.7	518.3	521.7	542.1	559.9	578.6	627.1	615.7	683.4
Correspondent accounts	0.2	0.2	0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Net domestic assets	2.9	-42.3	-27.1	12.3	24.7	12.0	16.2	12.8	25.4	39.5
Domestic credit	68.0	-7.5	23.8	45.6	70.1	57.4	61.6	58.2	70.8	84.9
Banks	63.3	47.4	42.9	44.3	42.5	66.7	64.2	55.3	68.2	63.0
Refinance credits	63.2	47.3	42.8	44.1	42.4	66.6	64.1	55.2	68.1	62.9
Government, net	4.6	-55.0	-17.1	1.3	27.5	-9.3	-2.6	2.9	2.6	21.9
BoP assistance	50.1	33.8	32.2	25.4	23.8	22.0	19.6	18.1	16.5	23.8
Other government, net 4/	-45.5	-88.8	-49.3	-24.1	3.7	-31.3	-22.2	-15.2	-13.9	-1.9
of which										
T-bills	30.2	46.9	68.0	63.2	49.6	59.6	59.6	59.6	59.6	59.6
Deposits	75.6	135.7	117.3	87.2	45.9	90.9	81.8	74.8	73.5	61.5
Other items, net	-65.1	-34.8	-53.0	-33.4	-45.4	-45.4	-45.4	-45.4	-45.4	-45.4
Memorandum Items:										
Percentage change from previous quarter										
Reserve money	17.1	-8.3	1.8	8.7	6.1	0.9	4.0	7.6	0.2	...
Domestic credit	25.2	-111.1	442.7	76.5	53.6	-18.0	7.2	-5.4	21.6	...
Percentage annual change										
Reserve money	11.6	...	...	...	7.7	...	...	...	13.1	12.8
Broad money	8.0	...	...	...	27.9	...	...	...	27.1	19.5
Credit to the nongovernment sector	15.3	...	...	...	36.7	...	...	...	28.5	18.9
Velocity	4.0	...	...	...	3.6	...	...	...	3.1	2.9
Money multiplier	1.894	2.218	2.315	2.252	2.250	2.354	2.395	2.409	2.528	2.679
Exchange rate (LVL/US$)	0.583	0.596	0.600	0.615	0.613	0.613	0.613	0.613	0.613	0.613
NFA total (US$mn)	897.7	880.8	864.2	848.7	884.3	913.4	943.9	1022.9	1004.3	1114.9
Nonconvertible NFA (US$mn)	0.4	0.4	0.4	0.4	-0.1	-0.1	-0.1	-0.1	0.0	0.0

Sources: Bank of Latvia; and staff estimates.

1/ As of January 1, 2001, commercial banks' time deposits with the Bank of Latvia are excluded from the reserve money definition.
2/ Valued at current exchange rates.
3/ As the Bank of Latvia has almost no medium- and long-term foreign currency liabilities, NFA largely equals NIR.
4/ Includes purchase of Treasury bills and change in government deposits.

Table 6. Latvia: Broad Money and Net Domestic Assets of the Banking System, 1999-2002
(in millions of lats)

	1999	2000				2001				2002
	Dec	Mar	Jun	Sep	Dec Act.	Mar Prog.	Jun Prog.	Sep Prog.	Dec Prog.	Dec Prog.
Broad money (M2X)	996.9	1,070.3	1,137.5	1,203.1	1,275.3	1,346.5	1,424.5	1,541.5	1,620.6	1,937.0
Currency held by public	377.4	372.8	397.6	406.9	427.7	427.6	439.3	466.9	462.1	508.3
Household deposits	121.1	133.6	156.9	167.4	193.9	200.8	217.5	238.7	262.2	349.5
Enterprise deposits	199.9	235.5	236.7	243.3	257.0	314.1	340.3	373.4	410.1	546.6
Residents' FC deposits 1/	298.5	328.5	346.3	385.6	396.8	404.0	427.3	462.4	486.2	532.7
Total deposits	619.4	697.5	739.9	796.3	847.7	918.9	985.2	1,074.6	1,158.5	1,428.7
Net foreign assets (total) 2/ 3/	363.7	417.5	469.4	599.2	538.3	556.2	574.9	623.3	611.9	679.7
Convertible net int'l reserves 1/ 2/	497.1	527.9	533.8	530.6	491.3	509.2	527.9	576.3	564.9	632.7
Nonconvertible reserves 1/ 3/	-133.4	-110.4	-64.4	68.7	47.0	47.0	47.0	47.0	47.0	47.0
Net domestic assets 3/	633.1	652.8	668.1	603.9	737.0	790.3	849.6	918.2	1,008.7	1,257.3
Domestic credit	745.0	748.1	814.6	907.0	1,062.5	1,115.8	1,175.1	1,243.7	1,334.2	1,582.8
Credit to the non-government sector	665.1	712.9	755.7	817.1	909.4	964.4	1,013.6	1,084.6	1,168.2	1,389.0
Households	94.3	104.1	118.1	139.3	158.9	173.0	188.0	199.0	213.5	253.3
Enterprises	570.8	608.8	637.6	677.8	750.6	791.4	825.6	885.6	954.7	1,135.8
Government, net	79.9	35.2	58.9	89.9	153.0	151.4	161.5	159.1	166.0	193.8
Restructuring Bonds	6.1	6.1	6.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other Credit to Government	73.8	29.1	52.8	89.9	153.0	151.4	161.5	159.1	166.0	193.8
Other items, net 3/	-111.9	-95.2	-146.5	-303.1	-325.5	-325.5	-325.5	-325.5	-325.5	-325.5
Memorandum Items:										
Percentage change from previous quarter										
Broad money(M2X)	5.2	7.4	6.3	5.8	6.0	5.6	5.8	8.2	5.1	...
Domestic credit	8.8	0.4	8.9	11.3	17.1	5.0	5.3	5.8	7.3	...
Credit to the non-government sector	6.4	7.2	6.0	8.1	11.3	6.0	5.1	7.0	7.7	...
Households	9.9	10.3	13.5	18.0	14.1	8.9	8.7	5.8	7.3	...
Enterprises	5.9	6.7	4.7	6.3	10.7	5.4	4.3	7.3	7.8	...
Credit to the government, net	33.8	-56.0	67.4	52.6	70.3	-1.1	6.7	-1.5	4.3	...
Exchange rate (LVL/US$)	0.583	0.596	0.600	0.615	0.613	0.613	0.613	0.613	0.613	0.613
Total NFA (US$mn) 2/										
Total	623.9	700.5	782.3	974.4	878.2	907.3	937.8	1,016.8	998.2	1,108.8
of which: commercial banks 3/	-273.8	-180.3	-81.9	125.6	-6.0	-6.0	-6.0	-6.0	-6.1	-6.1

Sources: Bank of Latvia; and Fund staff estimates.

1/ As of June 1997, residents' foreign currency deposits are deposits in all currencies except lats.
2/ In currencies of OECD countries, valued at the current exchange rates.
3/ Up to end-June 2000, NFA of commercial banks include equity in Latvian commercial banks that is owned by non-residents;
thereafter, such equity is treated like domestic capital and captured in "other items, net". As of end-December 2000, this equity amounts to LVL 141 million.

Table 7. Latvia: Selected Financial Sector Indicators, 1996-2000

(in percent unless otherwise indicated)

	1996	1997	1998				1999				2000			
	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
Net foreign assets of the BoL, in millions of U.S. dollars	638	734	780	880	825	815	828	931	824	898	881	864	848	882
Net foreign assets of commercial banks, in millions of U.S. dollars	172.0	315.1	240	243	8	-86	-122	-104	-105	-274	-180	-82	126	-6
Commercial banks total reserves/total deposits	15.8	16.3	15.8	15.5	18.2	16.1	16.3	16.0	15.3	18.9	14.8	15.5	4.9	16.3
Commercial banks excess reserves/total reserves	15.9	18.8	11.4	11.2	18.1	19.3	13.7	8.9	4.4	19.8	8.9	8.4	3.6	7.5
Loans/deposits	40.2	46.4	57.6	55.9	66.8	70.3	74.1	69.9	68.8	65.9	63.5	61.8	58.7	58.3
Loans/total assets	23.7	29.7	34.6	34.6	42.4	43.4	44.2	44.0	44.5	43.4	42.0	41.3	40.0	40.3
Credit to nongovernment/GDP 1/	6.6	9.8	12.5	13.4	14.9	14.8	16.9	16.0	15.3	15.8	18.0	17.5	18.8	19.6
Liquidity test 2/	69.7	77.0	56.7	58.8	36.3	36.6	38.5	39.3	40.1	42.9	43.0	44.3	44.8	44.2
Capital adequacy -- risk-weighted average 3/	24.5	21.0	23.0	21.0	18.0	17.0	18.0	16.0	15.0	16.0	16.0	15.0	15.0	14.0
Nonperforming loans/total loans	21.0	10.0	8.0	6.0	5.0	6.0	7.0	8.0	7.0	6.0	7.0	5.0	5.0	4.6
Loan-loss provisioning/gross loans	25.1	7.4	5.9	4.3	3.3	4.3	4.5	4.8	4.1	4.0	4.0	3.0	3.0	3.0
Return on equity 4/	24.0	26.0	17.0	15.0	-5.8	-12.9	19.8	14.6	13.0	11.0	21.0	22.0	20.0	19.0
Net foreign asset position 5/	349.3	310.5	171.4	188.2	85.9	152.4	111.1	123.2	159.2	245.6	368.6	451.7	580.1	579.5
Nominal interest rate spread 6/	10.9	5.7	8.1	8.8	9.9	7.9	9.5	6.4	5.1	8.4	5.6	6.3	9.0	7.5
Stock market index, level 7/	247.7	345.9	306.3	206.8	113.5	98.0	81.9	83.9	70.9	87.8	116.6	108.7	134.7	139.2
Stock market capitalization/GDP 1/	2.7	5.3	6.6	5.3	3.6	5.8	6.7	6.2	5.4	5.4	7.5	6.4	7.6	7.5

Sources: Bank of Latvia.

1/ GDP is calculated using annualized quarterly data.

2/ Liquidity test is defined as: (cash + claims on the central bank + claims on other credit institutions + fixed-income government bonds - liabilities to the central bank - liabilities to other credit institutions) / deposits.

3/ End-December values based on audited financial statements; otherwise, as reported by banks.

4/ Return on equity is defined as the ratio of the value of bank-issued equity to profits.

5/ Net foreign asset position vis-à-vis foreign credit institutions, in LVL millions.

6/ Commercial bank lending-deposit spreads for 3-month average of 3-6 months' maturities.

7/ Dow Jones Riga stock exchange index, end-of-period data.

Table 8. Latvia: Medium Term Macroeconomic Framework, 1999-2006

	1999	2000	2001	2002	2003	2004	2005	2006
		Est.	Projections					
	(In percent of GDP)							
Foreign savings 1/	9.7	7.2	6.3	5.8	5.7	5.4	5.1	4.9
Gross national saving	17.1	20.0	21.5	23.5	24.0	24.5	25.3	26.1
Nongovernment	16.3	19.3	19.5	19.8	20.0	20.2	20.5	20.9
Government 2/	0.8	0.7	2.0	3.6	4.0	4.4	4.8	5.2
Gross investment	26.7	27.2	27.9	29.2	29.7	30.0	30.4	31.0
Nongovernment fixed capital formation	19.8	21.2	24.1	24.7	24.9	25.1	25.4	25.8
Government fixed capital formation 3/	4.7	4.0	3.7	4.6	4.8	4.9	5.0	5.2
Change in inventories	2.2	2.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum item:								
Nongovernment savings-investment balance	-5.8	-3.9	-4.6	-4.8	-4.9	-4.9	-4.9	-4.9
Nominal GDP (in millions of lats)	3,897	4,317	4,700	5,131	5,602	6,116	6,678	7,291
Real GDP growth rate	1.1	5.5	6.0	6.0	6.0	6.0	6.0	6.0
Inflation (annual average rate)	2.4	2.7	2.3	2.8	3.0	3.0	3.0	3.0
Fiscal balance (in percent of GDP) 2/	-3.9	-3.3	-1.7	-0.9	-0.7	-0.5	-0.3	0.0
Revenues	40.0	37.5	37.5	37.9	38.2	38.2	38.4	38.4
Expenditures 3/	44.0	40.9	39.2	38.8	38.9	38.7	38.7	38.5
External debt / GDP (end-year)								
gross	57.8	63.5	65.1	65.3	66.0	66.7	67.4	67.7
net	12.2	14.6	15.6	15.9	16.5	16.7	16.6	16.9

Sources: Latvian authorities; and Fund staff estimates.

1/ External current account deficit.

2/ Government revenues do not include privatization receipts.

3/ Including net lending.

Table 9. Latvia: Indicators of External and Financial Vulnerability, 1999-2000 1/

	1999		2000					
	Dec.	Year	Mar.	Jun.	Sep.	Dec.	Latest	Date
Financial indicators								
Public debt (domestic and foreign, in percent of GDP)	13.1	13.1	12.8	13.4	12.8	...	12.8	Q3/2000
Broad money (year-on-year change in percent)	8.0	8.0	16.3	17.1	27.0	27.9	26.2	1/31/01
Broad money in percent of gross official reserves	181	181	194	210	221	226	231	1/31/01
Private sector credit (year-on-year change in percent)	15.3	15.3	19.6	24.6	30.7	36.7	37.9	1/31/01
External indicators								
Current account balance in percent of GDP	-14.9	-9.7	-3.7	-7.0	-5.8	...	-5.8	Q3/2000
Exports of GNFS (year-on-year change in percent)	0.4	-8.2	15.5	13.5	10.1	...	10.1	Q3/2001
Imports of GNFS (year-on-year change in percent)	-3.8	-8.7	8.5	10.1	7.2	...	7.2	Q3/2002
Capital and financial account balance in percent of GDP	20.4	12.1	5.0	5.3	6.4	...	6.4	Q3/2004
Gross official reserves (in millions of U.S. dollars)	944	944	924	904	886	919	915	2/28/01
Gross official reserves/short-term debt	0.45	0.45	0.41	0.39	0.35	...	0.35	Q3/2000
Gross official reserves/short-term debt corrected for current account deficit net of FDI	0.43	0.39	0.41	0.38	0.35	...	0.35	Q3/2001
Gross official reserves/reserve money	104.6	104.6	114.1	110.4	101.9	99.4	103.6	1/31/01
Gross official reserves in months of imports of GNFS	2.8	3.1	3.2	2.8	2.7	...	2.7	Q3/2000
Net foreign assets of financial sector (in millions of U.S.	624	624	701	782	974	878	878	1/31/01
Total external debt (in millions of U.S. dollars)	3,850	3,850	4,053	4,209	4,321	...	4,321	Q3/2018
in percent of GDP	57.8	57.8	56.9	59.1	60.7	...	60.7	Q3/2019
in percent of exports GNFS (over the last four quarters)	132.1	132.1	105.1	106.8	107.6	...	107.6	Q3/2020
of which:								
Public sector external debt (in millions of U.S. dollars)	708	708	706	707	681	704	704	Q4/2000
in percent of GDP	10.6	10.6	9.9	9.9	9.6	...	9.6	Q3/2001
of which:								
Short-term external debt (in millions of U.S. dollars)	2,080	2,080	2,265	2,330	2,516	...	2,516	Q3/2000
in percent of GDP	31.2	31.2	31.8	32.7	35.3	...	35.3	Q3/2001
Short-term external net debt (in millions of U.S. dollars) 2/	-171	-171	46.3	70.9	-18.0	...	-18.0	Q3/2002
in percent of GDP	-2.6	-2.6	0.7	1.0	-0.3	...	-0.3	Q3/2003
Public external debt service as percent of exports of GNFS	2.4	2.7	8.8	4.0	4.1	...	4.1	Q3/2000
Real effective exchange rate (year-on-year change in percent, "+" = appreciation) 3/	6.0	6.0	3.4	3.1	2.9	-1.2	-1.2	Q4/2000
Financial market indicators								
Foreign currency long-term debt rating 4/	BBB	BBB	BBB	BBB	BBB	BBB	BBB	3/2/01
Spread of benchmark bonds (percentage points) 5/	1.9	1.9	1.1	1.3	1.0	1.0	0.8	3/12/01
Memorandum items:								
Nominal exchange rate (end-of-period)								
Latvian lats/U.S. dollar	0.58	0.58	0.60	0.60	0.62	0.61	0.62	3/12/01
Latvian lats/euro	0.59	0.59	0.57	0.57	0.54	0.57	0.58	3/12/01

Sources: Bank of Latvia, Ministry of Finance, Department of Statistics, National Stock Exchange of Latvia, Bloomberg, Standard & Poor's, Baltic News Service, and Information Notice System.

1/ Actual data only.

2/ Short-term assets include reserve assets.

3/ CPI-based REER against the 12 major trading partners. Yearly number is end of period change.

4/ Standard and Poor's.

5/ End-of-period spread of 5-year Eurobond issued in May 1999 above the rate on German Euro denominated bond maturing July 15, 2004.

Table 10. Latvia: Medium-Term Framework Sensitivity Analysis, 2000-2006

(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006
I. Baseline							
Current Account	-7.2	-6.3	-5.8	-5.7	-5.4	-5.1	-4.9
Private Savings-Investment Balance	-3.9	-4.6	-4.8	-4.9	-4.9	-4.9	-4.9
Fiscal deficit	-3.3	-1.7	-0.9	-0.7	-0.5	-0.3	0.0
External Debt	63.5	65.1	65.3	66.0	66.7	67.4	67.7
Gross official reserves in months of GNFS imports	2.8	2.9	2.9	2.9	3.0	3.1	3.1
Real GDP growth	5.5	6.0	6.0	6.0	6.0	6.0	6.0
II. Temporary export price shock							
Current Account	...	-7.2	-6.7	-6.6	-6.3	-6.1	-5.9
Private Savings-Investment Balance	...	-4.7	-5.0	-5.1	-5.1	-5.0	-5.1
Fiscal deficit	...	-2.5	-1.7	-1.5	-1.3	-1.0	-0.8
External Debt	...	66.3	66.5	67.2	68.3	68.9	69.7
Gross official reserves in months of GNFS imports	...	2.8	2.6	2.5	2.5	2.5	2.5
Real GDP growth	...	4.5	6.0	6.0	6.0	6.0	6.0
III. General export growth decline							
Current Account	...	-6.7	-6.3	-6.4	-6.3	-6.2	-6.2
Private Savings-Investment Balance	...	-4.6	-4.6	-4.5	-4.3	-4.1	-4.0
Fiscal deficit	...	-2.1	-1.7	-1.9	-2.0	-2.1	-2.3
External Debt	...	65.7	66.5	67.8	69.0	70.3	71.3
Gross official reserves in months of GNFS imports	...	2.9	2.8	2.7	2.6	2.6	2.5
Real GDP growth	...	5.5	5.5	5.5	5.5	5.5	5.5
IV. No fiscal adjustment							
Current Account	...	-7.5	-7.8	-7.7	-7.7	-7.7	-7.9
Private Savings-Investment Balance	...	-4.9	-5.1	-4.6	-4.4	-4.5	-4.5
Fiscal deficit	...	-2.7	-2.7	-3.1	-3.3	-3.2	-3.4
External Debt	...	63.5	65.0	67.2	70.5	73.3	76.6
Gross official reserves in months of GNFS imports	...	2.6	2.5	2.5	2.5	2.5	2.5
Real GDP growth	...	7.0	6.0	5.0	4.0	4.0	3.0

Sources: Staff projections.

Table 11. Latvia: Schedule of Purchases Under the Stand-By Arrangement

Amount of Purchase	Available On or After	Contingent On
SDR 4.8 million (3.7 percent of quota)	Board approval	Board approval (April 2001)
SDR 4.7 million (3.7 percent of quota)	August 31, 2001	Observance of end-June 2001 performance criteria 1/
SDR 4.7 million (3.7 percent of quota)	November 30, 2001	Observance of end-September 2001 performance criteria and completion of program review 1/
SDR 4.7 million (3.7 percent of quota)	February 28, 2002	Observance of end-December 2001 performance criteria 1/
SDR 4.7 million (3.7 percent of quota)	May 31, 2002	Observance of end-March 2002 performance criteria and completion of program review 1/
SDR 4.7 million (3.7 percent of quota)	August 31, 2002	Observance of end-June 2002 performance criteria 1/
SDR 4.7 million (3.7 percent of quota)	November 30, 2002	Observance of end-September 2002 performance criteria 1/

1/ In addition to other standard clauses in the arrangements.

Table 12. Latvia: Indicators of Financial Obligations to the Fund, 2001-2006

	2001	2002	2003	2004	2005	2006
	Projections					
Debt service to the Fund (in millions of SDRs)	9.3	9.8	11.8	16.2	15.6	6.1
Repurchases (in millions of SDRs)	7.6	7.6	9.4	14.4	14.7	5.9
Charges (in millions of SDRs)	1.7	2.2	2.4	1.8	0.9	0.2
In percent of exports of goods and non factor services	0.3	0.3	0.3	0.4	0.4	0.1
In percent of gross official reserves	1.2	1.1	1.2	1.5	1.3	0.4
Memorandum items:						
Fund credit outstanding 1/						
In millions of SDRs	33.2	44.3	35.0	20.6	5.9	0.0
In millions of U.S. dollars	43.3	57.7	45.3	26.5	7.5	0.0
In percent of quota	26.2	35.0	27.6	16.2	4.6	0.0
In percent of GDP	0.6	0.7	0.5	0.3	0.1	0.0
U.S. dollar/SDR	1.3	1.3	1.3	1.3	1.3	1.3

Sources: Data provided by the Latvian authorities; and Fund staff estimates.
1/ Projections assume that no drawings are made under the current precautionary stand-by arrangement and all drawings are made under the proposed precautionary stand-by arrangement.

Table 13. Latvia: External Financing Requirements and Sources, 1999-2002
(In millions of U.S. dollars)

	1999	2000	2001	2002
	Act.	Est.	Proj.	
Gross financing requirements	-824.4	-624.4	-717.1	-738.7
Current account (exc. official transfers)	-706.7	-538.6	-553.6	-576.7
Long-term debt amortization	-36.7	-100.8	-43.4	-51.4
Public sector 1/	-36.7	-100.8	-43.4	-51.4
Gross reserves accumulation	-65.9	25.1	-110.1	-100.7
IMF repurchases and repayments	-15.1	-10.1	-10.0	-9.9
Available financing	902.4	632.5	717.1	738.7
Official current transfers and capital transfers	73.5	48.6	91.1	119.2
Foreign direct investment (net)	330.6	380.0	411.5	441.6
Portfolio investments (net)	284.1	-128.1	-96.1	-105.7
of which: Government	221.2	0.0	0.0	0.0
Other investments	214.2	332.0	310.7	283.7
Assets	-214.3	-345.9	-112.0	-119.4
Long-term	-26.3	42.7	29.9	34.1
Short-term	-188.0	-388.6	-141.8	-153.5
Liabilities	428.5	678.0	422.6	403.1
Long-term	47.3	247.5	272.6	205.1
of which: Government	54.1	117.4	117.5	47.6
Short-term	381.2	430.5	150.0	198.0
IMF	0.0	0.0	0.0	0.0
Errors and omissions	4.6	15.4	0.0	0.0
Reserves valuation change	-82.6	-23.5	0.0	0.0
Financing gap	0.0	0.0	0.0	0.0
Memorandum items:				
Access under proposed successor SBA	...	...	18.6	24.6
Expected purchase	...	...	0.0	0.0

Sources: Latvian authorities; and Fund staff estimates.
1/ Excluding the IMF

LATVIA: FUND RELATIONS
(As of January 31, 2001)

I. **Membership Status:** Joined May 19, 1992; Article VIII

II. **General Resources Account:**	**SDR Million**	**Percent of Quota**
Quota	126.80	100.0
Fund holdings of currency	151.55	119.5
Reserve position in Fund	0.06	0.0

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Holdings	0.50	N.A.

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent of Quota**
Systemic Transformation	24.78	19.5

V. **Financial Arrangements:**

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR million)**	**Amount Drawn (SDR million)**
Stand-by	12/10/99	4/9/01	33.0	0.00
Stand-by	10/10/97	4/9/99	33.0	0.00
Stand-by	5/24/96	8/23/97	30.0	0.00

VI. **Projected Obligations to Fund** (SDR million; based on existing use of resources and present holdings of SDRs):

	Overdue	Forthcoming				
	(12/31/00)	2001	2002	2003	2004	2005
Principal	0	5.7	7.6	7.6	3.8	0
Charges/interest	0	1.3	0.9	0.5	0.1	0
Total	0	7.0	8.5	8.1	3.9	0

VII. **Exchange Arrangements**:

The currency of Latvia is the lats, which was introduced in March 1993 to replace the Latvian ruble. The exchange rate has been pegged to the SDR since February 1994.

VIII **Resident Representative**:

The fourth resident representative of the Fund in Latvia is Mr. Knöbl, who took up his post in October 1999.

IX. **Consultation Cycle**:

Latvia is on the 12-month consultation cycle. The Executive Board concluded the 2000 Article IV Consultation on June 30, 2000. Directors commended the authorities for the generally sound macroeconomic policies which had helped Latvia weather the impact of the Russian financial crisis. Directors emphasized that Latvia's growth prospects over the medium term were promising, provided that the authorities continue to pursue appropriate macroeconomic policies, improve further the efficiency of the public sector, and remove the remaining impediments to private sector activity. In particular, Directors stressed the importance of continued fiscal adjustment aiming at a general government deficit at or below 2 percent of GDP in 2000 and 1 percent in 2001, and a balanced budget over the medium-term. This approach was seen as instrumental in bringing about a reduction in the persistently large external current account deficit, which, together with the decline in foreign direct investment in the wake of the Russian crisis, posed a potential risk to Latvia's external sustainability.

X. **Fourth Amendment:**

Latvia accepted the Fourth Amendment of the Articles of Agreement on February 16, 2001.

WORLD BANK RELATIONS
(As of February 28, 2001)

1. Latvia became a member of the World Bank on August 11, 1992. While the Bank's initial lending programs focused on assisting the government in deepening structural reforms and promoting private and public investment, the main emphasis of the Bank's current lending and economic sector work program is on improving public sector governance. In support of this strategy, the Bank has 7 projects under implementation totaling US$152.4 million in commitments, of which US$95.8 million have been disbursed as of end of February 2001. In addition, it has an IDF grant under implementation totaling US$0.4 million. The total amount of commitments and debt outstanding, including closed operations, is US$393.7 million, of which US$281.6 million is disbursed.

2. Since 1992, the Bank has financed a variety of loans in the following areas: agriculture, enterprise and financial restructuring, environment, heating and other municipal services, highway maintenance, and welfare reform. More recent loans include the Rural Development Project (September 1998, US$10.5 million), which supports diversification of the rural economy and strengthening of the rural financial system; the Health Project (November 1998, US$32 million); the State Revenue Service Modernization Project (January 1999, US$5million), which supports strengthening the organization and management as well as the operations of the revenue administration; and the Education Improvement Project (August 1999, US$31.1 million) which aims to improve education outcomes by strengthening the management of both resource inputs and the learning process. Other projects under implementation are Municipal Services Development Project, Municipal Solid Waste Management Project in Riga, Liepaja Region Solid Waste Project and Welfare Reform Project. Projects in energy and housing are also under preparation. More recently the government has worked with the World Bank to undertake a Programmatic Structural Adjustment Operation. This three-year reform program, which focuses on improving governance, was discussed and approved by the Bank's board in March 2000, and US$40.4 million have been disbursed under the first PSAL of the program. Negotiations for the second PSAL are expected to be completed in the second quarter of 2001.

3. The Bank has prepared a series of policy notes that provide advice on various macroeconomic and structural reform issues. A Public Expenditure Review report provided recommendations on public expenditure planning, programming, and management. A report on local government expenditure and resource transfer analyzed aspects of expenditure and revenue priorities facing local governments in Latvia. A report on macroeconomic and financial sector vulnerability assessed the overall level of vulnerability in the economy and financial sector and proposed policies to minimize these risk factors. The Bank has also undertaken sectoral reviews in the areas of agriculture, public sector management, municipal finance, enterprise development, pension reform, health care, financial sector, and private participation in infrastructure. In addition, the Bank has provided technical assistance on tariff policy, customs administration, the design of a city drawback scheme, and the preparation of the public investment program. The latest World Bank Country Assistance Strategy was presented to the board in April 1998. During 1999, the Bank undertook a

Municipality Finance study and a Poverty Assessment. In 2000, a Bank team conducted a second Public Expenditure Review to advise the Government on how to improve efficiency and effectiveness of its programs and on how to further rationalize its policy and budget decision-making processes. In February 2001, a Financial Sector Assessment on the Latvian financial system was carried out under the joint IMF/World Bank Financial Sector Assessment Program.

TECHNICAL ASSISTANCE FROM THE FUND, 1995–2000

DEPT	Project	Action	Timing	Counterpart
FAD	Tax Administration	Mission	February 1995	Ministry of Finance
MAE	Foreign Exchange, Banking Supervision, and Monetary Management	Mission	April 1995	Bank of Latvia
FAD	Tax Administration	Inspection Mission	July 1995	Ministry of Finance
STA	Multitopic	Inspection Mission	August 1995	Central Statistical Bureau
MAE	Banking Supervision	Mission	July 1995	Bank of Latvia
STA	Balance of Payments	Mission	October 1995	Central Statistical Bureau
MAE	Monetary Management	Long-term Expert	January to July 1996	Bank of Latvia
LEG	Bankruptcy Law	Mission	June 1996	Ministry of Finance
MAE	Banking Supervision	Long-term Expert	June 1996 to June 1997	Bank of Latvia
FAD	Tax Administration	Inspection Mission	September 1996	Ministry of Finance
FAD	Monitoring of Treasury System	Mission	September 1996	Ministry of Finance
STA	Resident Statistical Advisor	Long-term Expert	September 1996 to December 1998	Central Statistical Bureau
STA	Inspection	Regional Expert	February 1997	Bank of Latvia/Central Statistical Bureau
FAD	Monitoring of Treasury System	Mission	June 1997	Ministry of Finance
MAE	Consolidated Banking Supervision	Mission	September 1998	Bank of Latvia
MAE	Consolidated Banking Supervision	Short-term Expert	October 1998	Bank of Latvia
MAE	Banking Supervision	Mission	October 1999	Bank of Latvia
STA	Balance of Payments	Long-term Expert	October 1999 to October 2000	Bank of Latvia/Central Statistical Bureau
MAE	Banking Supervision	Short-term Expert	April 2000	Bank of Latvia
MAE	Banking Supervision	Short-term Expert	June 2000	Bank of Latvia
FAD	Expenditure Policy	Mission	June 2000	Ministry of Finance

STATISTICAL APPENDIX

The authorities have a very open and well-articulated data dissemination and publication policy. Most economic and financial statistics are reported to the Fund on a regular and timely basis, and a large number of additional economic and financial aggregates is readily available on the websites of Latvian government institutions and agencies, as well as of the Bank of Latvia (BoL). The authorities are reporting data for the Fund's *International Financial Statistics, Government Finance Statistics Yearbook*, the *Direction of Trade Statistics,* and the *Balance of Payments Statistics Yearbook*. Latvia has subscribed to the Special Data Dissemination Standard (SDDS), meets the SDSS specifications, and its metadata are posted on the Fund's Dissemination Standards Bulletin Board on the Internet. There is increased cooperation on data issues between the Central Statistical Bureau (CSB), the BoL, the Ministry of Finance, and the customs authorities.

2. During the period December 1996–December 1998, a Fund Resident Statistical Advisor for the Baltic States assisted the Latvian authorities in improving the database on macroeconomic statistics, and a Fund Resident Statistical Advisor for balance-of-payments issues assisted the authorities from October 1999-October 2000. Advice on statistical matters is also provided by EUROSTAT as a part of the EU accession process.

National accounts

3. The CSB compiles and publishes quarterly national accounts data from the production and expenditure approaches on a regular and timely basis, largely following the *1993 SNA* and *ESA-95*. However, there are significant discrepancies between the GDP estimates based on production and those based on expenditure. The underlying data for the production approach are primarily obtained through a comprehensive set of questionnaires that the CSB sends to businesses and individuals, supplemented by administrative data, labor force surveys, and information obtained from other agencies. The basic data are widely believed to understate economic activity, particularly in the private sector, and there is an ongoing effort to increase coverage. The official national accounts data published by the CSB incorporate an adjustment for under-recording, which the CSB currently estimates as 14 percent of total GDP. The data for the expenditure-based accounts are obtained from household budget surveys and other surveys from the State Treasury and ministries. Input/output tables are currently being prepared.

Prices

4. The CSB compiles a nationwide consumer price index. With Fund technical assistance, it has developed appropriate methodologies to deal with most of the technical problems resulting from the major structural shifts that have occurred in the economy. Reporting has improved markedly during 1998, in part due to the implementation of a new household budget survey, based on World Bank technical assistance, enabling the CSB to compile indices for different types of households. Following advice from EUROSTAT, the weights in the CPI basket are now revised annually. The weights in the producer price index

are updated annually and the index covers almost three quarters of total industrial activity. The CBS also publishes export and import unit value and volume indices.

Government finance statistics

5. The staff is provided with monthly information on revenues, expenditures, and financing of the central and local governments and special budgets. With some limitations, the available information permits the compilation of the consolidated accounts of the general government.

Monetary statistics

6. Monetary data are comprehensive, timely, and comply with international standards. Specifically, data on the balance sheets of the BoL, commercial banks, and other financial institutions, as well as the banking survey, are compiled with a very short time lag, i.e., within two weeks of the end of the reporting period. Fund staff is also weekly provided with the BoL balance sheet and data on foreign exchange transactions, including outright interventions and foreign currency swaps. The institutional coverage, classification, and sectorization of accounts comply with Fund standards. Interest rate data are compiled and published with equally short time lags. The BoL also reports comprehensive data on banking supervision and prudential regulations.

Balance of payments statistics

7. Since early 2000, the BoL has assumed the responsibility for compiling the balance of payments statistics from the CSB and has undertaken to develop monthly series based on an international transactions reporting system (ITRS). It has started to produce statistics on a pilot basis for internal use. This source is to be supplemented with the results of three other quarterly surveys that were launched in 2000: non-financial enterprises, foreign-direct investment and related income flows and transportation services. An annual survey of other services will be launched for 2002.

8. Current account transactions: Merchandise trade data, based for the most part on customs data, underestimate imports into and exports from Latvia's 140 or so Custom-bonded warehouses and the three free trade zones. The implementation by the customs department of transaction-price based valuation reduces previous problems relating to the valuation of goods. With regard to trade, proper procedures to assure that goods passing through customs warehouses are properly valued have not been completely implemented. Coverage of exports to Russia and CIS countries is incomplete. Exports of cars and shuttle trade items are particularly difficult to capture; improved survey techniques are recommended. Estimates of travel credits and debits have been improved through a revised survey.

9. Financial account operations: until the quarterly and annual surveys are fully implemented, enterprise surveys currently collect information on other services items and the

income component. Enterprise surveys, supplemented by balance sheet data from banks, are employed to estimate financial account flows. As additional sources, BoL has requested data from the Security and Exchange Commission and from the Privatization Agency on shares in state-owned companies sold to non-residents. Starting in 2000 BOL has also been using ITRS data for estimating new investment not captured by the main balance of payments survey.

Data dissemination standards

10. Latvia has subscribed to the Fund's Special Data Dissemination Standard since November 1996 and has been posting metadata on the Dissemination Standards Bulletin Board since December 1997. Latvia has been disseminating data on the reserves template since April 2000.

Survey of Reporting of Main Statistical Indicators
(As of end-February, 2001)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	Public External Debt and Debt Scheduling
Date of latest observation	Feb. 27	Feb. 23	Feb. 23	Feb. 23	Jan. 31	Jan. 31	Jan. 2001	Dec. 2000	Q3, 2000	Jan. 31	Q3, 2000	Dec. 31
Date received	Feb. 28	Feb. 26	feb. 26	Feb. 26	Feb. 20	Feb. 20	Feb. 08	Feb. 19	Dec. 29	Feb. 19	Dec. 19	Jan. 31
Frequency of data	D	W	W	W	M	M	M	M	Q	M	Q	M
Frequency of reporting	D	W	W	W	M	M	M	M	Q	M	Q	M
Source of data	C	A 1/	A 1/	A 1/	A 1/	A 1/, C	C	C	C	A 1/	A, N	A
Mode of reporting	E	C,E	C,E	C,E	C,E	C,E	E	E	E	C	E	V
Confidentiality	C	C	C	B	C	C	C	C	C	C	C	C
Frequency of Publication	D	M	M	M	M	M	M	M	Q	M	Q	M

Sources: A--direct reporting by Central bank, Ministry of Finance, or other official agency; C--commercial service; N--official publication or press release.
1/ Through the resident representative office.

Notes:
Frequency of data: D-daily, W-weekly, M-Monthly, Q-Quarterly.
Frequency of reporting: M-Monthly, Q-Quarterly, V-irregular in conjunction with staff visits.
Mode of reporting: C-cable or facsimile, E-electronic news reporting, V-staff visits, or O-other.
Confidentiality: (B) for use by the staff and the Executive Board, (C) for unrestricted use.

March 21, 2001

Dear Mr. Köhler:

The attached Memorandum of Economic Policies describes the policies the government and the Bank of Latvia intend to follow for the remainder of 2001 and 2002. These policies are focused on ensuring that our robust economic growth is sustained, our vulnerability to external shocks remains limited, and our accession to the European Union is as rapid as possible. The program is built on a reduction in the fiscal deficit this year and next, and a return to near fiscal balance over the medium term, combined with measures to enhance the efficiency, effectiveness and transparency of the public sector. At the same time, we are continuing those structural reforms needed to ensure that Latvia reaches its full economic potential, with a particular focus on further enhancing the framework for financial services. We have also included in the attached memorandum our policies in other structural reform areas (paragraphs 32 to 38), which, while important to support sustainable growth and strengthen our market economy, are not covered by formal conditionality under the Fund program. In support of these policies, we are requesting a 20-month Stand-By Arrangement, in the amount of SDR 33 million. We do not intend to make any purchases under the Stand-By Arrangement, although we would do so should circumstances warrant.

We believe that the policies described in the attached memorandum are adequate to meet the objectives of our economic program, but will take additional measures to meet these goals should the need arise. During the period of the arrangement, we will consult with the Fund on the adoption of any such measures that may be appropriate in accordance with the Fund's policies on such consultations. We will conduct with the Fund two reviews of economic developments and policies under the program, the first by end-November 2001, the second by end-May 2002. In addition to a comprehensive evaluation of economic performance, the first review would focus on public sector reform and financial sector developments and oversight. The program will also be evaluated on the basis of a number of quarterly performance criteria and structural benchmarks, specified in the attached Tables 1 and 2. Performance criteria for end-March 2002 and end-June 2002 will be specified at the time of the first review, and those for end-September 2002 and at the time of the second review.

Sincerely,

//s//	//s//
Gundars Bērziņš Minister of Finance Ministry of Finance	Einārs Repše Governor Bank of Latvia

Attachments

Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431

Memorandum of Economic Policies

I. Introduction

1. Latvia has weathered the recession triggered by the Russia crisis and succeeded in restoring strong economic growth in an environment marked by low inflation and a stable exchange rate regime. Real GDP grew by about 5½ percent in 2000, driven by the strengthening of exports and investment. Growth has been broad-based, with manufacturing, forestry, and services all showing strong gains. Inflation has remained subdued, with the CPI rising by less than 2 percent in the twelve months through December. Latvia has also made strong progress in its access negotiations with the European Union (EU) closing nine of the 29 chapters to date.

2. Latvia's external position and outlook have improved as well. The external current account deficit fell from close to 10 percent of GDP in 1998 and 1999 to about 7 percent of GDP in 2000, despite an appreciation of the lats against the euro and the sharp rise in oil prices. Further, the share of this deficit financed by foreign direct investment (FDI) rose noticeably from just over half in 1999 to about 75 percent in 2000. This helped contain our low external debt indicators and further reduce the yield spread on Latvia's Eurobond. Buoyant exports, especially to the EU, moderate growth in real wages, and a decline in unit labor costs, all indicate that Latvia remains competitive on international markets.

3. Such positive developments were achieved thanks to generally appropriate macroeconomic policies and continued progress on structural reforms. The general government fiscal deficit in 2000, some 3¼ percent of GDP, represents an improvement of half a percentage point of GDP over 1999, but fell short of our objective of cutting the deficit in half. This outcome reflects both a sizable shortfall in tax revenue—owing to unexpectedly large corporate income tax repayments resulting from depressed profit levels in 1999 and difficulties in excise tax collections—as well as additional spending. As a result of these developments, we did not observe the performance criteria on the general government deficit for end-June, end-September, and end-December 2000 under the previous stand-by arrangement (SBA) with the Fund.

4. Monetary conditions during 2000 were sufficiently tight to support the Bank of Latvia's (BoL) exchange rate objective, and all monetary performance criteria in 2000 under the previous SBA with the Fund were observed. Reserve money and broad money grew by some 8 percent and 28 percent, respectively, during the year. Credit to the nongovernment sector grew robustly, by 37 percent, from still-low levels, deposits to the banking system rose sharply, and deposit and lending rates showed a declining trend. These developments all point to a continued deepening of financial markets and increased confidence in the banking system and the economy more generally.

5. Financial sector developments continue to be encouraging, with key indicators improving. All banks are fully complying with the capital adequacy ratio of 10 percent, nonperforming loans are declining, and profitability is rising. Foreign investors have recently

either increased or acquired majority stakes in three of the six largest banks. The BoL is fully on track in modernizing its prudential framework and is now virtually at full compliance with the Basle Core Principles for Effective Banking Supervision (BCP) and the relevant EU directives. Preparations are proceeding well to ensure that unified financial sector supervision can begin as scheduled in July 2001.

6. We have redoubled our efforts in the structural area, with a view to creating an environment that is increasingly conducive to generating private sector activity, increasing productivity, enhancing and diversifying exports, and attracting FDI. We laid the foundation for the privatization of the Latvian Shipping Company (LASCO) and Ventspils Nafta in the first half of 2001, following selection of financial advisors and approval of the privatization guidelines for LASCO. We have also successfully implemented a wide array of measures aimed at improving the business climate, including through the simplification of permit, licensing, inspection, and registration procedures, all of which were drawn up in close consultation with foreign investors. In addition, we have harmonized our trade legislation with WTO rules and EU requirements while keeping our tariffs at or below EU levels. We have also eliminated all of our export subsidies.

II. THE GOVERNMENT'S PROGRAM FOR 2001-2002

Objectives and strategy

7. While we remain confident that Latvia's economic prospects are favorable, we are well aware of the important risks and challenges that face us:

- First, we fully recognize the importance of ensuring that our vulnerability to exogenous shocks—such as the Russia crisis in 1998—remains as limited as possible. In this regard, it is crucial that we continue to pursue sound macroeconomic policies, and to reign in Latvia's still large external current account deficit.

- Second, we understand that, while our prospective accession to the EU and NATO will generate important benefits for our citizens, it will also impose substantial fiscal costs. We must take those steps now that will allow us to meet our priority spending needs while returning to a broadly balanced fiscal position over the medium-term. This will require efforts to improve the prioritization, efficiency, and management of public spending, enhance tax administration, and complete the modernization of our pension system.

- Third, we aim to complete our program of structural reform, in order to support sustainable growth and strengthen our market economy and Latvia's capacity to weather the competitive pressures within the EU.

8. We consider such program fully consistent with, and an integral part of, our EU accession strategy, and we are convinced that it will provide a credible framework that will enable us to meet the relevant EU criteria for membership.

Macroeconomic framework

9. The economic program supported by the new SBA with the Fund will be based on a continuation of our successful exchange rate peg to the SDR, underpinned by tight fiscal and monetary restraint. Our macroeconomic objectives for 2001 and beyond are as follows: (i) real GDP growth of at least 5½ percent annually; (ii) inflation of no more than 3 percent per year; and (iii) a reduction in the external current account deficit to 6½ percent in 2001 and a gradual further amelioration over the medium term, with a large share of this deficit being financed by non-debt creating flows, i.e., foreign direct investment.

Fiscal policy and public sector reform

10. Fiscal policy is the major instrument of macroeconomic management under our exchange rate regime and, as such, bears the brunt of ensuring Latvia's continued external viability. To this end, our adopted budget for 2001 envisages a deficit of 1¾ percent of GDP, implying a fiscal adjustment of about 1½ percentage points of GDP compared to 2000. The budget calls for considerable expenditure restraint and would lower spending from 41 percent of GDP last year to 39 percent in 2001. This reduction reflects, among other things, our decision not to increase civil service wages during the current year, prudent capital spending, and the continued positive impact of the pension law amendments adopted in late 1999. Such fiscal tightening will help contain domestic demand pressures and leave sufficient resources available for robust private sector activity.

11. We consider this deficit as a ceiling rather than a target and, to this end, will strive to proceed cautiously with our expenditure plans until we conclude, at the time of the discussion of the first review under the program with the IMF, that both fiscal and external developments are firmly on track. In addition, should external developments make it necessary, we will pass a negative supplementary budget during the second half of the year, with a view to reducing spending in non-priority areas. Finally, any central government tax revenue above those projected under the 2001 budget will be fully dedicated to further deficit reduction.

12. We will refrain from undertaking any spending beyond the expenditure authorized in the 2001 budget and ensure that all privatization receipts, apart from those covering the administrative costs and the reserve fund of the LPA, as well as the receipts from the possible sale of UMTS and GSM licenses, are transferred to the Treasury. We will develop a medium-term plan for the best use of these additional resources, with a focus on debt reduction, the financing of pension reform and other key reforms, and infrastructure investment with high social returns. We will ensure that any spending so financed will fit within our deficit targets for 2001 and 2002 and our medium-term plan for further deficit reduction, as outlined below. In this context, we are cognizant of the importance of maintaining our external debt burden at a cautious level and will carefully assess the need for, and timing of, any further Eurobond issue in 2001 and beyond. In the same vein, to avoid taking on unwarranted fiscal risks, we will refrain from implementing the proposals to issue long-term foreign exchange swaps with involvement of the Treasury.

13. We will aim to reduce the deficit further to near balance over the medium-term, with a deficit objective of about 1 percent of GDP in 2002. Our primary emphasis in affecting fiscal adjustment will be to better identify and further reduce less productive expenditure, making room for spending required for EU and NATO accession. To the extent possible, we will seek to lower selected tax rates, including the social tax which is high by international standards.

14. In this context, we consider it crucial to make substantive progress in our efforts to rationalize spending. We have initiated a wide array of measures, which we will deepen over time, supported by technical assistance from the World Bank, the EU, and others. We aim, specifically, to improve our budgeting, expenditure management and procurement practices; contain the proliferation of public sector agencies and increase their accountability; enhance the transparency of public sector operations; review and modify as appropriate the functions, structure, and expenditure of ministries; implement a far-reaching civil service reform; and reduce the number of local governments.

15. First, we are moving ahead to ensure that budget coverage is comprehensive and that budget preparation and presentation are transparent. Last year, Parliament passed amendments to the Law on Budget and Financial Management (LBFM), which is to bring all accounts of budget-financed institutions (BFIs)—those fully and partially financed directly by the budget—into the budget, require submission of annual audited reports to the Treasury from all such institutions, and vest supervisory powers in the Ministry of Finance. By end-June 2001, we will transfer all BFI accounts from commercial banks to the Treasury and ensure that new agencies open accounts only with the Treasury. By end-June 2002, we will amend the LBFM to add provisions on accounting standards and reporting guidelines for BFIs consistent with the Law on Public Agencies. When presenting our 2002 budget documents to parliament before end-September 2001, we will (i) include annexes covering contingent liabilities, tax expenditures, and quasi-fiscal activities; (ii) provide a more comprehensive presentation of forecasting assumptions and fiscal risks; and (iii) supply financing information together with an analysis of the sources of financing. These steps will broaden fiscal analysis, provide a more comprehensive picture of fiscal activity and fiscal risks to the public, and help improve the allocation of scarce budgetary resources.

16. Second, we are taking the necessary steps to ensure that public agencies contribute to a more efficient functioning of the public sector. In March 2001, Parliament adopted the Law on Public Agencies, which defines, among other things, the functions of agencies, as well as the accounting, reporting, financial disclosure and auditing requirements for public agencies. We will adopt supporting implementation regulations by end-September 2001 to define the procedures for the formation of new agencies and for agency approval, staff remuneration issues, the determination of user charges, and financial management and accountability rules. These provisions, together with complementary legislation to be adopted to define the division of authority in the executive branch, will ensure that all agencies operate within an appropriate legal framework. Those agencies that are providing essentially commercial services will be reviewed, with a view to moving most of these activities out of the public sector. We will ascertain that all agencies comply with the requirements of the law to

produce financial accounts, and such accounts will be subject to review by the State Auditor's Office (SAO). Agencies will establish internal audit units, which will provide the assurance of the accuracy of financial accounts.

17. Third, public procurement legislation and observation of regulations are being strengthened. A new law on public procurement has been prepared and is expected to be in place by mid-year, and implementation of this enhanced framework will be supported by the European Union.

18. Fourth, we have completed functional and public expenditure reviews of three line ministries and begun the implementation of the derived action plans aimed at enhancing the respective ministries' organization, increasing the efficiency and monitoring of their spending programs, and better allocating resources according to priorities. We plan to merge these reviews into comprehensive public administration reviews, which will link policy and budget planning with improvements in the management structure. To this end, we will launch, by year-end, a pilot review in at least one ministry. In addition, by end-December 2001, we will complete a government-wide institutional development plan to improve the implementation of the EU *acquis communautaire*.

19. Fifth, we will strengthen our ability to develop a medium-term fiscal framework, including by placing more emphasis on our analysis of the medium-term implications of current and proposed new policies. In this context, we will draw on our public administration reviews of ministries and agencies and "zero-base" reviews of selected existing programs. We will form an interministerial budget working group which will review all proposed new policies—covering both investment and recurrent spending—and make recommendations to the Cabinet of Ministers. We will ensure that all new laws introduced by the government will be accompanied by detailed costing of their budgetary implications and will be subject to review by the Ministry of Finance before being approved by Cabinet.

20. Sixth, we are committed to modernizing our civil service to provide an adequate level and quality of government services to our citizens. In September 2000, Parliament adopted a new Law on the Civil Service, which aims at improving the performance incentives for public servants and extending the law's applicability to more government functions. The Cabinet of Ministers has also adopted the concept of a broad-banded, transparent, and uniform public sector wage scale, which rewards merit, minimizes discretionary and ad hoc bonuses, and allows for competitive levels of pay. To fully reap the benefits of our civil service reform, we will, by end-September 2001, adopt the implementation regulations that will allow this pay scale to become effective under a gradual implementation schedule.

21. Finally, we will address the inefficiencies brought about by the large number of very small local governments. In line with the provisions of the Law on Administrative and Territorial Reform, 27 local governments have already undergone the amalgamation into 11 larger local governments. We intend to speed up this process further by passing the necessary changes in legislation and simplify the amalgamation process. In accordance with the Law on

Administrative and Territorial Reform, we intend to complete the administrative-territorial reform of local governments by end-November 2004.

22. On the revenue side of the budget, we will focus our efforts on a continued improvement in our tax and customs administration. We are moving ahead with our program of modernization and computerization, as well as the development of our Eastern border posts, regional offices, and taxpayer services centers, all of which will contribute greatly to our monitoring and audit effectiveness. In the same vein, a tax administration manual is being developed to reduce discretion and regional variation in application of tax laws. In addition, we will rotate our mid-level managers in both the regional and central State Revenue Service (SRS) offices so as to curtail possibilities for corruption. We will refrain from granting any new tax holidays or exemptions under the corporate income tax law beyond those granted in November 2000 for large investments; further, we will carefully monitor the financial impact of the November amendments and move to curtail their applicability, should shortfalls in corporate tax receipts endanger the achievement of our overall tax revenue objectives. Similarly, we will not expand the current number and scope of existing free economic zones and ports and will bring tax benefits to these zones and ports in line with EU regulations once legislation to this effect is passed by Parliament.

23. Given recent shortfalls in collections of petroleum excises, we will make special efforts in this area. We will vigorously pursue our fight against smuggling and false declaration of imports, especially related to petroleum products, by stepping up our monitoring of oil transports; refusing licenses to wholesalers and retailers caught in illegal activity; increasing fines for offenders; and enhancing active monitoring of tax compliance. Nevertheless, we realize that our current system of petroleum taxation, with a wide range of rates and exemptions for the particular petroleum products in various uses, is non-transparent and facilitates such illegal practices. As a consequence, we will move to close the most damaging loopholes and, by end-June 2001, adopt amendments to the excise tax law that will (i) improve our monitoring of the existing exemptions granted to agriculture by eliminating the possibility to purchase petroleum products for such purposes in cash; (ii) require that all petroleum products which can be used for heating purposes be dyed (applying only to those products for which this is technically possible) so as to facilitate the detection of smuggling activity; and (iii) tax substitutes for, and components of, diesel fuel with the same excise duty rate as diesel fuel, provided that they are not used for heating purposes. In addition, in preparation for EU accession, we will review our excise duty rates and existing exemptions so as to bring them in line with EU requirements by the time of accession.

Pension reform and social assistance

24. Our policies with regard to pensions will continue to aim at placing the Social Fund on a solid financial footing, while ensuring adequate retirement income, and providing proper incentives for lifetime decisions on working and saving. We intend to submit to Parliament, by end-June 2001, amendments to the pension law which, among other things, will gradually eliminate current incentives to retire early. Our objective also remains to increase the

retirement age to 65 years over the medium-term. Details of these amendments will be agreed upon with the World Bank by end-April 2001.

25. Contributions to the fully-funded pillar of our three-tier pension system will begin on July 1, 2001. Initially, 2 percentage points of the social tax rate will go to individual accounts, to be administered by the Social Insurance Agency. Over time, however, the share of the social tax dedicated to the fully-funded system will rise to 4 percent in 2007 and then gradually to 10 percent by 2010, and in 2003 private fund managers will begin to manage the pension assets. These plans make it crucial both that we strengthen the first pillar of the pension system, as described above, and that we develop regulations to ensure that the fully-funded scheme achieves its goals of increasing savings and retirement income. Such regulations will be passed by end-June 2001, governing, among other things, the management of assets and the selection and change of asset managers; the procedures for the registration and closure of individual accounts; the procedures for the calculation of the funded pension capital; and the limits on administrative expenses.

26. We intend to improve our targeting of social assistance as a means of alleviating poverty among the poorest segments of the population, while reducing the overall cost of social assistance to the budget over the medium-term. Based on the experience gained in 2000 in some pilot municipalities, we will strive to introduce, by July 1, 2001 a national guaranteed minimum income, including a monitoring system, which will replace the current multiple social assistance programs by a unified payment. We will phase out the more poorly targeted elements of the system of social assistance.

Monetary and exchange rate policies

27. The current exchange rate peg to the SDR has served Latvia well, and we intend to maintain this peg until accession to the EU. In support of the exchange rate peg and to meet inflation targets, the BoL will undertake foreign exchange transactions and conduct open market operations as necessary.

28. We have formulated a quarterly monetary program, which includes performance criteria for the BoL's net domestic assets, taking into account the expected path for growth, inflation, and balance of payments developments. The program assumes a further increase in money demand and a rise in the money multiplier, reflecting a continued rise in confidence in the economy and increased financial intermediation in our expanding banking system. Reserve money is projected to increase by about 13 percent and broad money by 27 percent in 2001. Private sector credit is expected to continue its strong growth, but to moderate during the year and in 2002, mirroring prudent lending behavior by banks. In this regard, we will continue to rigorously implement our prudential regulations and closely monitor the quality of commercial banks' loan portfolios.

29. The performance criteria on the floor on net international reserves (NIR) under the program were derived on the basis of the need for an adequate level of international reserves. This floor has been set at a level that is lower than projected under the monetary program,

given the difficulties in accurately predicting capital flows. While we view the issuance of long-term (two-year) swaps as having played a role in developing longer-term lending in lats, we believe that the private sector is now ready to undertake this role. In this context, we intend to reduce the monthly auction volume by half, to LVL 5 million in April 2001, and decide on their full elimination by the time of the first review under the program. In the event of pressures in the foreign exchange market, the BoL will take the necessary measures to defend the peg, including by raising interest rates. We will consult with Fund staff in case of interventions in the foreign exchange market exceeding US$75 million in any two-week period.

Financial sector policies

30. Building on the excellent progress to date, the BoL will complete its endeavor to ensure full compliance with the Basle Core Principles for Effective Banking Supervision (BCP) and the relevant EU directives by July 1, 2001, the date when the banking supervision function will be transferred to the new Financial and Capital Markets Commission (FCMC), the unified financial sector supervisory agency. Specifically, by end-September 2001, we will submit to parliament amendments to the Law on Credit Institutions (LCI) to enable the FCMC to prohibit the establishment or continuation of close links with domestic and overseas third parties (including affiliated companies), as well as transactions with such parties, provided that such links and transactions are viewed to endanger the soundness and the safety of the bank or hinder the FCMC in effecting its supervisory functions. We envisage that these amendments will be passed by Parliament by end-March 2002. We aim to rewrite the LCI and finalize a draft for submission to Parliament by end-2002 so as to make it less subject to revisions than in the past, and delegate some of the law's current technical provisions to regulation, in line with international practice.

31. We are on track in establishing the organizational and institutional structure of the FCMC so as to ensure a smooth transition in unifying banking sector regulation with that for securities, insurance, and pension funds. A strategic plan is being implemented, which outlines measures to achieve operational efficiency and a smooth integration of supervisory functions, and which will be instrumental in ensuring that the relevant international supervision standards are being met. We are fully committed to ensuring adequate safeguards to maintain the political and operational independence of the new regulatory agency, and a high quality of staff.

Privatization and other structural reforms

32. The structural reform component of our economic program will focus on pursuing the privatization of our large-scale enterprises, creating a competitive framework for our energy and telecommunications sectors, and continuing our efforts to enhance the business climate, including by improving governance. Progress in these areas will lay the foundation for robust and sustainable economic growth in Latvia and make Latvia an attractive place for foreign investors in the years to come.

33. The privatization of small and medium-sized enterprises in Latvia is complete, and we are moving to privatize several of the remaining large public enterprises during 2001. Our emphasis is on implementing a transparent process that will bring the largest possible benefit to the Latvian economy and, toward this end, we have hired international advisors to help us develop privatization plans for each of the remaining large enterprises. Following the advice of one such advisor, we intend to complete the sale of 68 percent of the Latvian Shipping Company (LASCO) to a strategic investor by end-September 2001. We have agreed that Transparency International will be monitoring this privatization process. We expect to dispose of the government's remaining stake of 38 percent in Ventspils Nafta by end-2001. While we aim to complete the privatization of Lattelekom as quickly as possible, further action must await the outcome of arbitration proceedings related to the WTO-mandated relinquishing of the company's monopoly rights in 2003.

34. Improvements in the regulatory and legal framework for all utilities need to move forward in parallel with the privatization process. We will strive to put in place, by end-September 2001, a single regulatory agency (superregulator) with responsibility for all public utilities, comprising telecommunications, post, railway transportation, and the energy industry (except district heating, where electricity is not generated in the production process). In this regard, Parliament has already passed the Law on Regulators of Public Services, and necessary secondary legislation will be passed before the new regulatory agency begins operations. While the passage of a new telecommunications law has been put on hold until an agreement has been reached in the Lattelekom case, we are taking some interim steps to improve regulation and enhance competition in this area. Specifically, by end-September 2001, regulation of the telecommunications sector will be integrated with the superregulator, initially operating under the existing telecommunications law and an umbrella agreement. In addition, by end-June 2001, we will enact supporting legislation defining (i) the services to be regulated by the superregulator or deregulated, and (ii) rules for licensing. A clear segregation of responsibilities between the regulator and ministries is defined in the Law on Regulators of Public Services as well as sector-specific legislation.

35. We are committed to improving competition in the energy sector and, in that context, we intend to complete by end-December 2002 the restructuring program for Latvenergo, adopted by the Cabinet of Ministers in October 2000. The restructuring plan envisages the establishment of separate units and accounting systems for all arms of the company—distribution, transmission, and power generation. In addition, we have begun implementing a new grid code, which provides third parties access to energy transmission and distribution and establishes separate transmission and distribution service prices. We have decreased the criteria for qualified customers from 100 GWH to 40 GWH to increase the number of possible market participants. We will continue to review transmission and distribution tariffs to ensure competitive and market-based pricing.

36. We will continue to improve the business environment in Latvia, notably by implementing the requirements of the *acquis communautaire* and the action plan for improving the business environment adopted by the Cabinet of Ministers—based on the recommendations of the 1999 Foreign Investor Advisory Service (FIAS) report on

administrative barriers to foreign investment. We are making good progress in implementing these measures. For example, the visa and work permit regulation has been simplified; the real estate tax has been reduced to a flat 1 percent; customs procedures are now more transparent; regulations on the various inspections have been harmonized and written reports are now available to the inspected enterprise; the process of obtaining construction permits has been simplified; and a unified enterprise registration procedure has been put in place. We will work closely with municipalities to ensure that the simplified rules for obtaining construction permits are being applied, including the fee schedule. Following our action plan, we will enact new legislation on land transactions by end-2001, which will gradually remove the remaining barriers for land purchases by foreign investors. We will continue our efforts to strengthen the capacity of the judicial apparatus and increase judicial training. Other future key measures will include (i) setting up the Customs Advisory Service and introducing a national help line by September 2001 to simplify customs procedures and ensure transparency; and (ii) further streamlining overland border crossing procedures with neighboring countries, particularly Russia.

37. We have continued to make good progress in land registration and apartment privatization. By end-December 2000, nearly all land properties had been registered in the cadastre and some 50 percent had been entered into the Land Book. In addition, we have offered for privatization some 90 percent of the government-owned apartments, of which some two-thirds have been sold by end-December 2000.

38. In our view, the efforts mentioned above to simplify and make more transparent the government's role in the economy will have an important positive impact on governance, by limiting the scope for administrative corruption. We are also committed to undertaking our policy and institutional reforms to improve governance, under the leadership of the Corruption Prevention Council and in coordination with the World Bank. In this regard, we are strengthening our efforts to limit conflict of interest for public officials. To this end, the Anticorruption Unit (AU) of the SRS is preparing an action plan for the development of (i) a system of conflict of interest; (ii) adequate reporting forms for public officials for disclosure of income and assets and conflict of interest; (iii) a comprehensive list of public officials to be subjected to the disclosure requirements; and (iv) a draft manual and curriculum for training of SRS staff in processing and assessing declarations.

Trade policy

39. Latvia maintains a very liberal trade system. During the last four years, we have reduced the simple average MFN tariff from 5.6 percent to 4.6 percent, and we will eliminate the current MFN rate of 0.5 percent applied to some industrial goods by January 2002. We will ensure that our trade legislation will continue to be in line with EU requirements and follow WTO rules and agreements, and to this end, among other things, reduce our tariffs on agricultural commodities. We intend to keep our tariffs at or below EU levels. Further, we shall neither increase any ad valorem tariffs nor introduce any new specific tariffs or export subsidies.

Epilogue

40. We believe that the policies described above will help ensure that Latvia experiences strong and sustainable economic growth over the medium-term. We stand ready to take additional measures to meet these goals should such a need arise.

Table 1. Latvia: Quantitative Performance Criteria and Indicative Targets
Under the Stand-By Arrangement, 2001 1/

	Variable and Periods		Target		Outcome
					(In millions of lats)
I.	Ceilings on the general government fiscal deficit 2/				
	From January 1, 2001 to:				
	March 31, 2001: Indicative		20		
	June 30, 2001: Performance criterion		46		
	September 30, 2001: Performance criterion		62		
	December 31, 2001: Performance criterion		79		
II.	Ceilings on net domestic assets of the Bank of Latvia 3/				
	March 31, 2001: Indicative		21		
	June 30, 2001: Performance criterion		35		
	September 30, 2001: Performance criterion		40		
	December 31, 2001: Performance criterion		62		
					(In millions of US$)
III.	Floor on convertible net international reserves of the Bank of Latvia 4/ 5/				
	March 31, 2001: Indicative		798		
	June 30, 2001: Performance criterion		814		
	September 30, 2001: Performance criterion		878		
	December 31, 2001: Performance criterion		844		
IV.	Ceilings on contracting and guaranteeing of medium-and long-term nonconcessional external debt 6/ 7/	Total	Of which: maturity of more than 1 and up to 5 years	Total	Of which: maturity of more than 1 and up to 5 years
	Reference point: December 31, 2000				
	March 31, 2001: Indicative	52	52		
	June 30, 2001: Performance criterion	242	52		
	September 30, 2001: Performance criterion	300	52		
	December 31, 2001: Performance criterion	320	72		
V.	Ceilings on contracting or guaranteeing of external debt of up to and including one year 6/ 7/				
	March 31, 2001: Indicative		0		
	June 30, 2001: Performance criterion		0		
	September 30, 2001: Performance criterion		0		
	December 31, 2001: Performance criterion		0		
VI.	Indicative ceilings on reserve money 8/				
	March 31, 2001:		572		
	June 30, 2001:		595		
	September 30, 2001:		640		
	December 31, 2001:		641		

Table 1. Latvia: Quantitative Performance Criteria and Indicative Targets
Under the Stand-By Arrangement, 2001 1/

VII.	Indicative ceilings on net domestic assets of the banking system 3/ 9/	
	March 31, 2001:	790
	June 30, 2001:	850
	September 30, 2001:	918
	December 31, 2001:	1009
VIII.	Zero ceiling on the non-accumulation of external arrears by the general government	Continuous

1/ Definitions of the performance criteria and indicative targets are included in the Annexes to the Memorandum of Economic Policies.
2/ The ceilings on the general government fiscal deficit will be adjusted downward by the amount by which central government tax revenue exceeds the indicative targets mentioned in Annex I of the MEP.
3/ The ceilings will be adjusted upward (downward) for any shortfall (excess) from programmed levels of disbursements of foreign balance of payments assistance and for any decumulation (accumulation) of foreign exchange swaps compared to the stock of such swaps at end-December 2000. The ceilings will also be adjusted downward for any receipts from foreigners from privatization and the sale of UMTS and GSM licenses (see Annex II of MEP).
4/ The floors will be adjusted downward (upward) for any shortfall (excess) from programmed levels of disbursements of foreign balance of payments assistance and for any decumulation (accumulation) of foreign exchange swaps compared to the stock of such swaps at end-December 2000. The floors will also be adjusted upward for any receipts from foreigners from privatization and the sale of UMTS and GSM licenses (see Annex III of MEP).
5/ The program definition includes gross international reserves generated from foreign exchange swaps accumulated by end-December 2000 (see Annex III of MEP).
6/ Applies to the general government, the Bank of Latvia, or any other agencies acting on behalf of the government.
7/ The performance criteria on debt ceilings apply not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274 – (00/85), adopted August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received. Because of difficulties in ensuring effective monitoring of leasing and import financing by local entities, such transactions by local governments are not included under the external debt limits (see Annex IV of MEP).
8/ The program definition excludes time deposits of commercial banks held with the BoL (see Annex II of MEP).
9/ The program definition includes foreign equity of commercial banks, which is recorded in "other net assets" (see Annex II of MEP).

Table 2. Latvia: Structural Benchmarks Under the Stand-By Arrangement, 2001-2002

By end-June 2001:

1. Submit to Parliament amendments to the pension law, as described in paragraph 24 of the MEP.

2. Complete the transfer of all accounts of budget financed institutions (BFI) directly financed by the budget from commercial banks to the Treasury, as described in paragraph 15 of the MEP.

3. Parliament to pass the amendments to the Excise Tax Law, as described in paragraph 23 of the MEP.

By end-September 2001:

1. The Cabinet of Ministers to adopt supporting regulations for the implementation of the Law on Public Agencies, as described in paragraph 16 of the MEP.

2. Submit to Parliament the 2002 budget documents providing the information described in paragraph 15 of the MEP.

3. Submit to Parliament the amendments to the Law on Credit Institutions, as described in paragraph 30 of the MEP.

By end-March 2002:

1. The Bank of Latvia to discontinue two-year foreign exchange swaps, as described in paragraph 29 of the MEP.

PERFORMANCE CRITERIA ON GENERAL GOVERNMENT FISCAL DEFICIT AND INDICATIVE TARGETS ON CENTRAL GOVERNMENT TAX REVENUE

Ceilings on the General Government Fiscal Deficit

From January 1, 2001 to:	(In millions of lats)
March 31, 2001 (indicative)	20
June 30, 2001	46
September 30, 2001	62
December 31, 2001	79

Indicative Targets on Central Government Tax Revenue

From January 1, 2001 to:	(In millions of lats)
March 31, 2001 (indicative)	295
June 30, 2001 (indicative)	606
September 30, 2001 (indicative)	920
December 31, 2001 (indicative)	1,247

The general government is defined to include the central government basic and special budgets and the local governments basic and special budgets. The general government fiscal deficit is defined as the increase in net claims on the general government of the domestic banking system comprising the Bank of Latvia and licensed commercial banks; plus the net increase in all other claims on the general government of domestic and foreign financial and nonfinancial institutions or households; plus the privatization receipts net of the legally stipulated administrative expenditures and allocations to the reserve fund of the Latvian Privatization Agency (LPA). Upon closure of the LPA, the privatization receipts will accrue to the Ministry of Economy and, as is currently the case under the LPA, be transferred to the treasury.

The net claims of the domestic banking system on the general government are defined as all claims of the Bank of Latvia and licensed commercial banks on the general government, less all deposits of the general government with these institutions. The claims of the banking system on the general government include, but are not limited to: bank loans (including overdrafts) to the general government and securities issued by the general government held by banks. Deposits of the general government with banks include domestic or foreign currency deposits.

The ceilings on the general government fiscal deficit will be adjusted downward by the extent to which central government tax revenues exceed the respective indicative targets outlined above. The taxes to be included in this calculation are: (i) the corporate income tax; (ii) the value added tax (VAT); (iii) all excises; (iv) customs duties; (v) the personal income tax accruing to the central government special budgets; (vi) central government taxes in transit; and (vii) the social tax.

Monthly data on net claims of the domestic banking system on the general government are taken from the balance sheet of the Bank of Latvia and the consolidated balance sheet of all licensed commercial banks. The Bank of Latvia will also provide separate information on the deposits of the LPA with the domestic banking system, as long as the LPA is excluded from the definition of government applied in the monetary statistics. The treasury will record receipts from foreigners from privatization and the sale of UMTS and GSM licenses in a separate subaccount in the treasury system and report the monthly balance of such subaccount to both the Bank of Latvia and the IMF. In addition to providing the monthly Treasury Report showing all general government revenue and expenditure by economic classification, the Ministry of Finance shall provide information on: (i) net sales of all Latvian State Treasury securities and any other general government debt instruments; (ii) other general government net borrowing; (iii) net changes in general government deposits held abroad; (iv) disbursements and repayments related to foreign loans extended to the general government; (v) gross receipts from foreigners from privatization and the sale of UMTS and GSM licenses and the uses of such receipts, as well as information on the LPA's deposits with the banking system; (vi) net lending operations of the general government; and (vii) the receipt and use of foreign grants, including from the European Union. All such information is to be provided monthly to the IMF by electronic means and in hardcopy by the 17^{th} day of the following month. In addition, the official quarterly debt tables should be provided to the IMF by electronic means and in hardcopy within two months following the end of the quarter in question.

If any data taken from the above sources are subsequently revised due to errors, omissions, or any other reasons, the IMF will be notified, without any delays, of such revisions.

NET DOMESTIC ASSETS OF THE BANK OF LATVIA AND THE BANKING SYSTEM

Net domestic assets of the Bank of Latvia are defined as the difference between: (i) reserve money, i.e., the issuance of lats plus deposits of commercial banks with the Bank of Latvia (including obligatory reserves but excluding banks' term deposits with the Bank of Latvia); and (ii) the Bank of Latvia's net international reserves (as defined in Annex III). Net domestic assets of the Bank of Latvia would thus include: net credit to the general government; credit to commercial banks; and other net assets. Both (i) and (ii) will be expressed in lats.

The ceilings on net domestic assets are established on the basis of an assumption of (i) disbursements in balance of payments assistance of $0 million in the first quarter of 2001, $0 million in the second quarter of 2001, $40 million in the third quarter of 2001, and $0 million in the fourth quarter of 2001; and (ii) zero receipts from foreigners from privatization and the sale of UMTS and GSM licenses. The ceilings were derived from the Bank of Latvia balance sheet by assuming an underlying increase in foreign exchange swaps of $15 million per quarter; the stock of such swaps amounted to $184 million at end-December 2000. The ceilings on net domestic assets (both at the Bank of Latvia and banking system levels) will be adjusted upward (downward) for any shortfall (excess) in disbursements from foreign creditors of balance of payments assistance relative to the programmed levels. The ceilings on net domestic assets will also be adjusted downward for any receipts from foreigners from privatization and the sale of UMTS and GSM licenses, which remain in the subaccount of the Treasury established for such purpose (see Annex I). The ceilings will be adjusted downward (upward) for any accumulation (decumulation) of foreign exchange swaps compared to the stock of such swaps at end-December 2000. The limits indicated in the table below are stock numbers for the respective date and will be monitored monthly based on the balance sheet of the Bank of Latvia. The balance sheet at the program exchange rate and at the actual exchange rate is to be provided monthly by the Bank of Latvia to the IMF by electronic means and in hardcopy by the 17th day of the following month.

Net Domestic Assets of the Bank of Latvia

	(In millions of lats)
Ceiling for March 31, 2001 (indicative)	21
Ceiling for June 30, 2001	35
Ceiling for September 30, 2001	40
Ceiling for December 31, 2001	62

Net domestic assets of the banking system are defined as the difference between the liabilities of the banking system to the nonbank public (M2X) and net foreign assets of the banking system. Net foreign assets of the banking system are the sum of all gross claims on nonresidents, *less* liabilities to nonresidents (excluding foreign equity). Thus, net domestic assets of the banking system include: net credit to the general government; gross credit to the nongovernment sector; and other net assets (including foreign equity).

The indicative limits shown in the table below are stock numbers and will be monitored monthly from the consolidated balance sheets of the banking system. The balance sheet at the program exchange rate and at the actual exchange rate is to be provided monthly by the Bank of Latvia to the IMF by electronic means and in hardcopy by the 17th day of the following month.

If any data taken from the above source are subsequently revised due to errors, omissions, or any other reasons, the IMF will be notified, without any delays, of such revisions.

Net Domestic Assets of the Banking System

	(In millions of lats)
Ceiling for March 31, 2001 (indicative)	790
Ceiling for June 30, 2001 (indicative)	850
Ceiling for September 30, 2001 (indicative)	918
Ceiling for December 31, 2001 (indicative)	1,009

TARGET FOR THE CONVERTIBLE NET INTERNATIONAL RESERVES OF THE BANK OF LATVIA

Convertible net international reserves of the Bank of Latvia consist of gross international reserves *less* foreign liabilities in all convertible currencies, both expressed in U.S. dollars.

For purposes of the program, gross international reserves will comprise all liquid foreign assets of the Bank of Latvia which are readily available, including monetary gold, holdings of SDRs, any reserve position in the Fund, holdings of foreign exchange, and any deposits with nonresident financial institutions. For purposes of the program, foreign liabilities will be defined as use of Fund credit, and on balance sheet foreign currency liabilities of the Bank of Latvia.

For the entire period of the program, the exchange rates of the SDR and other currencies vis-à-vis the U.S. dollar will be those prevailing at end-December 2000.

The performance criteria on the floor on net international reserves of the Bank of Latvia are specified below. The floor on net international reserves is established on the basis of an assumption of (i) disbursements in balance of payments assistance of $0 million in the first quarter of 2001, $0 million in the second quarter of 2001, $40 million in the third quarter of 2001, and $0 million in the fourth quarter of 2001; and (ii) zero receipts from foreigners from privatization and the sale of UMTS and GSM licenses. The net international reserves floor was derived from the Bank of Latvia balance sheet by assuming an underlying increase in foreign exchange swaps of $15 million per quarter; the stock of such swaps amounted to $184 million at end-December 2000. The net international reserves floor will be adjusted downward (upward) for any shortfall (excess) in disbursements from foreign creditors of balance of payments assistance relative to the programmed levels. Likewise, the floor of international reserves will be adjusted upward for any receipts from foreigners from privatization and the sale of UMTS and GSM licenses, which remain in the subaccount of the Treasury established for such purpose (see Annex I). The net international reserves floor will be adjusted upward (downward) for any accumulation (decumulation) of foreign exchange swaps compared to the stock of such swaps at end-December 2000. The stock of net international reserves of the Bank of Latvia, as well as the stock of all outstanding swap operations, are to be provided monthly by the Bank of Latvia to the IMF by electronic means and in hardcopy by the 17th day of the following month.

If any data taken from the above source are subsequently revised due to errors, omissions, or any other reasons, the IMF will be notified, without any delays, of such revisions.

Net international Reserves of the Bank of Latvia

Minimum	(In millions of U.S. dollars)
Floor on March 31, 2001 (indicative)	798
Floor on June 30, 2001	814
Floor on September 30, 2001	878
Floor on December 31, 2001	844

EXTERNAL DEBT

	Maximum Ceilings		
Ceiling on the contracting and guaranteeing of nonconcessional external debt 1/ 2/	Maturity of up to and including 1 year	Medium- and long-term maturities	Of which: more than 1 and up to 5 years
	(In millions of U.S. dollars)		
Reference point: December 31, 2000			
March 31, 2001 (indicative)	0	52	52
June 30, 2001	0	242	52
September 30, 2001	0	300	52
December 31, 2001	0	320	72

1/ Concessional borrowing refers to loans with a grant element of at least 35 percent discounted on the basis of the OECD Commercial Reference Interest Rates (CIRRs).

2/ The performance criteria on debt ceilings apply not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85) adopted August 24, 2000), but also to commitments contracted or guaranteed for which value has not been received. Temporary exchanges of assets, such as swaps and lease arrangements with non-residents, are included under this definition of external debt. Because of difficulties in ensuring effective monitoring of leasing by local entities, such transactions by local governments are excluded from the external debt limits.

External debt limits apply to external debt—with original maturities of up to and including one year; to nonconcessional medium- and long-term external debt of original maturities of more than one year; and to commitments contracted or guaranteed for which value has not been received. For the purpose of the program, the so defined external debt limits apply to debt contracted or guaranteed after December 31, 2000 by the government, the Bank of Latvia, or any other agencies on behalf of the government, with sub-ceilings for such debt of maturities of more than one year up to and including five years. The definition of the government is the same as in Annex I. The stock of medium- and long-term debt was $648.4 million as of December 31, 2000. For the purpose of measuring the performance criteria on short-term external debt with a maturity of up to and including one year, the outstanding stock of this debt, which excludes normal import-related trade credits, was zero at December 31, 2000. Excluded from the limits are the use of Fund resources; but other balance of payments support would be covered by these limits, including loans from official creditors and foreign banks. Contracted loans shall be valued in the currency of transactions and converted into U.S. dollars at the exchange rate prevailing at the time the loan is contracted.

Compliance with the limits shall be verified at quarterly intervals for the dates shown above. Information on the contracting and guaranteeing of external debt, as well as the outstanding stock of government debt, will be reported monthly to the IMF by electronic means and in hardcopy by the Ministry of Finance by the 17th day of the following month. In addition, the official quarterly debt tables should be provided to the IMF by electronic means and in hardcopy within two months following the end of the quarter in question.

In addition to the performance criteria specified above, a continuous performance criterion respecting the nonaccumulation of external payments arrears by the government applies.

If any data taken from the above source are subsequently revised due to errors, omissions, or any other reasons, the IMF will be notified, without any delays, of such revisions.

Statement by the IMF Staff Representative
April 20, 2001

Since issuance of the staff report (EBS/01/44), additional information has become available on macroeconomic developments, the fiscal and monetary performance during the first quarter of 2001, and structural issues. This information does not alter the thrust of the staff appraisal.

The macroeconomic outcome in 2000 was better than expected. Reflecting a strong growth rate of 8.7 percent in the fourth quarter of 2000, real GDP grew by 6.6 percent for the year as a whole, about a percentage point above the estimate in the staff report. Indices on industrial production and retail trade indicate that economic activity remained buoyant in the first quarter of 2001. Inflation remains low, with the CPI increasing by 1.4 percent in the twelve months through March 2001. The external situation in 2000 also turned out better than estimated. Reflecting continued strong exports to the EU and improvements in the income account, the external current account deficit declined to 6.8 percent of GDP, about half a percentage point lower than expected. The share of this deficit financed by foreign direct investment rose to 82 percent, compared to the preliminary estimate of 75 percent in the staff report.

The general government fiscal deficit and the NIR and NDA of the Bank of Latvia were within the indicative targets set for end-March. The general government fiscal deficit amounted to LVL 9 million, about half of the deficit ceiling, with the authorities succeeding in containing expenditure in light of somewhat lower tax receipts. Parliament adopted the amendments to the excise tax law ahead of schedule, which bodes well for strengthening tax collections. In line with the commitments under the program, the Bank of Latvia reduced the monthly auction volume for two-year swaps to LVL 5 million beginning in April.

In the structural area, last week the government decided on the minimum bidding price for the privatization of the Latvian Shipping Company (LASCO), with the auction tentatively scheduled for May 11.

The Latvian authorities would like the staff report and the program documents to be published.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

EDITORIAL DIVISION
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Press Release No. 01/15
FOR IMMEDIATE RELEASE
April 20, 2001

International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves Stand-By Loan for Latvia

The International Monetary Fund (IMF) today approved a twenty-month stand-by credit for Latvia for SDR 33 million (about US$42 million) to support the government's program for 2001–02. The government of Latvia does not intend to make drawings under the stand-by credit and will treat it as precautionary, as with the previous stand-by credit (see Press Release No. 99/58).

In commenting on the Executive Board's decision, Shigemitsu Sugisaki, Deputy Managing Director, made the following statement:

"Latvia's economy has emerged from the recession triggered by the Russia crisis. Economic growth is strong and broad-based, inflation is close to rates prevailing in the European Union, and vulnerability to external shocks has lessened. A surge in foreign direct investment has helped contain external debt indicators. However, unemployment remains relatively high.

"With a view to sustaining robust economic growth and further improving Latvia's external outlook, a prudent fiscal policy is key, and the budget is to be broadly balanced over the medium term. The budget deficit is to fall in 2001 to 1¾ percent of GDP—a near halving—and in 2002, a fiscal deficit of no more than 1 percent of GDP is envisaged. In the medium-term, the authorities will raise expenditure related to EU and NATO accession; they also wish to make selective reductions in tax rates. To help achieve these goals at the same time, public expenditure policy and management is being improved, the pension system further reformed, the tax and customs administration strengthened, and the budget process made more transparent and efficient.

"The exchange rate peg to the SDR has been a reliable anchor for the past seven years and remains appropriate, provided that macroeconomic policies remain sufficiently tight and external competitiveness is maintained.

"The Bank of Latvia is to be commended for its ongoing effort to bring financial regulations into full compliance with international standards. As a result, the financial sector has strengthened considerably. The entry of foreign strategic investors in several of the major banks, and possible mergers among key players in the market, are likely to further strengthen the banking system and make it more resilient to exogenous shocks.

"Structural reforms remain essential to achieve Latvia's medium-term goals and reduce further its vulnerability to external shocks. Key reforms include creation of an environment conducive to private sector development and increased foreign direct investment, privatization of remaining state-owned enterprises, and measures to enhance governance," Mr. Sugisaki said.

ANNEX

Program Summary

The Latvian economy has fully recovered from the recession triggered by the Russian crisis, with the resumption of strong growth in a low-inflation environment. Broad-based growth is driven by private investment and buoyant export performance, despite the appreciation of the lats relative to the euro.

The main focus of Latvia's new program will be on fiscal policy in 2001 and over the medium term, underpinned by a continuation of the successful exchange rate peg to the SDR. The key objective will be to provide a credible framework within which the authorities' medium-term fiscal goals – a broadly balanced fiscal stance, increased expenditure for EU and NATO accession, and selective tax rate cuts – can be achieved.

Under the program, GDP growth is projected at 6.0 percent in 2001, after 6.6 percent growth in 2000 and 1.1 percent in 1999. Inflation is targeted to remain low at, 3.0 percent 2001, compared with 1.8 percent in 2000. International reserves are targeted to remain in the range of three months of imports.

To achieve these goals, the budget for 2001 approved by Parliament late last year envisages a deficit of 1 ¾ percent of GDP. The budget is based on conservative revenue assumptions, with nominal tax receipts projected to grow by 8 ½ percent, somewhat slower than nominal GDP.

The structural component under the new program will focus on three areas that are key to medium-term macroeconomic stability and growth: public expenditure policy and management, including pension reform; improvements in tax and customs administration; and financial sector supervision. The program's prudent macroeconomic policy stance is complemented by key structural reforms that constitute a vital building block in supporting durable growth and Latvia's attractiveness to foreign investors. Measures include concerted efforts to expedite privatization and further improve the business climate.

Latvia joined the IMF on May 19, 1992 and its quota[1] is SDR 126.8 million (about US$161 million). Its outstanding use of IMF financing currently totals SDR 24.8 million (about US$31 million).

[1] A member's quota in the IMF determines, in particular, the amount of its subscription, its voting weight, its access to IMF financing, and its share of the allocation of SDRs.

Table 1. Latvia: Selected Economic and Financial Indicators

	1996	1997	1998	1999	2000 Est.	2001 Proj.
(Annual percent changes unless otherwise specified)						
National income						
Nominal GDP (millions of lats, estimates for 2000)	2,829	3,276	3,590	3,897	4,333	4,717
GDP (millions of $US)	5,137	5,639	6,086	6,662	7,144	7,709
Real GDP	3.3	8.6	3.9	1.1	6.6	6.0
Registered unemployed (in '000, end of period)	90.8	84.9	111.4	109.5	92.3	...
Unemployment rate (end of period)	7.2	7	9.2	9.1	7.8	...
Prices and wages (annual change)						
Consumer price index (period average)	17.6	8.4	4.7	2.4	2.7	2.3
Consumer price index (end-period)	13.1	7.0	2.8	3.2	1.8	3.0
Producer price index (end-period)	13.7	4.1	1.9	-1.1	1.1	...
Real wage (growth rate)	-5.3	11.2	6.2	3.5	...	...
Average monthly wage (in lats)	99	120	133	141	...	...
General government (in percent of GDP)						
Revenue 1/	37.4	41.3	42.6	40.0	37.5	37.5
Expenditure	39.0	40.7	43.3	43.8	40.9	38.9
Net lending	0.2	0.3	0.1	0.2	0.0	0.3
Fiscal balance 1/	-1.8	0.3	-0.8	-3.9	-3.3	-1.7
Gross government debt (millions of lats)	408	392	377	505	570	...
Gross debt as percentage of GDP (in percent)	14.4	12.0	10.5	13.0	13.2	...
Foreign debt (millions of lats)	227	218	232	358	347	...
External sector						
Current acct. balance (incl. official transfers, percent of GDP)	-4.2	-5.1	-9.8	-9.7	-6.8	-6.3
External trade balance (percent of GDP) 2/	-15.5	-15.0	-18.6	-15.4	-14.8	-14.6
Exports						
Value	8.8	23.6	9.4	-6.1	9.0	11.7
Imports						
Value	17.4	17.5	17.0	-7.2	6.9	9.8
CPI-based real exchange rate indices (1994=100)						
INS weights	101.4	105.9	134.2	141.6	...	...
International reserves (in months of imports of goods and nonfactor services, end-of-period)	3.1	3.0	2.7	3.1	2.8	2.9
Exchange rate (lats per $US; end-of-period)	0.56	0.59	0.57	0.58	0.61	...
Exchange rate (lats per $US; period average)	0.55	0.58	0.59	0.59	0.61	...
Money and credit (end-period, change in percent)						
Reserve money	25	30	7	12	8	13
Domestic credit (non-government)	1	76	59	15	37	29
Broad money	20	39	6	8	28	27
Ratio of broad money to NFA of the BoL	1.8	2.0	1.7	1.9	2.4	2.6
Riga Stock Exchange Price Index, RICI, (end-of-period)	417	741	186	171	176	...
Interest rates (in percent, a year end-period)						
Deposit 3/	11.0	6.0	7.0	6.0	4.9	...
Credit 3/	20.0	13.0	15.0	15.0	11.3	...
Three-month treasury bill auction rate	10.8	4.0	7.9	5.1	4.5	...

Data: Latvian authorities and IMF staff estimates and projections.
1/ Privatization receipts are classified as a deficit financing component, i.e., they are excluded from revenues.
2/ Goods only.
3/ Average volume-weighted commercial bank interest rates on 3-6 month domestic currency transactions.

Statement by Olli-Pekka Lehmussaari, Executive Director for Republic of Latvia
April 20, 2001

My authorities would like to thank Mr. Schiff and his team for their guidance in maintaining macroeconomic stability and external sustainability in Latvia. They are delighted that fruitful cooperation with the staff team has developed into a new economic program, and they welcome Mr. Mueller as a new mission chief.

At the outset of the new millennium, Latvia is witnessing brisk economic growth coupled with ongoing macroeconomic stability. These successful developments were backed by the sound and responsible economic policies of the Latvian government. Only three years have passed since the Baltic countries were severely affected by the Russian crisis. Meanwhile, the government effectively proved its ability to cope with external shocks by implementing a number of corrective measures which enabled the Latvian economy to return to a sustainable growth path. Looking ahead, the authorities are committed to meeting key economic challenges through a tighter fiscal policy and faster structural adjustment.

With its healthy growth rates and low inflation, Latvia has become one of the most rapidly developing countries in Central and Eastern Europe and is on a path towards real convergence with the EU countries. Since 1996, real GDP growth in Latvia has exceeded GDP growth in the EU (except in 1999), thus narrowing the per capita income gap. Moreover, Latvia's production structure is converging to that of the EU countries. Latvia also competes well in the international markets. In 2000, nearly 2/3 of total Latvian exports went to EU countries. By anchoring its economic, political, and institutional structures to those of advanced Western European nations, Latvia has improved its investment climate markedly. In 2000, FDI inflows increased by 21.9 percent and constituted almost 6 percent of GDP.

Topping Latvia's political and economic agenda, EU accession has become one of the key driving forces behind the country's adjustment and reform efforts. Having met many of the criteria for membership in the European Union, Latvia is addressing the remaining challenges. Eleven negotiation chapters are provisionally closed, 24 are open and the country is looking forward to opening all remaining chapters by the mid-2001. The Government aims to complete the accession negotiations by 2003. Thanks to significant advancement and firm policies, the country is catching up to the first wave of the EU candidate countries.

Recent economic developments and outlook

In 2000, growth reached the highest level in the Baltics at 6.6 percent, fostered by exports and investments. Growth was particularly strong in industries producing high value-added manufactured goods, such as shipbuilding and agricultural machinery production. Construction, transportation and communication industries, retail trade and, to a much lower extent, agriculture, also contributed to growth.

In most industries, wages grew more slowly than productivity, and productivity gains more than offset the recent real appreciation of the lats. Exports to the EU increased faster than those to non-EU trading partners. While unemployment, particularly in rural areas, approached a level well above that of most industrial countries, it reflects a problem typical in many fast developing transition economies. At about 8 percent, official unemployment was one percentage point lower than a year ago.

The external position has improved despite fast economic growth. The external current account deficit narrowed from 9.6 percent in 1999 to 6.8 percent in 2000. While the current account deficit remains large, it was mostly financed by non-debt-creating capital flows. The public sector debt-to-GDP ratio reached only about 10 percent, while reserves of Bank of Latvia are at a comfortable level covering roughly 3 months of imports.

The medium-term outlook is favorable. The recent credit expansion and further implementation of structural reforms should promote investments and generate an increase in productivity and robust growth over the medium term. Also, inflation is expected to remain low over the medium-term.

Fiscal policy

My authorities clearly understand that, under Latvia's fixed exchange rate regime, fiscal policy is the main line of defense against negative external shocks. In 2000, the general government fiscal deficit declined compared with the previous year, but remained above 3 percent of GDP. In addition to higher-than-projected spending, the fiscal deficit was adversely affected by tax-revenue-depressing factors, including low profit levels in 1999, high oil prices and difficulties in collecting petroleum excise taxes.

The 2001 general government budget fiscal deficit is projected to be 1.7 percent of GDP, the larger part of which stems from the Social Fund and the central government budget, while the local government budgets are broadly balanced. The fiscal deficit of the first quarter is significantly better than expected, which bodes well for achieving the annual deficit target.

The Latvian authorities consider the fiscal deficit for this year as a ceiling rather than a target. Should external developments make it necessary, a negative supplementary budget will be adopted during the second half of the year. The deficit will be further reduced in 2002 and over the medium term, thus creating the necessary preconditions for improvement of the external balance. In light of the strong GDP growth and further strengthening of the tax administration, tax revenues should comfortably match the program targets. In line with the fiscal goals, all transactions linked to privatization receipts (both revenues and spending) will be brought into the budget process. One of the major tasks is to eliminate the structural deficit of the Social Fund by accelerating pension reform in the years to come.

Over the medium term, the government's policies aim at achieving two goals simultaneously. On the one hand, the Government has to maintain a broadly balanced fiscal position over the medium-term, but, on the other hand, the authorities have to accommodate substantial fiscal costs related to accession to the EU and NATO. To meet these goals, the authorities are improving the way they prioritize and manage public spending. Strengthening the medium-term fiscal framework, with the assistance of the World Bank under the PSAL, will help assess and manage difficult trade-offs between fiscal discipline and extra spending. In this context, the Fund's assessment of Latvia's compliance with the fiscal transparency module of the ROSC is also important.

Exchange rate and monetary policies

Latvia has had a conventional exchange rate peg to the SDR since 1994. The composition of Latvia's foreign trade by settlement currencies closely resembles the composition of the SDR basket. This regime has been tested by severe shocks and it has successfully passed the test. Moreover, the peg has served Latvia well in bringing down inflation and moderating bilateral exchange rate fluctuations. Also, Bank of Latvia has employed and developed the full set of indirect, market-based monetary policy instruments that are used by the European Central Bank, and is fine-tuning the use of these instruments. The exchange rate peg continues to be appropriate, as evidenced by various indicators of Latvia's external competitiveness. As long as Latvia is well served by its exchange rate regime, there appears to be little reason to change it, and the authorities intend to shift to a euro peg at the time of Latvia's accession to the EU.

In December 2000, Bank of Latvia lowered the reserve requirements for credit institutions in Latvia by one percentage point to 6 percent. This cut will not only ease profit pressures on banks, but also bring reserve requirements more in line with those in the EU. Moreover, Bank of Latvia will gradually reduce the proportion of cash to be used for the purposes of complying with the reserve requirements, and will eventually abolish the use of cash for this purpose.

Healthy credit growth last year is a good evidence of a strengthened financial system. For instance, loans with a maturity of over one year increased by more than 40 percent, albeit from a very low level. The relatively strong increase in bank lending was not accompanied by deterioration of the quality of credit portfolios. On the contrary, at the end of 2000, the share of non-performing loans in total loans for the whole banking sector was only 5 percent, down from 6 percent in 1999. The commercial banks' risk management system and use of collateral appear to be appropriate.

In May 2000, Bank of Latvia, for the first time, auctioned foreign exchange swaps with a maturity of two years to foster long-term lending in lats by commercial banks. The swaps have contributed to the broader availability of long-term credits in lats, and the private sector is now ready to undertake this role. Therefore, Bank of Latvia has reduced the volume of monthly auctions, and will decide on a date for their full elimination by the time of the first review under the program.

Structural reforms and financial sector policies

Pension reform remains a centerpiece of the structural reform agenda. The authorities intend to further raise the retirement age up to 65 years over the medium term, while, in the short term, current incentives for early retirement will be eliminated. Contributions to the second, fully funded, pillar will begin soon, on July 1, 2001. Eventually, this pillar will promote savings and capital market development. After an initial two year period under the Treasury, pension assets will be managed by private fund managers.

The restructuring of the Latvian banking sector has been completed. The industry is almost entirely in private hands, while foreign institutions own around 70 percent of total stock capital. Banking supervision is well advanced, and among the strictest in Central and Eastern Europe. Latvia is close to full compliance with the Basle Core Principles for Effective Banking Supervision and the relevant EU Directives. The transition to the new unified financial sector supervisory agency is being implemented in accordance with the schedule and will start operating on July 1, 2001. The Latvian authorities welcome the ongoing FSAP work which will be completed later this year.

Privatization of small- and medium-sized companies, which was launched in 1991, has been successfully completed. Also, the authorities are moving firmly to complete the transparent privatization of remaining large public enterprises. In December 2000, the Government passed privatization rules for the Latvian Shipping Company (LASCO), with a view to sell the majority interest (68 percent) of LASCO to private investors in May 2001. As of April 4, two firms have submitted initial tenders regarding LASCO to the Latvian Privatization Agency. The procedure for the privatization was thoroughly monitored by Transparency International. The Latvian Privatization Agency is also conducting negotiations with private co-owners of Lattelekom (telecommunications), with the help of foreign advisors, to advance the privatization process. Privatization of this company highly depends on the outcome of the above negotiations. It is also expected to sell a significant part of the public shares of Ventspils Nafta (oil company) by the end of 2001.

The Latvian authorities welcome the publication of the staff report for the Latvian request for a Stand-By Arrangement and the Letter of Intent, including the Memorandum of Economic Policies. They also initiated the publication of the main findings and recommendations of the fiscal ROSC in the staff report.