July 2000
IMF Staff Country Report No. 00/78

Republic of Latvia : Staff Report for the 2000 Article IV Consultation and First Review Under the Stand-By Arrangement

As required under Article IV of its Articles of Agreement, the International Monetary Fund conducts periodic consultations with its member countries. In the context of the 2000 Article IV consultation with Republic of Latvia, the following documents have been released and are included in this package:

- the staff report for the 2000 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 5, 2000**, with the officials of Republic of Latvia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on June 15, 2000.** 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 **June 28, 2000**, updating information on recent economic developments;

- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during the June 30, 2000, Executive Board discussion** of the staff report that concluded the Article IV consultation;

- a statement by the authorities of *Republic of Latvia*.

Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports and PINS allows for the deletion of market-sensitive information.

The Article IV staff report is published—both in hard copy and on the IMF's website (http://www.imf.org)—as part of a pilot project. To assist the IMF in evaluating the pilot project for release of Article IV staff reports, reader comments are invited prior to October 5, 2000, and may be sent by e-mail to Pilotproject@imf.org.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

Staff Report for the 2000 Article IV Consultation and First Review Under the Stand-By Arrangement

Prepared by European II and Policy Development and Review Departments

Approved by Oleh Havrylyshyn and G. Russell Kincaid

June 15, 2000

- Discussions were held in Riga during April 26-May 5 and, upon appointment of a new government, during May 23-26, 2000. The new four-party coalition government, which enjoys broad support in parliament, was formed following the resignation of the previous government over disagreement on privatization issues.

- The staff representatives comprised Messrs. Schiff (head), Mueller, Zytek (all EU2), Mr. Sakr (PDR), and Ms. Immers (staff assistant, EU2). Mr. Knöbl, the Fund's resident representative in Riga, assisted the mission, and Ms. Steinbuka, Advisor to the Executive Director for Latvia, attended policy meetings during the second mission.

- The mission met with members of the new government, including 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 Stand-By Arrangement in an amount of SDR 33 million (equivalent to 19.5 percent of quota). The authorities have indicated their intention to make no purchases under the arrangement.

- In the attached letter dated June 15, 2000, the Minister of Finance and BoL Governor request the completion of the first review by the Board. Their request is supported by a Supplementary Memorandum of Economic Policies (MEP; Attachment I), which the authorities intend to publish.

- The second program review is expected to be concluded before December 15, 2000.

As background to the upcoming Board discussions, papers on "Pension Reform in the Baltics: Issues and Prospects" and on "Saving, Investment, and External Adjustment in the Face of Exogenous Shocks in the Baltics," as well as a paper on "Selected Issues and Statistical Information" will be forthcoming.

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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	-0.8 percent per year
Life expectancy at birth	
Male	64.1 years
Female	75.5 years
Infant mortality rate (per 1,000 births)	14.9
Hospital beds (per 10,000 inhabitants)	89
Physicians (per 10,000 inhabitants)	33

	1995	1996	1997	1998	1999
	In percent of GDP				
Shares of gross domestic product					
Agriculture and hunting	8.9	7.8	4.6	2.9	2.4
Fishing	0.4	0.3	0.2	0.3	0.1
Forestry and logging	1.5	0.9	1.0	1.2	1.5
Mining and quarrying	0.2	0.2	0.2	0.2	0.2
Manufacturing	22.4	20.9	22.2	17.9	14.8
Electricity, gas, and water	5.5	5.3	5.0	5.3	5.0
Construction	5.1	4.7	4.8	6.8	7.6
Services	56.0	59.9	62.0	65.4	68.4
GDP					
Nominal GDP (in millions of lats)	2,349	2,829	3,275	3,589	3,662
GDP per capita (in lats)	934	1,136	1,327	1,466	1,506
Real GDP (percentage change)	-0.8	3.3	8.6	3.9	0.1
Consumer prices (percentage change, end-period)	23.1	13.1	7.0	2.8	3.2
General government finances	In millions of lats, unless otherwise stated				
Total revenue	875	1,057	1,352	1,529	1,561
(in percent of GDP)	37.2	37.4	41.3	42.6	42.6
Total expenditure	952	1,104	1,332	1,554	1,707
(in percent of GDP)	40.5	39.0	40.7	43.3	46.6
Financial balance	-77	-47	20	-25	-146
(in percent of GDP)	-3.3	-1.7	0.6	-0.7	-4.0
Net lending	15	5	10	3	7
(in percent of GDP)	0.6	0.2	0.3	0.1	0.2
Fiscal balance	-92	-52	10	-27	-153
(in percent of GDP)	-3.9	-1.8	0.3	-0.8	-4.2
Money and credit (end-period)					
Net foreign assets	300	445	619	415	364
Broad money	524	628	871	923	997
Domestic credit	332	366	479	647	745
Velocity (level)	4.5	4.5	3.8	3.9	3.7
Balance of payments					
Total exports (GNFS)	1,102	1,475	1,702	1,873	1,728
Total imports (GNFS)	1,156	1,668	1,945	2,329	2,109
Current account balance	-9	-120	-167	-362	-354
Official reserves (in months of imports of goods and nonfactor services)	3.2	3.1	3.0	2.7	3.1
Exchange rate, lats per US$, end-period	0.537	0.556	0.590	0.569	0.583

Sources: Latvian authorities; and Fund staff estimates.

Executive Summary

With the resumption of growth in the second half of 1999, the economic recession triggered by the Russian crisis has ended. Following three successive quarters of negative growth, the economy grew by 3 percent in the fourth quarter of 1999 and growth may have reached 4 percent in the first quarter of 2000, while inflation continued to be subdued at about 3½ percent.

The external current account deficit declined only marginally in 1999, to 9½ percent of GDP, and is projected to fall by an additional percentage point in 2000. Despite the continued appreciation of the real effective exchange rate vis-à-vis EU trading partners, other indicators, including the recent robust export performance—exports grew by 12 percent overall and by 17 percent to the EU in the first quarter of 2000—and a marked slowdown in wage growth, point to a continued margin of competitiveness.

Nevertheless, the large current account deficit, coupled with the failure of FDI to recover fully from the Russian crisis, pose a potential risk to Latvia's external sustainability, which the staff urged the authorities to be prepared to address. To this end, the authorities committed to a variety of measures that would allow an additional tightening of the fiscal stance during the remainder of this year and next, should such a need arise, including the specification of contingency measures to reduce the deficit by up to ½ percent of GDP. Over the medium-term, approximate fiscal balance is targeted, which hinges on additional measures to put the Pension Fund finances on solid footing, building on the considerable progress to date. The program also contains measures to address backtracking as to the transparency of public sector operations.

The revised monetary program supports the Bank of Latvia's commitment to maintaining the peg to the SDR, which has served Latvia well and remains appropriate. An eventual shift to the euro could take place at the time of Latvia's official accession to the EU. With the banking system's apparent return to soundness and considerable progress in enhancing banking sector supervision, more emphasis is now being placed on the supervision of nonbank financial institutions in the run up to the creation of the Unified Financial Sector Supervision Agency.

The program contains targeted measures to encourage the continued restructuring of the economy, including the rapid completion of the privatization of the remaining large public enterprises, the creation of an appropriate post-privatization regulatory framework, and measures to improve the business climate so as to create an environment more conducive to private sector activity; the latter would be instrumental in raising the inflow of FDI and thus improving the financing of the external current account deficit.

I. Introduction

1. On December 10, 1999, the Executive Board approved the 16-month SBA in an amount of SDR 33 million (equivalent to 19.5 percent of quota). The authorities have indicated their intention to make no purchases under the arrangement. No purchases have been made under the arrangement to date.[1]

2. The Executive Board concluded the 1999 Article IV consultation on July 28, 1999. At that time, Directors commended the authorities for their generally prudent financial policies in the wake of the Russian crisis and for progress in the implementation of structural reforms. However, while stressing that the external position remained broadly sustainable, they expressed concern about the significant fiscal expansion in 1999. They emphasized the need to accelerate the privatization of large-scale public enterprises and address the weaknesses in the banking system, which were revealed during the Russian crisis. The exchange rate peg was considered to have served Latvia well and remained appropriate, although a switch to a euro peg in the medium term was seen as desirable. Latvia participated in the pilot project for the release of Article IV staff reports, and the authorities have requested that the 2000 Article IV consultation staff report be placed, without deletions, on the Fund's external website.

3. Relations with the Fund and the World Bank are summarized in Appendices I and II, respectively. Extensive technical assistance has been provided by the Fund (Appendix III), as well as by other multilateral organizations, notably the World Bank and the EU/Phare, and bilateral sources. The periodicity and timeliness of the most important statistics are adequate and presented in Appendix IV.

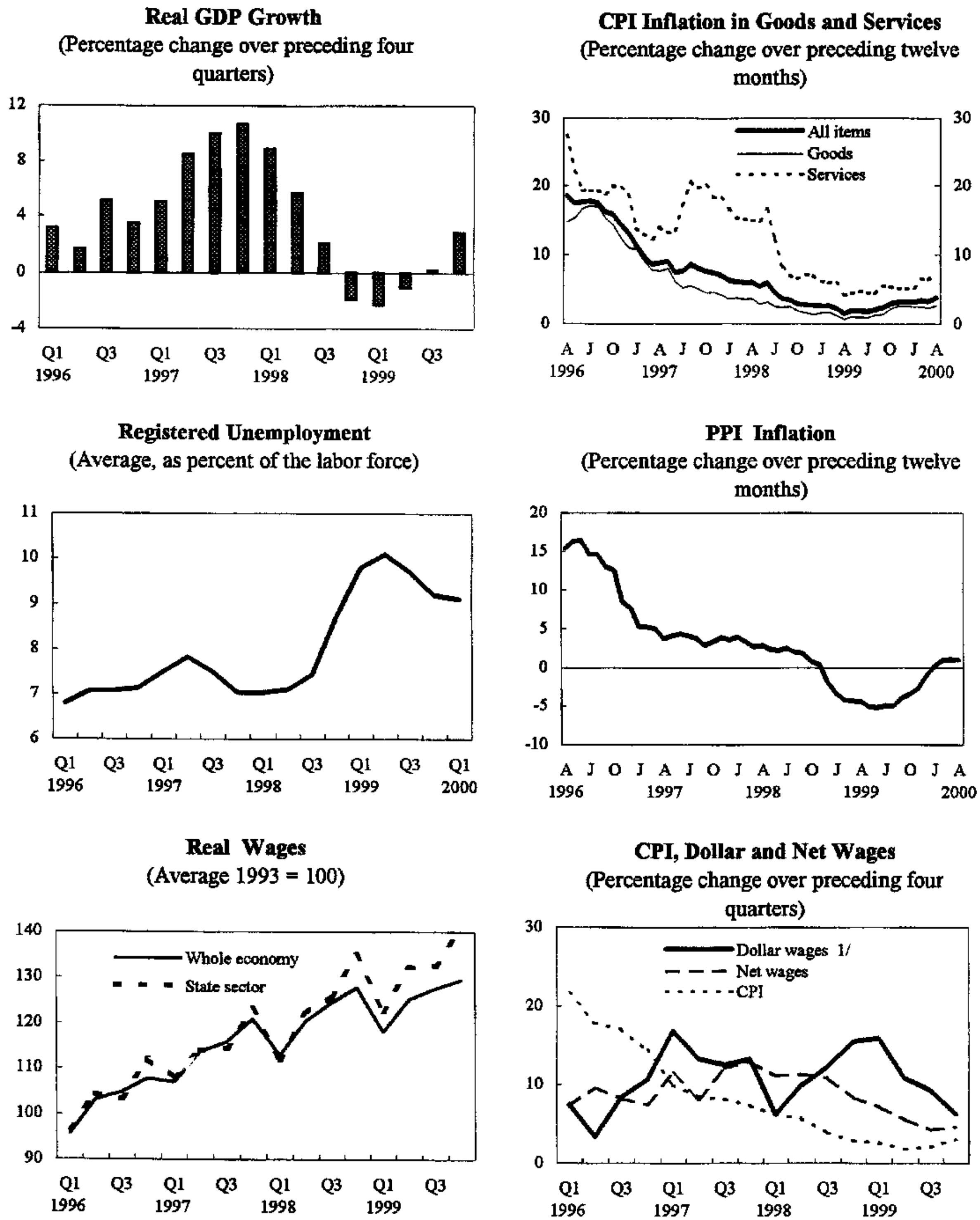
II. Recent Economic Developments and Performance under the Program

4. **Latvia has emerged from the economic recession triggered by the Russian financial crisis of August 1998** (Table 1 and Figure 1).[2] Following three successive quarters of negative growth, the economy grew by 3 percent in the fourth quarter of 1999, and indications are that the economic recovery has accelerated in early 2000: industrial output and tax revenues rose by about 4 percent year-on-year during the first quarter of 2000, while credit to the private sector has expanded by about 11 percent in the first four months of the year. The recovery appears to be driven by a rebound in exports and transport and transit

[1]Tables 9 and 10 provide indicators of financial obligations to the Fund and the schedule of purchases under the SBA.

[2]When national accounts data for 1999 were published in March 2000, the authorities also provided revised 1998 data. GDP growth for 1998 was raised from 3.6 percent to 3.9 percent, but—due to a larger downward revision of the deflator—all ratios to GDP for 1998 and 1999, such as for the current account and fiscal deficits, are now slightly higher compared to EBS/99/202.

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.

services, as well as a rise in consumer spending. The unemployment rate fell to 8.8 percent in mid-May 2000, more than 1½ percentage points below its peak in April 1999.

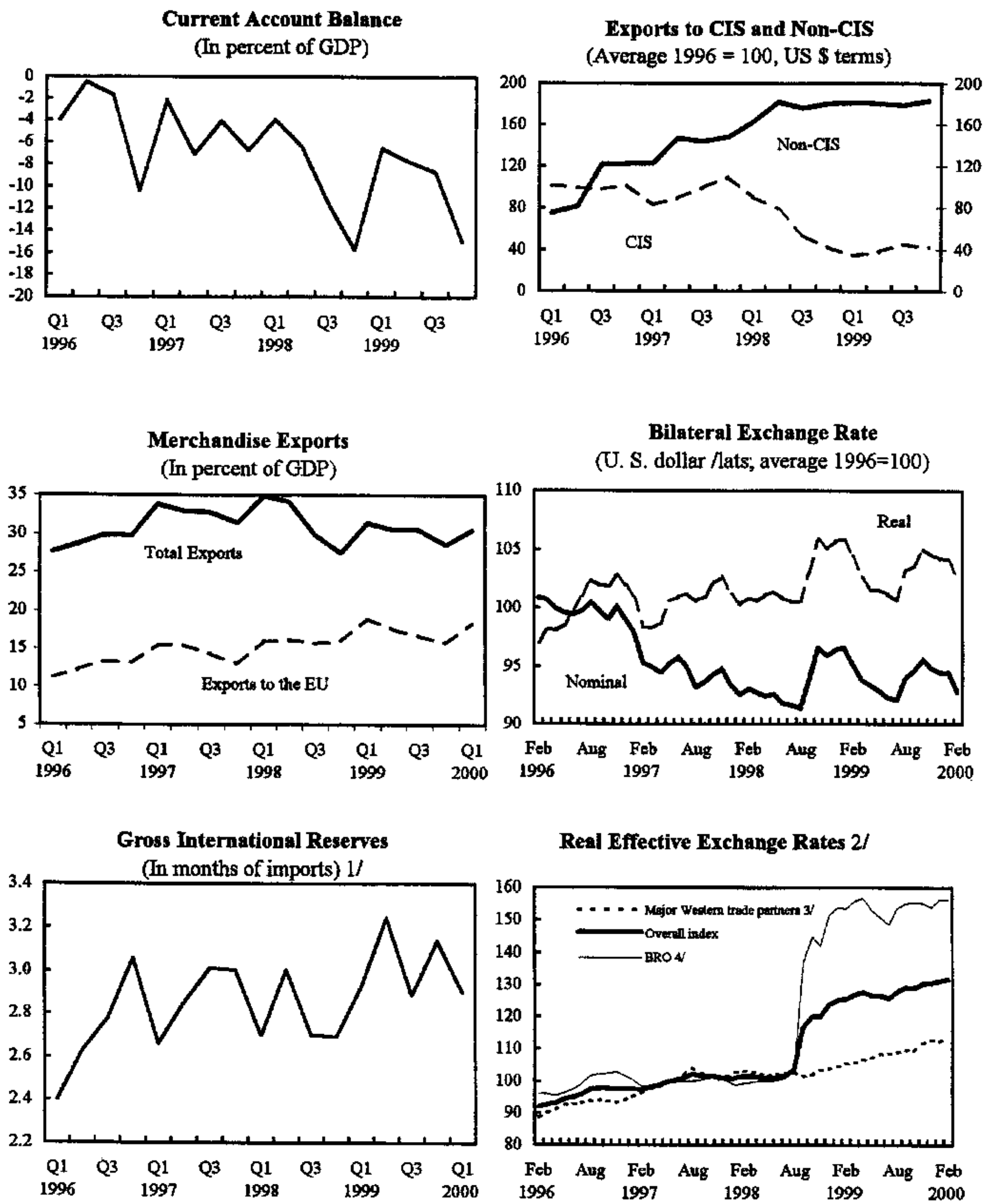
5. **Notwithstanding the pickup in domestic demand, inflation has remained subdued, with a twelve-month growth rate of the consumer price index of about 3½ percent and of the producer price index of 1 percent in April.** The recent rise in consumer prices mainly reflects increases in administrative prices, such as for utilities and local transportation, and food prices, which have begun to pick up from their depressed levels during the recession. Real wage growth slowed markedly throughout 1999, aided by the unchanged minimum wage since January 1999.

6. **All but one performance criteria under the program for end-December 1999 and all end-March 2000 performance criteria were observed** (Table 2). Several structural benchmarks for end-March were not met, but corrective action has been initiated (see below).

7. **The current account deficit declined marginally to about 9½ percent of GDP in 1999, but remained one percentage point higher than projected in EBS/99/202** (Table 3 and Figure 2). The 1999 outcome reflects slower-than-expected growth of exports to the EU owing in large part to the steady appreciation of the dollar, and hence the lats, to the euro, as well as a decline in the surplus in the services account. For 1999 as a whole, exports fell by 6 percent and imports by 7 percent. However, in the fourth quarter of 1999, export growth to the EU began to pick up, while exports to the CIS showed their first growth since the onset of the Russia crisis. Imports recovered as well in the last quarter of the year, in line with the economic recovery. On the capital account, FDI expanded toward end-1999, lifting FDI financing of the current account deficit to close to 60 percent, still well below the unusually high pre-Russia crisis cover of about 180 percent in 1997. Net portfolio investment also strengthened, rising from virtually nil in 1998 to US$ 61 million in 1999 (about 10 percent of the current account deficit). Notwithstanding the greater reliance on debt financing in the wake of the Russian crisis, Latvia's key external debt indicators have remained moderate.[3] The spread in the secondary market on Latvian Eurobonds has steadily declined to about 100 basis points by mid-May 2000, among the lowest for emerging markets.

[3]For example, the public external debt-to-GDP ratio rose from 7½ percent at end-1997 to 12 percent at end-1999, while international reserves fell from 11 to 8 times short-term debt over this period. Total external debt broadly defined (including trade credit, deposits, and borrowing by foreign investors from their headquarters) stood at 61 percent of GDP at end-1999 compared to 48 percent at end-1997. Of this, short-term debt remained at about 200 percent of gross reserves. The high ratios of total external debt reflect Latvia's role as a banking center for CIS countries. Indeed, at end-1999, on a net basis, external debt stood at only 12 percent of GDP, while for short-term debt, Latvia was a net creditor to the rest of the world by US$ 782 million.

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.

8. **The external current account deficit appears to have developed broadly as expected during the first quarter of 2000.** Preliminary data indicate that export growth, at 12 percent, was quite buoyant, as exports to the EU rose especially markedly, while the services account improved due to increased transport receipts. Imports also rebounded, rising by 11 percent. Similarly, FDI rose strongly in the first quarter, partly reflecting the successful privatization of most of the remaining government shares in Latvijas Gaze.

9. **The general government deficit in 1999, at about 4 percent of GDP, was in line with the program, and the respective performance criterion for end-1999 was observed** (Table 4 and Figure 3). The fiscal outcome in 1999 was achieved primarily by restraining expenditure below the budget appropriations, as tax receipts were broadly as planned and non-tax revenue fell short of expectations.

10. **During the first quarter of 2000, the general government fiscal deficit fell to about 1.2 percent of GDP as tax revenue strengthened across the board, while expenditures were held to about 92 percent of their planned levels.** As a consequence, the performance criterion on the fiscal deficit was met with a comfortable margin. The impact of the November 1999 amendments to the pension law on the fiscal balance of the Social Fund has been positive and broadly in line with projections. Taking advantage of the historically low interest rates and the favorable market sentiment, the government successfully issued, for the first time, three-year bonds at end-January and five-year bonds at end-March and mid-April, at an average yield of 9.3 percent, 9.1 percent, and 8.8 percent, respectively.[4]

11. **Monetary conditions loosened somewhat during the last two weeks of 1999 to accommodate banks' demands for lats to guard against potential Y2K-related problems** (Tables 5 and 6; Figure 4). This unconditional temporary liquidity support by the central bank caused the performance criterion on NDA of the BoL and the indicative ceiling on reserve money for end-December to be exceeded.[5] However, the BoL comfortably met the performance criterion on net international reserves for end-1999, as its interventions during the summer of 1999 were reversed subsequently. Owing to the stronger-than-expected pick-up of credit to the nongovernment sector since October 1999, which may also have been partly Y2K-related, the indicative ceiling on the NDA of the banking system for

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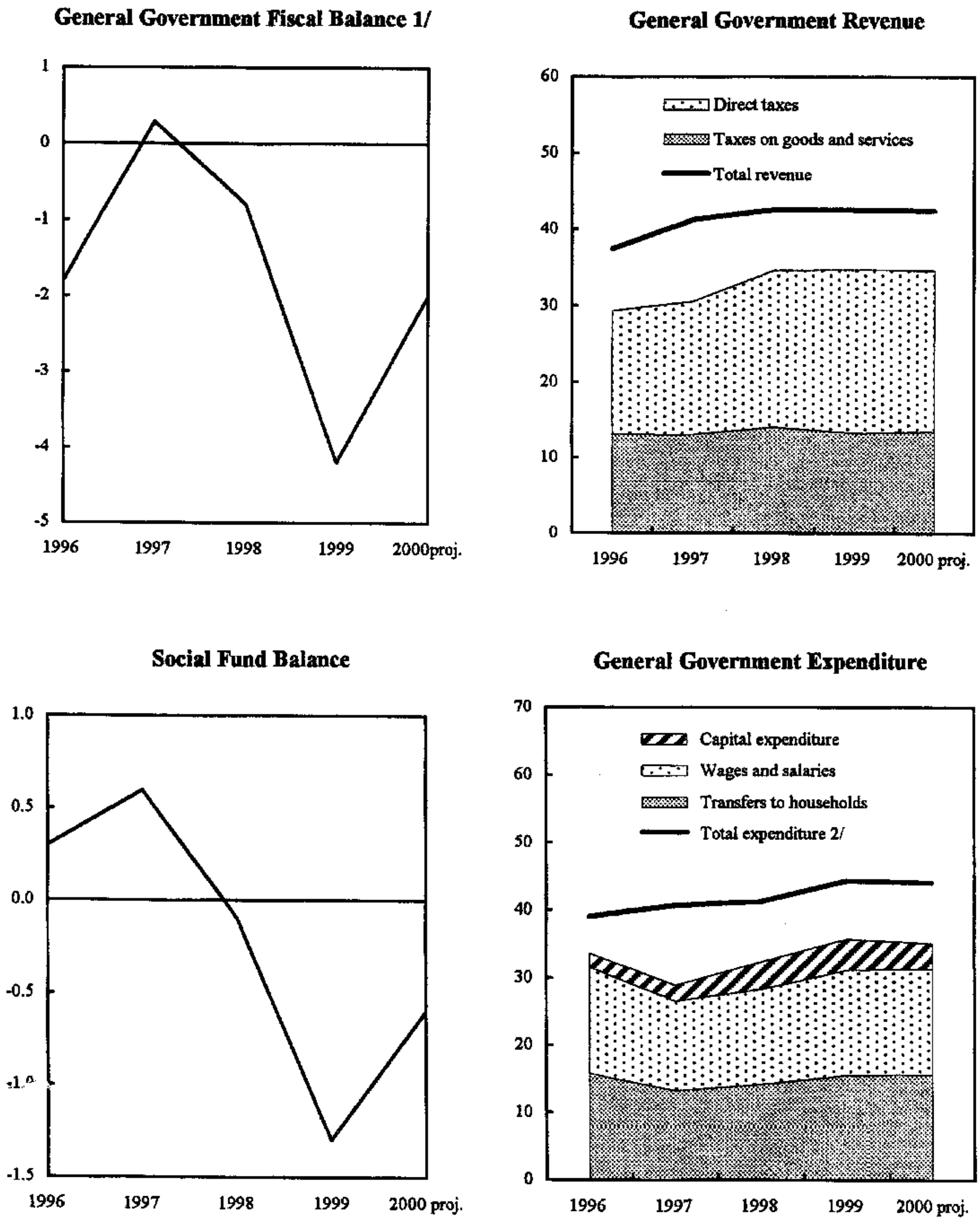
[4]The yield on these bonds in the secondary market has subsequently declined to about 8 percent in May despite the global increase in interest rates.

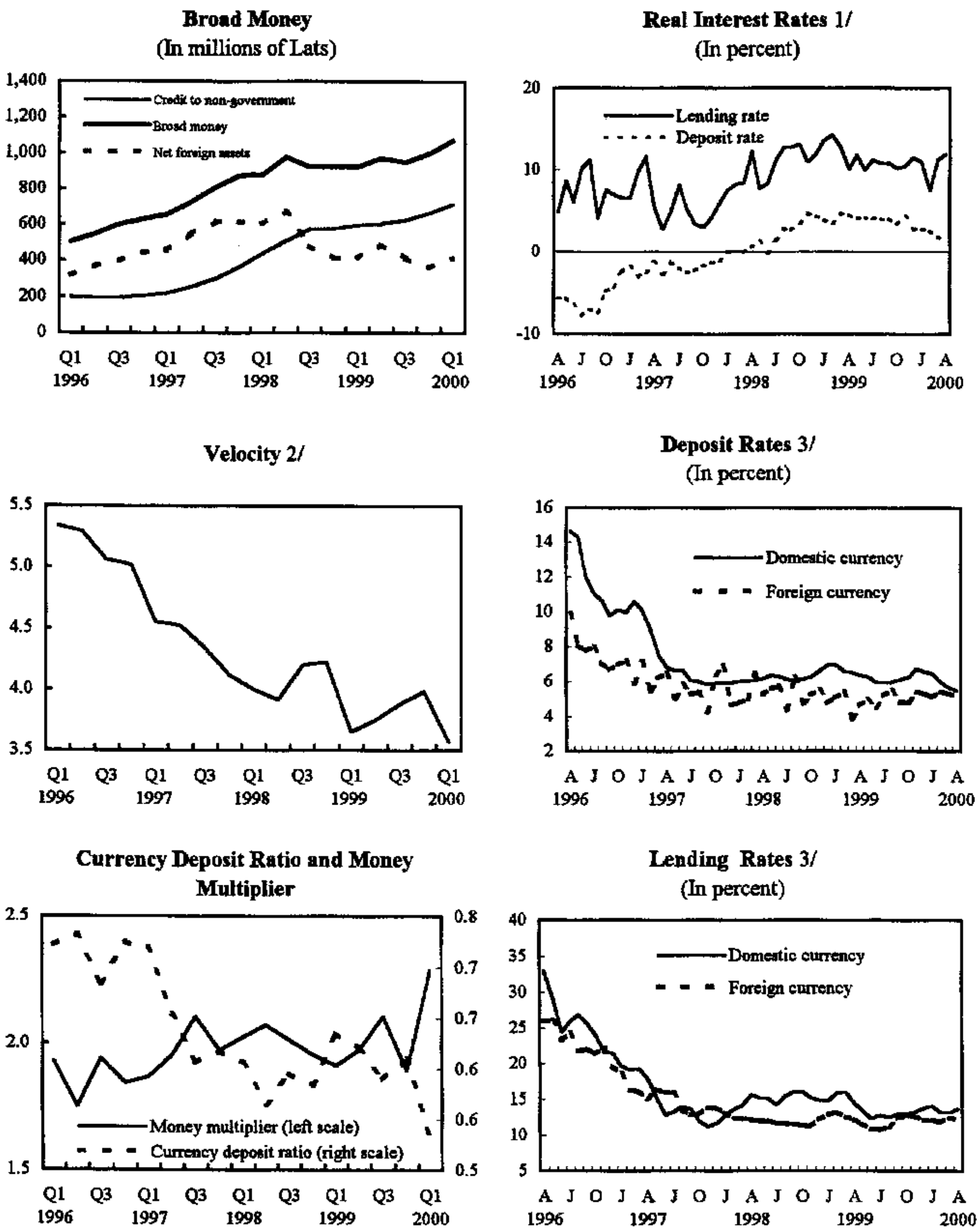
[5]The program had envisaged a cushion for Y2K-related problems, but the demand was larger than anticipated. Base money grew by 10 percent in December alone, with currency accounting for about two-thirds of this increase. The liquidity impact of the lowering of reserve requirements by 1 percentage point in early December as a first step toward harmonization with the ECB monetary policy framework had already been sterilized when the Y2K-related liquidity demand set in.

Figure 3. Latvia: Fiscal Developments, 1996-2000
(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, 1996-2000



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.

end-December was exceeded. Nevertheless, it appears that commercial banks have shown prudence in their lending decisions, increasing their use of collateral. Toward end-1999, Latvian banks benefited from significant inflows of deposits from non-residents, especially Russians, which banks have generally invested abroad in securities and other assets in OECD countries.[6]

12. **The end-1999 liquidity injection was appropriately reversed during the first quarter of 2000, and all performance criteria for end-March were met comfortably.** The BoL mopped up the excess liquidity during the first two months of 2000 by only partially rolling over expiring repos and short-term foreign exchange swaps. Largely offsetting the liquidity impact of the Treasury's issuance of five-year bonds in March and April, the BoL injected liquidity by purchasing large amounts of these bonds from commercial banks, which exerted a downward pressure on interest rates and helped the BoL stock up its portfolio for future open market operations. In the same vein, in mid-March, the BoL reduced the reference refinance rate by half a percentage point to 3.5 percent—the first such decrease since April 1997—and lowered other key central bank rates. Credit expansion continued at a healthy pace, while the inflow of deposits from non-residents slowed marginally. No pressure on the exchange rate emerged during the first few months of 2000, and NIR covered 109 percent of the monetary base at end-March. In May, the BoL began to offer two-year foreign exchange swaps to promote long-term lending in lats.

13. **Considerable progress has been made in restoring the soundness of the banking system, and the BoL's prudential standards are now largely in line with international norms** (Table 7 and Figure 5). Notwithstanding continued large provisioning for Russian crisis-related losses, which was facilitated by the system-wide return to profitability, Latvian banks have succeeded in maintaining or increasing their capital and reserves in 1999 and early 2000, and all banks are now in compliance with the new minimum capital requirement of € 5 million. A further substantial strengthening of banks' capital is expected in the near future with the entry of foreign strategic investors in three larger banks. The sale of 90 percent of one of these banks, Pirma Latvijas Komercbanka (PLK; formerly RKB), to a German bank was announced at end-May; PLK had resumed operations in late October 1999 as a result of a BoL-led rehabilitation plan. In the meantime, the BoL has implemented new prudential regulations on loan classification and loan-loss provisioning and adopted regulations to implement capital charges and reporting requirements on the market risk (both were structural benchmarks). The BoL also completed the MAE-proposed self-assessment of compliance with the Basle Core Principles of Effective Banking Supervision (CP); the preliminary findings suggest that the BoL is close to full compliance with the CP (Box 1).

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[6]As of end-March 2000, 50 percent of these deposits were received from the United States, with a large share reportedly being transferred via the Delaware offshore financial center.

Box 1. A Preliminary Assessment of the Bank of Latvia's Compliance with the Basle Core Principles of Effective Banking Supervision (CP)

Prelude. Based on the Core Principles Methodology issued by the Basle Committee on Banking Supervision in October 1999, the BoL completed its self-assessment of its compliance with the CP in May 2000. The self-assessment was evaluated on a preliminary basis in early June 2000 by a Fund-appointed expert who focused on the Methodology applied and on the appropriateness of the BoL's findings as to weaknesses in the supervisory system.

Latvia is the first example of a CP self-assessment followed by a preliminary independent evaluation by the Fund. Such setup can be seen as an appropriate intermediate step, as the assessments are needed as a first step to identify weaknesses and implement measures to strengthen domestic regulation and supervision while recognizing the impossibility of regularly conducting a full-fledged outside evaluation in all 182 member countries. However, such setup should not be regarded as a substitute for a full-scale Fund Core Principle Assessment (CPA) or, indeed, an FSSA, which provide deeper insights into the weaknesses and vulnerabilities of a financial system.

Preliminary Findings. The self-assessment was performed in a comprehensive manner, providing detailed answers to each of the more than 200 criteria for assessing compliance with the CP. The Fund expert found the descriptive part on the individual CPs to be in line with the intentions of the Methodology and similar to country assessments made by the Fund. The expert, therefore, considered the Latvian pilot case as successful and suggested only some minor amendments to the BoL's self-assessment document to further improve the method and focus more on the degree of implementation.

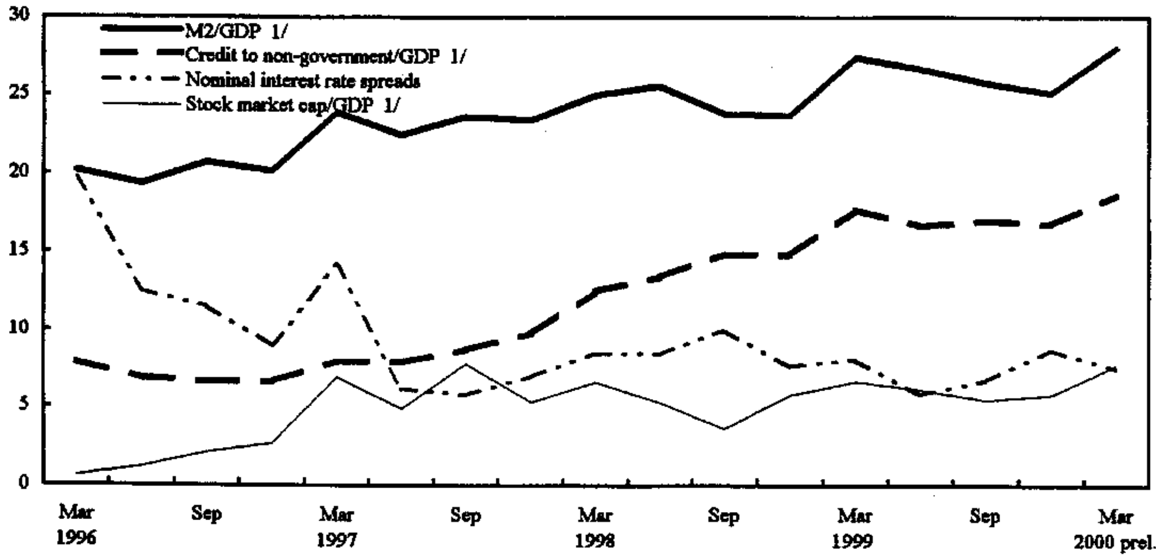
The expert concurred with the BoL's judgement that after the scheduled implementation of some key prudential regulations on July 1, 2000, the BoL will be "compliant" or "largely compliant" (the two highest gradings under the Methodology) with all CPs. These high gradings reflect the substantial progress by the BoL since 1998 in modernizing its prudential framework, such as the implementation of supervision on a consolidated basis and the formulation of policies on the country risk.

On July 1, 2000, implementation of the Basle capital-adequacy standards will be improved by the introduction of capital requirements for foreign exchange risks, which will be followed by capital requirements for equity risk and for interest risk in the trading book effective January 1, 2001. On July 1, 2000, a new regulation for liquidity management and one requiring banks to pre-notify the BoL of any significant acquisitions and investments will be introduced. In September 2000, a "Know Your Customer" rule will enter into force, giving more guidance to banks to identify "suspicious transactions" and thus counteract possible money laundering activities. Memoranda of Understanding (MoUs) are being negotiated with three foreign supervisory agencies: Lithuania as the only host country for a Latvian bank affiliate, and Germany and Sweden, which are home countries to banks represented in Latvia. On January 1, 2001, banks will also be required to present their trading book policies to the BoL for endorsement.

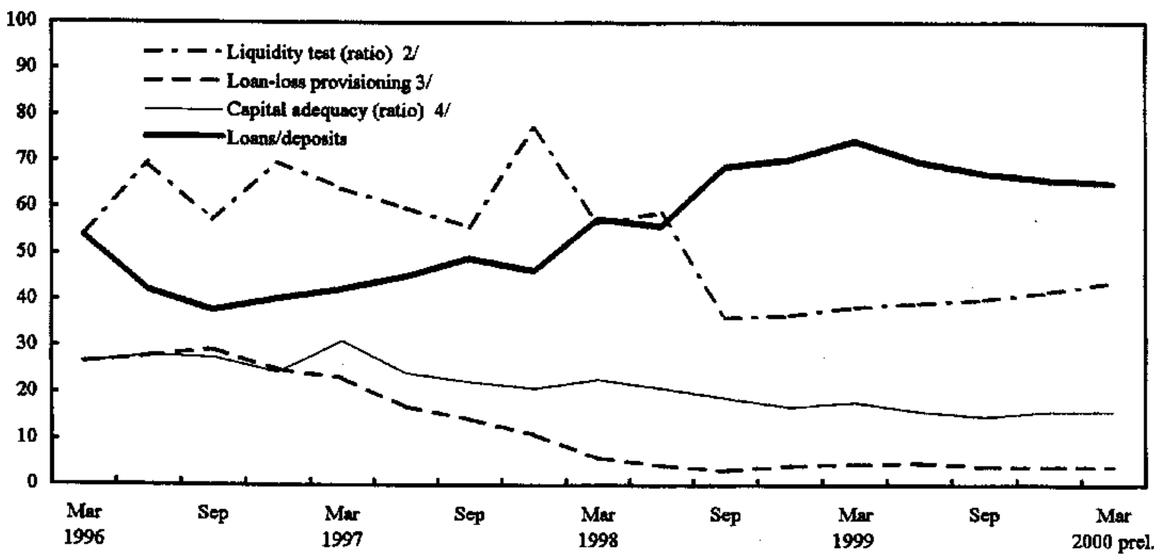
The BoL and the Fund expert concurred that after the successful implementation of these forthcoming measures, only a few supplementary improvements are needed to bring Latvia into full compliance with all CPs. For example, while the regulatory means to ensure rapid corrective action for banks in distress are considered close to sufficient (the BoL was rated as "largely compliant" in this regard), more needs to be done to ensure timely action also in seemingly less acute situations, which might lead to deeper problems. In addition, while the BoL judges that it already at present can hinder a bank from acquiring holdings which may be detrimental to the financial situation of the bank, it would be preferable that this was explicitly stated in the Law on Credit Institutions. Similar considerations relate to BoL's powers to restrict harmful activities of subsidiaries abroad; present regulations only explicitly refer to branches, not to subsidiaries or joint ventures.

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

Financial Sector Developments Measures



Banking Sector Soundness Variables
(In percent)



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.

14. **Since mid-1999, stock market capitalization has increased by half, to close to 8 percent of GDP, while the stock market index has risen by two-thirds.** In early May 2000, the Riga Stock Exchange (RSE) signed a letter of intent to join the Scandinavian Stock Exchange alliance NOREX during the course of this year, which, together with the forthcoming privatizations of large-scale enterprises, should boost activities at the RSE.

15. **The process of privatizing the remaining large enterprises has begun to move forward, although important obstacles remain.** The World Bank Programmatic Structural Adjustment Loan (PSAL) approved in March 2000 has created a new impetus for the privatization process.[7] In this context, following considerable political debate, the cabinet approved the method and timetable for restructuring and privatizing Latvenergo in mid-February,[8] and parliament adopted the Law on Concerns, needed for restructuring of the company. (These steps met structural benchmarks, albeit with a six-week and ten-week delay, respectively). An unsuccessful tender in December 1999 to initiate the privatization of the Latvian Shipping Company (LASCO) made it impossible for the authorities to comply with the respective structural benchmarks for end-January and end-March. As the successive March tender (with a more realistic sales price) did not attract a foreign investor either, corrective actions will be taken in line with the agreements under the PSAL (see below).

16. **Progress in the other areas of structural reform has been generally positive.** Legislation to begin the second pillar of the pension system in July 2001 was approved by parliament in March and the new Commercial Code in April 2000, but the enactment of the amendments to eliminate tax benefits to special economic zones and free ports that are inconsistent with EU regulations experienced delays due to coordination difficulties between the ministries involved (all three actions were structural benchmarks for end-March). Steps were taken to further liberalize Latvia's already quite open trade regime. In May, parliament approved the abolition of the safeguards tariff on pork products effective June 1, 2000. Further, effective April 1, 2000, well ahead of the program benchmark dates, agricultural tariff rates were reduced in line with WTO commitments, and all tariff rates above EU levels were reduced to EU levels. The authorities also eliminated the 3 percent tariff band.

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[7] The PSAL aims at strengthening the institutional infrastructure of the public sector; finalizing the privatization process; defining a clear and transparent regulatory framework for private sector activity; streamlining business regulation; and reinforcing anti-corruption efforts.

[8] The government decided to create a holding company, with the Daugava Hydro Plants, the Riga Combined Heat and Power Plants (CHP), and the transmission and distribution units as subsidiaries. Actual privatization will begin with the divestiture of 49 percent of the two Riga CHP, and of the company's non-core business activities. The PSAL envisages the hiring of a reputable international investment bank to advise the government on the divestiture process.

III. Policy and Program Discussions

A. Overview

17. **There was a broad consensus in the discussions that, while Latvia's economic prospects have improved following its emergence from recession, the large current account deficit poses a risk to external sustainability.** This concern is exacerbated by the failure of FDI to fully recover from the Russian crisis, and by a possible deterioration in external competitiveness as a result of the recent depreciation of the euro vis-à-vis the lats, although other indicators, such as trends in dollar and real wages as well as recent export growth, suggest that Latvia continues to maintain a margin of competitiveness, as discussed below.

18. **The maintenance of a sustainable external position is predicated on the ability to reduce the external current account deficit and increase its financing through FDI.** The authorities were of the view that implementation of the financial and structural policies under the program would be sufficient to achieve these objectives, as well as—more generally—to create an environment more conducive to private sector activity. Such policies were also seen as instrumental in maintaining confidence of the international community in Latvia.

19. **The staff pointed to the necessity to be prepared to further strengthen fiscal policy in the event that the external current account deficit fails to decline or FDI falls short of projections.** The authorities committed to a variety of measures that would allow additional tightening of the fiscal stance during the remainder of this year and next. Emphasis was also placed on continued efforts to encourage the continued restructuring of the economy. In this regard, the rapid completion of the privatization of the remaining large enterprises and the creation of an appropriate post-privatization regulatory framework was seen as particularly important.

B. Macroeconomic Framework and External Sector Prospects

Discussions focused on:

- ***The assumptions underlying medium-term macroeconomic framework***
- ***Projections of the external current account and its financing in 2000 and beyond***
- ***The need to increase export market shares in the EU and diversify the export base***
- ***Latvia's external competitiveness***

20. **The main assumptions underlying the medium-term macroeconomic framework in EBS/99/202 remain largely valid** (Table 8).[9] Real GDP growth is expected to reach 4 percent this year and accelerate to 6 percent over the medium term, fostered by increased investment and a recovery in FDI, as well as efficiency gains reflecting continued structural

[9]Historical data on investment and saving have been revised upward and the medium-term projections have been adjusted to the new base.

reforms. Private savings, which are anticipated to benefit from the successful rehabilitation of the banking system, the deepening of financial markets, and rising incomes, would help to gradually lower the current account deficit, notwithstanding an expected strengthening of private investment. Overall, these developments are expected to reverse the deterioration in the public and private sector savings-investment balances, which followed the Russian crisis and led to a doubling of the current account deficit between 1997 and1998 (Box 2).

Box 2. Latvia: Current Account Developments

After rising gradually during the period 1995-97, Latvia's external current account deficit doubled in 1998, reaching 10 percent of GDP, and declined only marginally in 1999.

The sharp rise in the current account deficit in 1998 reflected, in part, the robust growth of the economy, and in particular private investment, prior to the Russian crisis in August. The economy grew by some 7 percent in the first half of the year, although, aided by a tight fiscal policy, the economy began to cool by summer. The Russian crisis affected Latvia both through sharply reduced exports and—in contrast to its Baltic neighbors—through its adverse impact on the banking sector, and so on private savings. While the downturn in economic activity late in the year also dampened imports, this effect was limited by a significant fiscal expansion in the second half of the year. The overall result was a deterioration in the private savings-investment balance of about 4 percentage points of GDP in 1998, with public savings broadly unchanged.

In 1999, the full-year impact of the Russian crisis was seen in a sharp contraction of imports and exports. Also, substantial increases in public sector wages and pension benefits granted in late-1998 carried over, and led to a significant reduction in public sector savings. Therefore, while the private sector savings-investment balance improved by 4 percentage points of GDP—reflecting both a slowdown in private investment and increased private savings as confidence in the banking system returned—the current account deficit showed little improvement.

A projected gradual decline in the current account deficit over the medium-term is predicated on the return to near fiscal balance and a steady rise in private savings, reflecting growing incomes and further development of financial markets, offsetting higher private investment. In this regard, the econometric analysis in the accompanying paper on "The Baltics—Savings, Investment and External Adjustment in the Face of Exogenous Shocks" indicates that (i) both private savings and investment in Latvia are strongly and positively associated with increased income, (ii) the savings-investment balance tends to worsen with higher income, and (iii) Private savings is inversely related to public savings, but the effect is small (elasticity of 0.05). As a consequence, as economic growth recovers over the next two years, the private savings-investment balance can be expected to worsen, with gradual improvement in subsequent years. (The paper was unable to find a significant impact of the real effective exchange rate on savings or investment.) Finally, the extent to which the deficit is financed by FDI is expected to recover over time, limiting debt creation and allowing continued external sustainability.

21. **This deficit is projected to be increasingly financed by FDI, with a major impetus anticipated for 2001 due to the likely divestiture of the remaining large public enterprises (Box 3).** In the later years, substantial transfers from the EU associated with the accession process are expected to complement such non-debt creating inflows. As a consequence, the external debt-to-GDP ratio is projected to decline from 22 percent in 1999 to about 17 percent by 2006, and the import coverage of reserves is likely to strengthen and stabilize above 3 months. Inflation is projected to remain subdued at about 3 percent, slightly above the EU rate of inflation, reflecting continued productivity gains in the tradables sector.

Box 3. FDI Inflows in Latvia—Developments and Prospects

FDI inflows to Latvia peaked in 1997, reaching about US$520 million, more than double their levels two years earlier and about 40 percent higher than their present levels. In per capita terms, FDI in Latvia was the highest among the Baltic states and as a percent of GDP, FDI in Latvia was almost double that in any other CEE country in 1997. The ratio of FDI to current account deficit in Latvia peaked at the exceptionally high level of almost 180 percent in 1997 before declining to 50 percent and 60 percent in 1998 and 1999, respectively.

Unsurprisingly, the most dynamic sectors of the economy have attracted the largest share of accumulated FDI. As of 1998, transport and communication accounted for 30 percent of all FDI in Latvia, followed by the financial sector (24 percent), manufacturing (18 percent), and retail trade (16 percent). About 70 percent in FDI in Latvia in 1999 came from industrial countries, 6 percent came from the other Baltic states, and 8 percent from Russia.

Foreign-owned companies in Latvia tend to be more export-oriented and exhibit higher productivity than domestic firms. While accounting for 39 percent of total sales, foreign companies were responsible for about 53 percent of all Latvian exports, and just 24 percent of total employment in 1998. On average, labor productivity in foreign-owned companies was double its level in domestic companies. Furthermore, while on average the FDI sector is relatively capital intensive, its capital efficiency (output-capital ratio) is also higher than the domestic sector.

According to the results of a survey conducted by the Latvian Development Agency (LDA) and EU/Phare in 1999, the major administrative barriers that hindered business were corruption, excessive bureaucracy, and difficulty in obtaining long-term lats credit. To address these obstacles, in May 1999, the government approved an action plan containing recommendations to, *inter alia,* improve the quality and dissemination of information by government; combine enterprise and tax registration into a single process; simplify and relax immigration requirements for expatriate workers; simplify customs procedures; and improve the process for issuance of construction permits. A Phare/LDA project to improve the business environment was established to work with representative of the cities and districts of Latvia, and a foreign investors council was founded to provide a forum for the views of these investors. In February 2000, the government approved the recommendations of that council as a part a combined action plan to improve the business environment, which is also in line with the requirements of the *acquis communautaire*.

Staff projects, conservatively, that FDI will decline from about 6 percent of GDP in 2000 to about 5 percent of GDP in 2005. The completion of the privatization process will attract significant FDI over the next 1-2 years, with secondary effects in subsequent years. Further, as EU accession approaches it is expected that Latvia will become an increasingly attractive destination for foreign investment. One large potential project, a pulp mill to be owned one-third each by Finnish and Swedish investors and one-third by the Latvian government, would bring in a projected $900 million during 2002-2004. Ultimately, however, prospects for FDI growth hinge on continued efforts to improve the business climate.

22. **Current indications point to a narrowing in the external current account deficit in 2000 by about one percentage point, to about 8½ percent of GDP, and a further pick-up in FDI during the course of 2000.** However, a faster-than-expected recovery would place additional strain on the current account deficit, which could require implementation of a tighter fiscal policy stance. Both exports and imports are forecast to grow at a healthy pace of 7 to 8 percent, with exports to the EU expected to remain buoyant and continue their rise relative to GDP (see Figure 2), following the 17 percent growth year-on-year during the first quarter of 2000. While the latter points toward a reversal of the recent declining trend in

Latvia's share in total EU imports,[10] the overall export growth is still significantly less rapid than before the onset of the Russia crisis and could reflect the still incomplete process of restructuring the economy and thereby broadening the export base.

23. **In this context, while recognizing the great strides made in establishing a market economy, staff reiterated the importance of further progress in structural reforms and additional improvements in the business climate** (as described in Box 3). Such gains would help to bring about strong and diversified export growth, and promote further productivity gains and FDI inflows. Staff noted that the continued concentration of Latvian exports on wood and wood products—which account for about two-fifths of Latvian exports, with a rising trend—may give rise to an increased vulnerability to adverse shocks in the future.[11]

24. **Latvia's external competitiveness suffered somewhat during the second half of 1999, as the appreciation of the real effective exchange rate vis-à-vis EU trading partners continued with the further weakening of the euro.** The real effective exchange rate appreciated by 4.4 percent in 1999, which reflected a real effective appreciation of some 8.3 percent vis-à-vis major Western trading partners due to the depreciation of the euro, and broad stability vis-à-vis BRO currencies. While these developments have diminished Latvia's room for a further real appreciation—such room was identified in the previous comprehensive analysis of Latvia's competitiveness[12]—other indicators still point toward Latvia's continued competitiveness. In particular, the strong export growth since mid-1999, especially the surge in exports to the EU during the first quarter of 2000, and the slowdown in the increase in dollar wages and in real wages—the latter rose by slightly above 1 percent in 1999—bode well for Latvia's external competitiveness. Export performance is also expected to benefit from improved growth prospects in the EU, Russia and other CIS countries. Further, should the euro strengthen, Latvia's prospects would be aided significantly.

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[10]Keeping in mind the significant measurement problems underlying the Direction of Trade (DoT) statistics, such share dropped from 0.092 percent in 1997 to 0.076 percent in the third quarter of 1999. However, DoT data for the fourth quarter of 1999 have not yet been published and thus do not allow a full year-on-year analysis.

[11] In January 2000, a new forestry law was adopted by parliament, which is intended to avoid deforestation and links the cutting of trees in privately-owned forests to adequate replanting efforts. About half of all forest land in Latvia is privately owned.

[12]See EBS/99/202 and the accompanying paper on "The Baltics—Exchange Rate Regimes and External Sustainability" (SM/99/282).

C. Fiscal Policy and Pension Reform

Discussions focused on:

- ***The possible need to further tighten fiscal policy if called for by external developments***
- ***The necessity to reverse the recent backtracking in the area of fiscal transparency***
- ***The main parameters of the 2001 budget***
- ***Pension reform and measures to strengthen the finances of the Pension Fund***

25. **The government aims at achieving a fiscal deficit of about 2 percent of GDP in 2000 and approximate fiscal balance over the medium-term.** The budget margin during the first quarter of 2000 gives increased confidence that these targets will be achieved. The authorities indicated that they expected to meet all quarterly fiscal program targets in 2000.

26. **Staff argued that the programmed fiscal deficit should be seen as a ceiling rather than a target, while steps needed be taken to allow for a tighter fiscal stance in the event of adverse external developments.** Such a policy stance would help raise government savings, reduce the excessively high expenditure-to-GDP ratio, keep the expansion of public debt in check, and provide a clear signal as to Latvia's commitment to macroeconomic stability. To this end, the following steps were agreed upon: First, the authorities will not pursue their plans to put forward a supplementary budget with additional spending of up to 0.7 percent of GDP.[13] Second, the authorities will develop, by end-June 2000, and with the help of a Fund/Bank technical assistance mission on expenditure policy, contingency measures providing budgetary savings of up to 0.5 percent of GDP. And third, with a more medium-term perspective, measures to further strengthen the pension fund will be submitted to parliament by year-end.

27. **Revenue performance is expected to be bolstered by intensified efforts to enhance tax administration** (see paragraph 10 of the MEP). Such efforts also include the submission to parliament, as a prior action before end-June 2000, of amendments to streamline tax benefits granted to enterprises in free ports and tax-free zones and to eliminate those benefits that are inconsistent with EU regulations.

28. **While the authorities have made great strides in enhancing the transparency and efficiency of public sector operations (see paragraph 9 of the MEP), some backtracking required prompt remedial action.** During the first quarter of 2000, the cabinet issued several government resolutions authorizing the direct spending of privatization receipts in an amount of about LVL 20 million through the Latvian Privatization Agency (LPA), thereby bypassing the Treasury.[14] Staff pointed out that such a policy severely complicated

[13]The supplementary budget was intended to provide for increased spending on pensions, teachers' salaries, road construction, benefits for families, and subsidies to pork producers.

[14] Such spending was for, inter alia, the national census, compensation payments to redeem special privatization vouchers held by former deportees to Siberia, and unpaid salaries to employees of previously state-owned enterprises that went bankrupt.

expenditure management and the implementation of macroeconomic policy, as well as the timely monitoring of the fiscal performance criterion. Staff indicated that such spending would be included in the fiscal deficit and counted in the measurement of the fiscal performance criterion.[15] In addition, staff insisted that a reversal of this policy become a prior action for Board consideration of the first program review, a position that was also supported by the Minister of Finance. To this end, it was agreed that the cabinet would pass a government resolution stipulating that all privatization receipts, beyond those covering the legally defined administrative costs and reserve fund of the LPA, be transferred to the Treasury. Further, staff emphasized, and the authorities agreed, that, consistent with the program, any additional privatization receipts beyond the budgeted amounts should be utilized for debt reduction and should not generate any additional discretionary spending.

29. **Understandings were reached on the main parameters of the 2001 budget.** With a view to achieving fiscal balance over the medium term, the 2001 budget will aim at a deficit of less than 1 percent of GDP, to be achieved primarily by a further reduction in the expenditure-to-GDP ratio; the recommendations of the Fund/Bank technical assistance mission in June 2000, as well as the ongoing functional reviews of ministries, will guide efforts to streamline and reprioritize expenditure. Given the already heavy tax burden in Latvia, no new tax increases are planned, and the authorities aim at reducing tax rates over the medium term, including by further lowering the real estate and social tax rates.[16] A modest improvement in the revenue-to-GDP ratio in 2001 is envisaged, predicated on the successful implementation of the measures under the program to strengthen tax administration. In addition, the authorities committed to continue to reduce their use of earmarked taxes in the 2001 budget law, and refrain from introducing new earmarked taxes and from expanding existing ones. The 2001 budget will partially reflect the adoption of the new public sector wage scale and the new civil service law, both of which are structural benchmarks for end-June.[17]

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[15] Since the privatization of most of the government's remaining share in Latvijas Gaze took only place in the last week of March (see below), no such spending outside of the Treasury was effected during the first quarter of 2000, but did occur during April and early May 2000.

[16] In 2000, the real estate tax rate was reduced from 4 percent to 1½ percent and its base was broadened, while the social tax was lowered from 38 percent to 37 percent.

[17] The draft civil service law has been submitted to the Seima, although it is unlikely that it will be approved before late 2000; the respective end-June structural benchmark would not be met. Cabinet recently adopted the new public sector wage scale which is to be implemented during the course of 2001. The new pay scale is broad-banded and transparent, rewards merit, and minimizes the scope for discretionary and ad hoc bonuses.

30. **The move toward a balanced budget hinges on the efforts to contain the structural deficit of the Pension Fund.** Staff welcomed the authorities' resolve in ensuring that the November 1999 pension law amendments were passed[18]—notwithstanding heavy opposition—and their commitment to adopt additional measures to put Pension Fund finances on a more solid footing. While recognizing that these measures can have their full effect only over the medium term, the staff and the authorities concurred on the need for further action. In particular, agreement was reached on the government submitting to parliament by year-end a set of additional amendments to the pension law which will, inter alia, tighten the rules allowing early retirement, increase the pace at which the retirement ages are raised, and eliminate the current limits on pensions to working pensioners (so as to enhance formal labor market participation and social tax collections). Such measures will help ensure that the three-pillar pension system—comprising the Pension Fund, the newly created second fully-funded pension pillar (Box 4), and the third pension pillar (the voluntary private pension funds)—is financially sustainable and can provide adequate retirement income to Latvian pensioners in the future.

31. **Over the medium-term, efforts to improve the system of social assistance will be key to reducing poverty.** Unemployment is concentrated among less-skilled workers and in the rural Eastern regions of Latvia, and long-run unemployment (greater than six months in duration) accounts for about one-third of total unemployment. While poverty declined during 1997-98 (the most recent years for which data are available), more than half of all households remained below the Ministry of Welfare's subsistence minimum, with the percentage significantly higher in rural regions.[19] In this context, staff urged the authorities to continue their efforts to reform the organization and financing of local governments, which provide the bulk of social assistance. By ensuring that both central government transfers to local governments and local government assitance to the poor are based on objective measures of need, targeting of social benefits can be significantly improved. Further, by consolidating, over time, small non-viable local governments—an objective under the World Bank PSAL—their ability to provide adequate resources for social assistance will be strengthened as well.

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[18]Under the November 1999 amendments, the retirement ages for men and women were raised and a clear schedule for further gradual increases was re-affirmed; the practice of allowing working pensioners to have their pension benefits recalculated on the basis of their most recent earnings was discontinued; and indexation will take place only once per year (in October) as opposed to twice per year, which should also save administrative resources.

[19] However, most social indicators, including life expectancy and school enrollment, have improved since 1994.

Box 4. Pension Reform in Latvia: Establishment of a Fully Funded Second Pillar

On February 17, 2000, the Saeima adopted the Law on State-Funded Pensions. The law sets forth the general principles of the establishment and operation of a state-funded defined contribution second pillar of the pension system, including general provisions for making contributions; the administration, management, investment, and disbursement of the funds; and its supervision.

Participation in the scheme is mandatory for all individuals, who are subject to the state pension insurance (the first pension pillar) and are under the age of 30 when the Law becomes effective, and optional for those between the age of 30 and 49. Contributions will be collected starting July 1, 2001, rising from 2 percent of income in 2001 - 2006 to 4 percent in 2007, 8 percent in 2008, 9 percent in 2009, and 10 percent from 2010 onwards; contributions to the first pillar will be reduced accordingly. Benefits of the second pillar are to be financed from accumulated contributions and income on these contributions (capital).

For the initial 18 months, the State Treasury will be the sole manager of the accumulated capital of the funded pension scheme and will likely invest it primarily in the securities of the State of Latvia and time deposits with banks (regulations are yet to be finalized). Starting from 2003, the management of the accumulated funds will be entrusted to private companies. The Law sets some broad investment principles for the investment companies and refers to future detailed regulations. The pillar will be supervised by the Unified Financial Sector Supervisory Agency starting from 2003.

Upon retirement, a retiree will instruct the State Social Insurance Agency to either (i) transfer his/her accumulated capital to the state special pension budget and include it in calculating the pension amount, or (ii) purchase a life insurance (life pension) policy from an insurance company. The Law does not offer the option to withdraw a certain amount of capital as a lump sum. The Law also restricts the extent to which the accumulated capital can become part of the individual's inheritance; it is envisaged that it can only be passed on to be fully utilized for financing of the survivor's pension to dependent family members.

The contribution rates were set at low levels during a lengthy transition period. This approach to the establishment of a second pillar is a cautious one, that limits both transition costs and potential benefits over the medium-term so that the fully-funded system will only over time play a major role in providing retirement funding and contribute to the strengthening of capital markets. Nevertheless, in view of the projected demographic trends over the long-term, the adoption of the Law represents an important step in creating a financially sustainable pension system that links benefits to contributions, thereby providing sufficient incentives for employment in the formal sector.

For more details, see the accompanying paper on "Pension Reform in the Baltics: Issues and Prospects."

D. Exchange Rate and Monetary Policies and Financial Sector Reform

Discussions focused on:

- ***The maintenance of the SDR peg until EU accession***
- ***The monetary program for the remainder of 2000***
- ***The suitability of foreign exchange swaps to foster long-term lending in lats***
- ***Enhancements to banking and financial sector supervision***

32. **The exchange rate peg to the SDR has served Latvia well and should be maintained, given that Latvia has maintained its external competitiveness (see Section III. B above).** BoL officials reiterated their long-standing view that the maintenance of the peg sends a strong positive signal regarding the stance of financial policies, and that the currency composition of Latvia's foreign trade by and large corresponds to the composition of the SDR basket. Staff, agreed with the BoL's view that, under the assumption that financial policies are kept sufficiently tight and Latvia's competitiveness is not further significantly eroded, there is no need to abandon the SDR peg or widen the current narrow band around the peg. An eventual shift to a euro peg could take place at the time of Latvia's official accession to the EU. While the exact modalities of such shift are still being discussed within the EU and between the EU and the first wave of accession countries, the BoL currently envisages Latvia's membership in the ERM2 mechanism for about two years before joining the euro area.[20]

33. **The monetary program for the remainder of 2000, updated in light of developments, supports the BoL's exchange rate objective.** Within this framework, and relying principally on its open market operations, the BoL will contain the expansion of its net domestic assets, implying that reserve money growth does not exceed 10 percent in 2000. The government's commitment to keep all proceeds from the issuance of government securities in excess of its short-term financing needs with the central bank will help restrain reserve money expansion. In the same vein, with the initial large issuance of three- and five-year bonds now completed, the BoL will cease its purchases of government securities unless they are needed to replace maturing securities so as to preserve its arsenal for future open market operations. The purchases had been undertaken in response to the large liquidity absorption by the government and exerted a downward pressure on interest rates. Staff called on the BoL to better and more transparently explain to all market participants its plans for, and rationale behind, purchases of government securities, thereby defusing possible market perceptions that the BoL was facilitating financing of the government and reducing interest rates to support the economic recovery.

34. **The general assumptions underlying the monetary program—a moderate inflation projection and increase in money demand, as well as a rise in the money multiplier as confidence in the economy and the banking system strengthen—remain largely unchanged compared to EBS/99/202.** However, the program reflects a somewhat stronger increase in credit to the non-government sector, which, based on current trends, could exceed 25 percent for the year as a whole, implying a growth rate of broad money of about 21 percent for 2000.

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[20] The Governor indicated that Latvia may, during ERM2, unilaterally strive to maintain a 1 percent corridor—as under the current SDR peg—compared to a possible 15 percent band under ERM2.

35. **The monetary program will continue to be monitored on the basis of performance criteria on NIR and NDA of the BoL, as well as indicative ceilings for reserve money and NDA of the banking system.** The NIR target was redefined to exclude foreign exchange proceeds from all swap transactions (see Annex III), in line with the reserves template.[21] The BoL has been relying on short-term swaps, with maturities of between 7 and 182 days, to control liquidity in the banking system, in line with practice of some other central banks. While the magnitude of the swaps has not affected the observance of the NIR performance criterion, their volume at times has exceeded 10 percent of NIR.

36. **The BoL's issuance of long-term foreign exchange swaps to foster long-term lending in lats by commercial banks and deepen domestic financial markets was an issue of debate.**[22] Since learning of the BoL's plans to issue such swaps in February, staff has cautioned the BoL to more thoroughly evaluate the benefits and inherent risks in this instrument, such as the possibility of mispricing and the emergence of an open position. Staff also pointed to the principle that a central bank should not provide foreign exchange guarantees and to the potential large cumulative volume of the transactions over a two-year period. Staff questioned the efficacy of such swaps in meeting the intended policy objective, noting that this instrument might well provide disincentives for potential private issuers of long-term securities. Staff also stated that the emergence of a long-term lending market in lats could be expected to be promoted by other factors, such as the prospect of EU accession, the lengthening of maturities of government and mortgage bonds, the availability of medium- to long-term external private credit lines, and the increasingly foreign ownership structure of Latvian banks. In the end, it was decided to revisit the experience with the swaps at the time of the second program review, while the swap amounts would be limited to a maximum of LVL 10 million per month until October. The BoL assured the staff that the swap operations would not adversely affect its conduct of monetary policy.

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[21] The exclusion of all outstanding swaps from the NIR definition will lead to a one-time downward adjustment of the program targets for end-September and end-December 2000. The amount of the downward adjustment is US$97 million, equivalent to the outstanding swaps at end-March 2000. Owing to the large change in the U.S. dollar/SDR exchange rate since the beginning of the program period, the NIR targets for end-September and end-December 2000 are lowered by US$25 million to avoid an unintentional tightening of the program. In addition, these targets also already reflect the shortfall in external financing that occurred in the second quarter of 2000 and the government's decision not to issue another Eurobond during the remainder of 2000, given the government's decision to tap the domestic bond market; this has a corresponding upward impact on NDA.

[22] The swaps have a maturity of two years and provide lats liquidity to commercial banks against foreign exchange in any of the SDR basket currencies. The first auction of such swaps took place in early May 2000, and LVL 1.5 million were allocated to one bank, well below the BoL's intended standard monthly offer of LVL 10 million.

37. **While the strong recovery of the banking system and the pickup in credit growth from a still low base are welcome, staff urged the authorities to remain vigilant regarding the quality of banks' credit portfolios, the adequate use of collateral, and the appropriateness of loan loss provisioning.**[23] Aggregate audited profits of Latvian banks are reported at LVL 15 million for 1999, after an aggregate loss of LVL 99 million in 1998. Only five, mainly smaller, banks reported losses in 1999. The purchase of PLK by a large German bank, which the BoL approved in early June, makes the observance of the end-September structural benchmark on the BoL's divestiture of its shares in that bank virtually certain. One bank merger has recently been completed and another is close to completion. The BoL recently announced its intention to double the minimum capital requirement to €10 million over the medium term, which should provide impetus for further bank consolidation.

38. **Staff impressed on the authorities the need to monitor the large inflows of deposits from non-residents, since such deposits could be prone to sudden withdrawal and may come from questionable sources.**[24] The authorities downplayed these concerns, given that Latvian banks do not appear to rely on such inflows to finance their lending business but largely invest them in marketable securities in OECD countries. The authorities and financial sector representatives also claimed that non-residents, in particular from the CIS, consider Latvia a "safe haven", and that such deposits exhibit greater stability than deposits from residents, as evidenced during the 1998/99 banking crisis.

39. **In view of the largely completed harmonization of the BoL's prudential framework with international norms, the major challenge ahead lies in the creation of the Unified Financial Sector Supervision Agency.** The new agency would consolidate the supervision of the entire financial sector, which is currently borne by the BoL's banking supervision department, the Securities Markets Commission (SMC), and the Insurance Supervision Inspectorate (ISI). The law on creating this agency was adopted by parliament in early June 2000, and the target date for making the agency operational is July 1, 2001. The new law seeks to ensure the agency's independence from political interference, and includes a fee structure to guarantee the agency's financial autonomy. Staff impressed on the authorities the need to ensure that the high quality standards of the BoL's banking supervision department are maintained throughout the transition and carried over to the new agency; the

[23] The bulk of the credit growth has been concentrated in larger banks, all of which have majority foreign ownership, modern management structures, and sufficient expertise in business plan evaluation and risk assessment.

[24] The December 1999 MAE technical assistance report judged Latvia's Money Laundering Law and procedural guidelines to be in line with international standards, although it is still too early to judge whether enforcement by the judicial system is adequate. This assessment was largely confirmed in discussions with financial sector representatives; some of them pointed to, at times, insufficient follow-up by the prosecutor's office in cases of reported suspicious activities.

transition is smooth; and the supervisory standards for non-bank financial institutions are brought largely in line with international norms (especially EU directives) by the time unified supervision becomes effective. To this end, the adoption by the SMC of the EU directives on capital adequacy and investor protection was made a structural benchmark for end-September 2000. Finally, the authorities have indicated their willingness to participate in a Financial Sector Assessment Program (FSAP) mission in early 2001.

E. Structural and Trade Policies

Discussions focused on:

- ***The jump-starting of the privatization program***
- ***The importance of creating an adequate post-privatization regulatory framework***
- ***Measures to improve the business climate***
- ***Further trade liberalization***

40. **The new government reaffirmed past commitments to complete the privatization process by end-March 2001.** In line with its obligations under the World Bank PSAL, best commercial practices will be introduced to jump-start the lagging privatization of the three majority-owned state enterprises (LASCO and Latvenergo at 100 percent, Lattelekom at 51 percent).

41. **International advisors will be procured by end-September 2000 for the divestiture of LASCO and Latvenergo.** Staff also impressed on the authorities the need to stick to the restructuring plan for Latvenergo adopted by the previous government in February 2000 and complete the creation of separate generation, transmission, and distribution subsidiaries under a holding company by end-2000.[25] This would allow the timely completion of the sale of 49 percent of the government's share in the two Riga Combined Heat and Power Plants in early 2001. Staff encouraged the authorities to persevere in the negotiations with the current foreign minority shareholder of Lattelekom on compensation for relinquishing its monopoly rights in 2003 instead of 2013—in line with Latvia's commitments under the WTO. The authorities intend to hire an international investment bank to advise them in these negotiations; it is hoped that they can be completed in early 2001.

42. **Progress has been made with respect to the divestiture of the large enterprises with minority government ownership.** Staff commended the authorities for the successful sale of government shares of Latvijas Gaze (equivalent to 27 percent of capital) at end-March 2000, yielding some LVL 28 million in privatization receipts and reducing the state's ownership share to 10 percent. However, a recent attempt to sell 12 percent of Ventspils Nafta (the Ventspils oil terminal) was unsuccessful, as the sales price and the residual

[25] At end-May, Latvenergo signed a letter of intent with the EestiEnergia, the state-owned Estonian energy company, on studying possibilities for enhanced cooperation between both companies.

government stake in the company (31 percent) were considered too high. The new government now intends to sell all but 5 percent of the company in an international tender in November or December of this year, with the advice of an international investment bank.

43. **The successful privatization of the large state enterprises should be accompanied by the creation of an appropriate regulatory framework.** The Law on Public Service Regulators, aimed at creating a "superregulatory" agency for all public utilities by early 2001, has been submitted to parliament; its enactment is expected before end-September 2000. The "superregulator" will incorporate the independent telecom regulator, which will be created under the telecommunications law that awaits adoption by parliament (a structural benchmark for end-June). An interministerial working group has been established to derive a plan and schedule for the implementation of the "superregulator" law, and it is expected to finalize this work by year-end.

44. **Four-fifths of government-owned apartments were offered for privatization and more than half were actually privatized by end-March 2000.** The government expects these shares to rise to 90 percent and 70 percent, respectively, by end-2000. As regards land registration, about 44 percent of land properties were registered in the Land Book as of end-March 2000; capacity constraints have slowed progress. To further liberalize the land market, the government intends to lift the remaining restrictions on foreign ownership.[26]

45. **The Latvian authorities have taken a number of steps to enhance the business climate and encourage both foreign and domestic investment.** The new commercial code has strengthened minority shareholder rights and creditor interests. Ongoing judicial training, including on tax issues, is increasing the capacity of the legal system to implement legislation fairly and appropriately. The government continues to work as well to reduce bureaucratic barriers to investment (see Box 3). In several of these areas, however, implementation of planned measures has proceeded more slowly than expected, and staff urged the authorities to make every effort to accelerate progress. Finally, the government has established a Corruption Prevention Council, which has developed a program to increase public sector transparency and enhance cooperation among government institutions to combat corruption.

46. **Latvia continues to progress in trade liberalization since it joined the WTO in February 1999.** As a result of the recent reduction in tariff rates, the simple average MFN rate has declined to 2.5 percent (9.2 percent for agricultural goods, and 1.5 percent for non-agricultural goods), and the average basic rate declined to 3.8 percent. Trade legislation continues to be harmonized with WTO rules, and an anti-dumping law in line with such rules is to become effective July 1. The authorities indicated that they would not introduce any new specific tariffs or any export subsidies.

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[26] Currently, foreign ownership of land is unrestricted for residents of countries which with Latvia has bilateral agreements to mutually recognize such ownership. Residents of other countries can currently acquire only 50 percent ownership of a property.

F. Cooperation with the Fund and Data Compilation and Dissemination

47. Latvia has accepted the obligations of Article VIII and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

48. The authorities have an excellent record in their dissemination and publication of data and other information (see Appendix IV). Latvia is a subscriber to the Special Data Dissemination Standard and has recently submitted the Data Template on International Reserves and Foreign Currency Liquidity. The authorities have submitted all necessary material in advance of the Fiduciary Assessment.

IV. Staff Appraisal

49. **With the resumption of growth in the second half of 1999, the economic recession triggered by the Russian crisis has come to an end.** Latvia has weathered this large external shock owing to its efforts over a number of years to cement macroeconomic stability and to develop a flexible market-oriented economy. Further, the tightening of fiscal policy since mid-1999, the generally cautious monetary policy stance, and the renewed impetus in the area of structural reforms, have positioned Latvia well for a strong economic rebound in an environment marked by relatively low inflation and a stable exchange rate regime. Notwithstanding these positive developments, the persistently large external current account deficit poses a risk to external sustainability, which is aggravated by the increased reliance on debt financing of this deficit compared to the pre-Russian crisis situation and by the impact on Latvia's external competitiveness of the recent appreciation of the lats vis-à-vis the euro.

50. **Against this background, while the program supported by the precautionary stand-by arrangement is largely on track, additional efforts may be needed to reduce the current account deficit and increase its financing by FDI.** The staff welcomes the Latvian authorities' commitment—should external developments prove worse than expected—to contain domestic demand by returning to a balanced budget at a faster pace than targeted and, in particular, by narrowing the general government budget deficit by up to half a percentage point of GDP in 2000. In the same vein, the steps taken to jump-start the lagging privatization program and enhance the business climate bode well for initiating a recovery in FDI flows.

51. **In the fiscal area, the deficit targets of about 2 percent of GDP for 2000 and 1 percent of GDP for 2001 should be considered ceilings and not targets.** To this end, the authorities should continue their prudent budget execution and implement the measures under the program intended to enhance the efficiency, effectiveness, and control of public spending, as well as to reduce the size of the government. Latvia's expenditure-to-GDP ratio is already high by international standards, and the process of accession to the European Union will generate additional spending pressures. In this light, the recommendations of the recent

Fund/Bank technical assistance mission on expenditure policy and the conclusions of the government's functional reviews of various line ministries should provide guidance.

52. **The recent bypassing of the Treasury to spend privatization receipts directly by the Latvian Privatization Agency raises serious concerns.** This action has severely complicated expenditure management, reduced the transparency of budgetary procedures, and impaired the implementation of macroeconomic policy. With potentially large privatization receipts in the future, continuation of this policy could have even more serious consequences. Staff is, however, satisfied with the authorities' intention to reverse this policy, and to continue their efforts to enhance expenditure management.

53. **In the same vein, staff is encouraged by the authorities' intention to streamline tax benefits granted to enterprises in free ports and tax free zones and to eliminate those benefits that are inconsistent with EU regulations.** Such measures are part of a broader package to enhance tax administration and limit possibilities for tax avoidance, which—in light of Latvia's high tax rates—are considered instrumental in achieving the medium-term fiscal targets.

54. **The public pension system has been a major drag on the budget and contributed to a large extent to the drop in the public savings rates over the last few years.** The implementation of the November 1999 amendments to the pension law has been successful in containing the structural deficit of the Pension Fund. However, complacency must be avoided, and the authorities are urged to persevere in placing the Pension Fund finances on more solid footing. In this context, staff attaches great importance to the government's intention to submit before year-end another set of amendments to the pension law, which would act to gradually raise the retirement age to more sustainable levels, while limiting the scope for early retirement and encouraging private sector activity in the formal sector. The recent adoption of the second, fully-funded pension pillar and the emergence of private pension funds as the third pension pillar, should help to ensure adequate retirement income and encourage private sector savings.

55. **The current exchange rate regime remains appropriate, and the peg to the SDR could be maintained until EU accession.** However, this is predicated on the maintenance of sufficiently tight financial policies and should be carefully weighed against a potential erosion in Latvia's competitiveness that could result from continued appreciation of the lats against the euro.

56. **The monetary program is consistent with the BoL's exchange rate objective.** The monetary program ensures that recent steps taken by the BoL to reduce interest rates to support the economic recovery remain consistent with the exchange rate regime. In this context, the authorities should also counter any liquidity impact of their long-term foreign exchange swaps. Staff doubts that this new instrument will foster long-term lending in lats and deepen domestic financial markets, but it accepts the BoL's view that experience with the instrument should be gained in the coming months before making a final decision.

57. **A healthy and efficient financial sector is imperative for both continued external sustainability and durable economic growth.** Progress has been achieved since the Russian crisis to strengthen the Latvian banking system, to enhance banking supervision, and to bring the prudential framework in line with international standards. The BoL is to be commended for this progress and for the imminent divestiture of its share in former RigasKomercBanka. Although Latvian banks nowadays appear to be generally healthy, profitable, and largely in compliance with banking legislation and prudential regulations, the BoL should remain vigilant in monitoring the quality of banks' credit portfolios, the use of collateral, and the adequacy of banks' loan loss provisioning, as well as the unabated inflow of deposits from non-residents, in particular given the possibility of their sudden withdrawal. The still large number of banks calls for continued consolidation efforts, and many banks would still benefit from increasing their capital base, preferably by inviting foreign partners, which would bring with them the necessary know how. In addition, the Unified Financial Sector Supervision Agency will need to maintain the high quality standards set by the BoL's banking supervision department and to bring the supervisory standards for non-bank financial institutions in line with international norms.

58. **A crucial test of the authorities' resolve to complete the needed structural reforms will be their ability to implement their privatization program and address the remaining impediments to an enabling business climate.** In this regard, staff is encouraged by the new government's commitments to complete the privatization process of the remaining large state enterprises by end-March 2001. While past commitments have proved difficult to meet, recent decisions, in close consultation with the World Bank, to hire international advisors should help ensure the use of best commercial practices and remove much of the detailed decision-making from the political process. The gains to Latvia from privatization will be increased via the efforts of the authorities to create an appropriate post-privatization regulatory framework. In addition, continued perseverance in the creation of an enabling business climate—in particular, by enhancing property rights, strengthening the judicial system, reducing possibilities for corruption, and cutting red tape—will be instrumental in continuing to attract foreign direct investment and completing the much-needed restructuring of the economy.

59. The periodicity and availability of official statistics for surveillance are adequate, but there still is room for improvement, especially in the area of balance of payments and external debt.

60. The staff welcomes the authorities' intention to publish the Article IV staff report in its entirety.

61. The staff recommends conclusion of the first program review.

62. It is proposed that Latvia continue on the standard 12-month consultation cycle.

V. Proposed Decision

The following draft decision, which can be adopted by a majority of votes cast, is proposed for adoption by the Executive Board:

1. The Republic of Latvia has consulted with the Fund in accordance with paragraph 3(c) of the Stand-By Arrangement for the Republic of Latvia (EBS/99/202, Sup. 2, 12/15/99) and the second paragraph of the letter dated November 10, 1999 from the Minister of Finance and the Governor of the Bank of Latvia.

2. The letter dated June 15, 2000 from the Minister of Finance and the Governor of the Bank of Latvia, with annexed memorandum, shall be annexed to the Stand-by Arrangement for the Republic of Latvia, and the letter dated November 10, 1999 from the Minister of Finance and the Governor of the Bank of Latvia shall be read as supplemented by the letter dated June 15, 2000 from the Minister of Finance and the Governor of the Bank of Latvia, with annexed memorandum.

3. Accordingly, the performance criteria for September 30, 2000 and December 31, 2000 set forth in paragraph 3(a) of the Stand-by Arrangement for the Republic of Latvia shall be as set forth in Table 2 and Annexes I to IV to the memorandum annexed to the June 15, 2000 letter.

4. The Fund determines that the first review contemplated in paragraph 3(c) of the Stand-by Arrangement for the Republic of Latvia has been completed.

Table 1. Latvia: Selected Economic and Financial Indicators, 1996–2000

	1996	1997	1998	1999		2000	
				EBS/99/ 202	Est.	EBS/99/ 202	Proj.
	(Annual percentage changes unless otherwise specified)						
National income, output, and employment							
Nominal GDP (millions of lats)	2,829	3,275	3,580	3,895	3,662	4,175	3,946
GDP (millions of $US)	5,134	5,638	6,068	6,690	6,260	7,211	6,620
Real GDP	3.3	8.6	3.9	0.9	0.1	4.0	4.0
Registered unemployed (in '000, end of period)	90.8	84.9	111.4	...	109.5	...	...
Unemployment rate (end of period)	7.2	7	9.2	...	9.1	...	...
Prices and wages (annual change)							
Consumer price index (period average)	17.6	8.0	4.7	2.2	2.4	3.0	3.5
Consumer price index (end-period)	13.1	7.0	2.8	2.0	3.2	3.0	3.6
Producer price index (end-period)	13.7	4.1	1.9	...	-1.1	...	...
Real wage (growth rate)	-5.3	11.2	6.2	...	3.5	...	...
Average monthly wage (in lats)	99	120	133	...	141	...	...
Average monthly wage (in $US)	179	207	226	...	242	...	...
General government (in percent of GDP)							
Revenue 1/	37.4	41.3	42.7	40.8	42.6	40.1	42.5
Expenditure	39.0	40.7	43.4	44.3	46.6	41.7	44.1
Net lending	0.2	0.3	0.1	0.5	0.2	0.4	0.4
Fiscal balance 1/	-1.8	0.3	-0.8	-3.9	-4.2	-1.9	-2.0
Gross government debt	408	392	377	504	505	536	...
Gross debt as percentage of GDP (in percent)	14.4	12.0	10.5	12.9	13.8	12.8	...
Foreign debt (millions of lats)	227	218	232	354	358	379	...
External sector (change in percent) 2/							
Exports							
Value	28.3	9.4	7.8	-4.1	-6.1	7.0	8.0
Volume	9.0	20.0	11.0	-4.1	...	6.0	...
Imports							
Value	38.0	10.6	16.5	-7.2	-7.2	8.5	7.9
Volume	23.0	16.0	16.0	-5.7	...	7.5	...
Real effective exchange rate (INS weights)	7.9	4.4	26.7	...	5.7	...	...
Real effective exchange rate (non-BRO trading partners)	12.7	10.2	1.8	...	11.2	...	...
Terms of trade	-2.0	-5.0	-3.9	...	...	...	...
External trade balance (percent of GDP) 3/	-15.5	-15.0	-18.6	-16.4	-16.4	-15.7	-16.7
Current account balance (including official transfers, percent of GDP)	-4.2	-5.1	-10.1	-8.7	-9.7	-7.8	-8.7
International reserves (in months of imports of goods and nonfactor services, end-of-period)	3.1	3.0	2.7	3.0	3.1	3.1	3.0
Exchange rate (lats per $US; end-of-period)	0.556	0.590	0.569	0.579	0.583	0.579	...
Exchange rate (lats per $US; period average)	0.551	0.581	0.590	0.579	0.585	0.579	...
Money and credit (end-period, change in percent) 4/							
Reserve money	25	30	7	6	12	15	10
Domestic credit (non-government)	1	76	59	11	15	16	25
Broad money	20	39	6	12	8	16	21
Broad money to NFA of the BoL (level)	1.8	2.0	1.7	2.0	1.9	2.0	2.2
Riga Stock Exchange Price Index (end-of-period)	417	741	186	...	171	...	...
Interest rates (in percent, per annum, end-period)							
Deposit 5/	11	6	7	...	6	...	...
Credit 5/	20	13	15	...	15	...	...
One-month treasury bill auction rate	10.1	3.5	6.3	...	3.9	...	...
Five-year treasury note rate	...	...	...	...	...	...	...

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 and nonfactor services, in $US terms for value growth. The data for 1996 are not comparable with the later periods due to methodological improvements introduced in 1997.

3/ Goods only.

4/ Growth rates for 1999 are on a quarter-on-quarter basis.

5/ 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 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		54		
January 1, 2000-September 30, 2000: Performance criterion		63		
January 1, 2000-December 31, 2000: Performance criterion		81		
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		-10		
September 30, 2000: Performance criterion		22		
December 31, 2000: Performance criterion		37		
			(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		848		
September 30, 2000: Performance criterion 5/		671		
December 31, 2000: Performance criterion		687		
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	109	75
March 31, 2000: Performance criterion	435	200	150	75
June 30, 2000: Performance criterion	565	200		
September 30, 2000: Performance criterion	565	200		
December 31, 2000: Performance criterion	565	200		
V. Limits on external government debt of up to one year 7/				
September 30, 1999: Indicative		0		
December 31, 1999: Performance criterion		0		
March 31, 2000: Performance criterion		0		
June 30, 2000: Performance criterion		0		
September 30, 2000: Performance criterion		0		
December 31, 2000: Performance criterion		0		

Table 2. Latvia: Quantitative Performance Criteria and Structural Benchmarks Under the 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	
September 30, 2000:	555	
December 31, 2000:	579	
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:	612	
September 30, 2000: 8/	660	
December 31, 2000:	696	
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	
January 1, 2000-September 30, 2000:	943	
January 1, 2000-December 31, 2000:	1290	

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
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

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

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.	
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.	
5. Enact a telecommunications law, as described in paragraph 23 of the MEP dated November 10, 1999.	
By end-September 2000:	
1. The Bank of Latvia to divest its investment in Rīgas Komerc Banka (RKB).	
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.	
4 . The Securities Market Commission to adopt the directives on capital adequacy and investor protection, for implementation by January 1, 2001.	
By end-December 2000:	
1. Complete the restructuring of Latvenergo, as described in paragraph 17.	
2. Submit to parliament amendments to the pension law, as described in paragraph 12.	

Table 2. Latvia: Quantitative Performance Criteria and Structural Benchmarks Under the 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 are to be 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).

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).

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).

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

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).

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).

Table 3. Latvia - Balance of Payments, 1996-2006

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
								Projections			
						(in millions of U.S. dollars)					
Current account balance	-217.2	-287.5	-613.3	-605.2	-575.4	-562.6	-565.1	-567.7	-552.2	-523.0	-494.1
excluding official transfers	-266.3	-320.2	-695.1	-666.1	-615.4	-602.6	-605.1	-607.7	-592.2	-563.0	-534.1
Trade Balance	-798.3	-847.9	-1130.4	-1027.1	-1105.1	-1163.7	-1205.5	-1237.9	-1264.1	-1287.4	-1301.4
Exports, f.o.b.	1487.6	1838.1	2011.1	1889.1	2040.2	2264.6	2536.4	2840.8	3181.6	3563.4	3991.1
Imports, f.o.b.	-2285.9	-2686.0	-3141.5	-2916.1	-3145.3	-3428.3	-3741.9	-4078.7	-4445.7	-4850.9	-5292.4
Services, income & transfers balance	581.1	560.4	517.2	421.8	529.7	601.1	640.4	670.2	711.9	764.4	807.3
Transport sector, net	533.1	515.1	506.2	521.7	557.4	580.8	604.6	619.3	644.5	680.0	706.0
Travel, net	-93.7	-75.7	-68.9	-115.3	-61.8	-40.1	-32.9	-26.5	-20.8	-12.6	-10.1
Interest and investment income, net	2.7	14.3	12.2	-88.7	-85.9	-76.0	-74.6	-73.6	-71.6	-72.6	-69.2
Other income	38.6	40.5	41.5	41.1	40.0	56.4	63.3	71.1	79.8	89.6	100.6
Other services	9.1	-11.2	-80.3	-30.0	-30.0	-30.0	-30.0	-30.0	-30.0	-30.0	-30.0
Current transfers, net	98.1	77.4	106.5	93.0	110.0	110.0	110.0	110.0	110.0	110.0	110.0
Capital account balance	547.9	360.7	614.2	695.4	612.3	682.6	657.6	704.5	687.4	688.3	687.3
Capital transfers	0.0	13.7	14.1	12.6	12.6	12.6	12.6	12.6	12.6	12.6	12.6
Foreign investment , net	237.6	-56.8	296.0	427.3	420.0	440.0	460.0	490.0	490.0	490.0	490.0
Foreign direct investment, net	378.6	515.0	302.5	366.2	380.0	400.0	420.0	450.0	470.0	470.0	470.0
FDI in Latvia	381.7	521.1	356.7	366.5	410.0	430.0	450.0	480.0	500.0	500.0	500.0
Direct investment abroad	-3.0	-6.1	-54.2	-0.3	-30.0	-30.0	-30.0	-30.0	-30.0	-30.0	-30.0
Portfolio investment, net	-141.0	-571.8	-6.5	61.1	40.0	40.0	40.0	40.0	20.0	20.0	20.0
Other medium and long-term capital	57.4	164.9	177.9	226.9	73.0	123.4	78.3	95.3	78.2	79.1	78.1
Government, net	44.7	20.2	45.2	249.9	47.6	68.4	23.3	40.3	23.2	24.1	23.1
Other sectors, net	12.7	144.7	132.6	-23.0	25.4	55.0	55.0	55.0	55.0	55.0	55.0
Other capital and investment, net	252.9	238.9	126.2	167.9	106.6	106.6	106.6	106.6	106.6	106.6	106.6
Errors and omissions	-104.5	29.0	61.7	-139.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	226.2	102.2	62.6	90.2	36.9	120.0	92.4	136.8	135.2	165.3	193.2
Financing items:	-226.2	-102.2	-62.6	-90.2	-36.9	-120.0	-92.4	-136.8	-135.2	-165.3	-193.2
Change in NFA, total	-215.3	-102.2	-62.6	-90.2	-36.9	-120.0	-92.4	-136.8	-135.2	-165.3	-193.2
Gross convertible reserves	-189.8	-65.4	-37.9	-75.1	-19.8	-103.0	-75.5	-128.3	-135.2	-165.3	-193.2
Use of Fund credit net	-25.5	-36.8	-24.7	-15.1	-17.0	-16.9	-16.9	-8.5	0.0	0.0	0.0
						(In percent of GDP)					
Current account balance	-4.2	-5.1	-10.1	-9.7	-8.7	-7.8	-7.1	-6.6	-5.9	-5.1	-4.4
excluding official transfers	-5.2	-5.7	-11.5	-10.6	-9.3	-8.3	-7.7	-7.0	-6.3	-5.5	-4.8
Trade balance	-15.5	-15.0	-18.6	-16.4	-16.7	-16.1	-15.2	-14.3	-13.4	-12.5	-11.7
Merchandise exports	29.0	32.6	33.2	30.2	30.8	31.3	32.1	32.9	33.8	34.6	35.7
Merchandise imports	44.5	47.6	51.8	46.6	47.5	47.3	47.3	47.2	47.2	47.1	47.4
Services, income & transfers balance	11.3	9.9	8.5	6.7	7.9	7.9	7.7	7.5	7.4	7.2	7.1
Gross official reserves (millions of US$)	772.5	837.9	875.8	950.9	970.7	1073.7	1149.2	1277.5	1412.8	1578.1	1771.2
in months of GNFS imports	3.1	3.0	2.7	3.1	3.0	3.1	3.0	3.1	3.1	3.2	3.3
Value growth of merchandise exports (percent)	8.8	23.6	9.4	-6.1	8.0	11.0	12.0	12.0	12.0	12.0	12.0
Value growth of merchandise imports (percent)	17.4	17.5	17.0	-7.2	7.9	9.0	9.1	9.0	9.0	9.1	9.1
Value growth of exports of GNFS (percent)	28.3	9.4	8.4	-6.9	9.1	9.7	10.3	10.4	10.5	10.5	10.6
Value growth of imports of GNFS (percent)	38.0	10.6	17.9	-8.7	7.2	8.9	9.0	8.9	8.9	9.0	9.0
FDI stock	17.7	25.3	29.4	35.4	39.8	42.4	44.7	46.6	47.9	48.6	49.2
FDI/current account deficit (percent)	174.3	179.1	49.3	60.5	66.0	71.1	74.3	79.3	85.1	89.9	95.1
External public debt (millions of US$) 1/	432.1	417.4	469.4	753.5	874.1	974.4	989.5	1021.4	1022.3	1015.7	1004.8
in percent of GDP	8.4	7.4	7.7	12.0	13.2	13.5	12.5	11.8	10.8	9.9	9.0
Public debt service (in percent of exports) 1/	4.4	7.0	3.8	4.2	8.3	5.4	6.1	5.7	11.9	4.8	4.4
Total external debt (in millions of US$)	726.6	775.7	1080.9	1385.0	1313.7	1392.3	1490.7	1589.8	1686.0	1789.3	1898.4
in percent of GDP	14.2	13.8	17.8	22.1	19.8	19.2	18.9	18.4	17.9	17.4	17.0
of which short-term (in millions of US$)	148.9	74.1	109.4	113.4	120.8	131.1	142.2	154.3	167.4	181.7	197.1
Gross official reserves / short-term debt	518.8	1130.7	800.5	838.2	803.4	819.1	808.0	827.8	843.7	868.6	898.6

Source: Data provided by Latvian authorities and staff estimates.

1/ Includes publicly guaranteed debt.

Table 4. Latvia: Consolidated General Government, 1996-2000

	1996	1997	1998	1999		2000 3/	
				Act.	Prog.	Prog.	Proj.
			(In millions of lats)				
Revenue 1/ 2/	1,056.9	1,351.8	1,528.7	1,560.6	1,588.9	1,676.1	1,676.1
Tax revenue	954.6	1,141.2	1,294.0	1,321.7	1,323.6	1,409.8	1,409.8
Direct taxes	538.3	642.6	739.5	785.7	781.9	836.4	836.4
Corporate income tax	57.4	78.6	92.4	92.2	86.3	95.0	95.0
Personal income tax	153.0	183.2	219.7	240.8	244.7	261.4	261.4
Social taxes	327.9	380.8	427.4	452.6	450.9	480.0	480.0
Indirect taxes	405.2	467.6	553.9	534.0	541.7	573.4	573.4
Taxes on goods & services	374.1	430.5	505.5	487.4	496.6	533.4	533.4
VAT	267.7	288.5	316.3	316.2	308.6	335.1	335.1
Excises	87.8	119.9	169.5	155.1	172.3	185.3	185.3
Customs duty	18.7	22.0	19.8	16.1	15.7	13.0	13.0
Property taxes	31.1	37.2	48.4	46.6	45.1	40.0	40.0
Real estate tax	12.9	16.9	0.0	20.3	...	40.0	40.0
Taxes in transit	0.4	0.7	0.6	2.0	0.0	0.0	0.0
Non-tax revenue	102.4	223.3	234.8	238.9	265.3	266.3	266.3
Expenditure	1,103.6	1,331.8	1,553.5	1,706.9	1,724.6	1,740.7	1,740.7
Current expenditure: *of which*	1,044.8	1,253.1	1,408.1	1,529.7	1,568.4	1,589.9	1,589.9
Wages & salaries	266.0	297.1	355.1	386.1	386.8	386.2	386.2
of which: Social security contributions	68.8	68.5	74.6	82.2	81.7	80.6	80.6
Goods & services	269.0	317.8	307.3	300.8	325.5	328.0	328.0
Interest	40.1	33.3	24.5	25.3	31.1	38.8	38.8
Subsidies & transfers	469.6	604.9	706.4	817.4	824.9	836.9	836.9
Transfers to households	446.5	435.2	537.4	615.9	609.8	619.2	619.2
Capital expenditure	58.8	78.7	145.4	177.2	156.2	150.8	150.8
Financial balance	-46.7	20.0	-24.8	-146.3	-135.7	-64.6	-64.6
Net lending (+)	5.0	10.0	2.6	6.9	18.0	16.0	16.0
Fiscal balance	-51.7	10.0	-27.4	-153.2	-153.7	-80.6	-80.6
Financing	51.7	-10.0	27.4	153.2	153.7	80.6	80.6
Privatization receipts	2.3	46.8	39.0	6.2	20.2	50.5	50.5
Domestic	37.4	-62.8	-24.6	36.2	-9.9	3.7	3.7
Banks	25.4	-56.9	-24.7	34.7	-24.7	-0.3	-0.3
Other domestic	12.0	-5.9	0.1	1.5	14.8	4.0	4.0
Foreign	12.0	6.0	13.0	110.8	143.4	26.4	26.4
Memorandum items							
			(In percent of GDP)				
Revenue	37.4	41.3	42.6	42.6	40.8	40.1	42.5
Direct taxes	19.0	19.6	20.6	21.5	20.1	20.0	21.2
Taxes on goods & services	13.2	13.1	14.1	13.3	12.7	12.8	13.5
Expenditure	39.0	40.7	43.3	46.6	44.3	41.7	44.1
of which:							
Expenditure financed by EU grants	0.0	0.0	0.0	0.0	0.0	0.9	1.0
Wages & salaries (net of social taxes)	7.0	7.0	7.8	8.3	7.8	7.3	7.7
Transfers to households	15.8	13.3	15.0	16.8	15.6	14.8	15.7
Capital expenditure	2.1	2.4	4.1	4.8	4.0	3.6	3.8
Net lending	0.2	0.3	0.1	0.2	0.5	0.4	0.4
Fiscal balance	-1.8	0.3	-0.8	-4.2	-3.9	-1.9	-2.0
			(In millions of lats)				
Social Budget							
Revenues (social taxes)	327.9	380.8	427.4	452.6	450.9	480.0	480.0
Transfers from basic budget	9.1	6.4	13.5	7.7	7.7	0.0	0.0
Transfers to individuals	319.8	361.0	430.2	499.8	499.5	502.5	502.5
Pensions	299.3	340.9	401.7	445.2	...	461.2	461.2
Balance	8.1	19.8	-2.8	-47.2	-48.6	-22.5	-22.5
Balance excl. transfers to GDP (in percent)	0.3	0.6	-0.1	-1.3	-1.2	-0.5	-0.6
Nominal GDP (in millions of lats)	2,829	3,276	3,589	3,662	3,897	4,178	3,946
Nominal GDP (in millions of U.S.$)	5,137	5,639	6,086	6,260	6,690	7,215	6,620

Sources: Ministry of Finance; and Fund staff estimates.

1/ Revenues exclude receipts from privatization.

2/ Before 2000, the receipts and expenditure related to EU accession were not part of the budget.

3/ Starting from FY 2000, the bulk of Forest Development Fund operations were taken over by a newly created nonprofit entity outside the budget.

Table 5. Latvia: Reserve Money and Net Domestic Assets of the Bank of Latvia, 1996-2000
(in millions of lats)

	1996	1997	1998	1999					2000					
	Dec	Dec New Acct. 1/	Dec	Mar	Jun	Sept	Dec	Dec Prog.	Mar Prel.	Mar Prog.	Jun Prog.	Jun Proj. 6/	Sep Rev. Prog.	Dec Rev. Prog.
Reserve money	340.7	441.7	471.5	481.0	491.5	449.6	526.3	499.5	482.6	522.9	539.2	539.2	554.7	578.9
Currency in circulation	282.6	359.4	374.4	393.4	407.9	386.5	426.1	404.6	411.1	423.6	436.7	436.7	449.3	468.9
Bank deposits	58.1	82.4	97.0	87.6	83.7	63.1	100.2	94.9	71.6	99.4	102.4	102.4	105.4	110.0
Foreign currency deposits	6.8	0.1	--	--	--	--	--	--	--	--	--	--	--	--
Other	51.3	82.2	97.0	87.6	83.7	63.1	100.2	94.9	71.6	99.4	102.4	102.4	105.4	110.0
Net foreign assets 2/ 3/	349.4	433.1	463.9	488.5	556.8	477.4	523.4	523.7	524.9	530.0	549.1	522.3	532.3	542.1
Net International Reserves 1/	354.6	438.2	463.6	488.2	556.5	477.1	523.1	523.4	524.7	529.8	548.9	522.1	532.0	541.9
Correspondent accounts 1/ 2/	-5.2	-5.1	0.3	0.3	0.3	0.3	0.2	0.3	0.2	0.3	0.3	0.3	0.3	0.3
Net domestic assets	-8.7	8.7	7.6	-7.4	-65.3	-27.7	2.9	-24.2	-42.3	-7.1	-10.0	16.9	22.4	36.7
Domestic credit	43.3	83.0	113.8	100.8	17.6	54.3	68.0	57.9	-7.5	74.9	72.1	51.6	57.2	71.5
Banks	10.0	7.6	52.0	84.0	44.8	39.1	63.3	39.6	47.4	41.7	40.4	40.4	44.9	49.8
BoP assistance	5.6	0.6	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Refinance credits	4.3	6.9	51.9	83.9	44.7	39.0	63.2	39.5	47.3	41.6	40.3	40.3	44.8	49.7
Government, net 4/	33.3	75.5	61.7	16.8	-27.2	15.2	4.6	18.3	-55.0	33.2	31.7	11.2	12.3	21.7
BoP assistance	50.3	59.4	54.3	55.6	54.7	51.4	50.1	50.3	33.8	33.2	31.7	31.7	23.3	21.7
Other government, net 5/	-16.9	16.1	7.4	-38.7	-81.9	-36.2	-45.5	-32.0	-88.8	0.0	0.0	-20.5	-11.0	0.0
Other items, net	-52.0	-74.4	-106.2	-108.2	-82.9	-82.0	-65.1	-82.0	-34.8	-82.0	-82.0	-34.8	-34.8	-34.8
Memorandum Items:														
Percentage change from previous quarter														
Reserve money	10.0	15.5	3.1	2.0	2.2	-8.5	17.1	11.1	-8.3	4.7	3.1	11.7	2.9	4.4
Domestic credit	-30.8	173.3	34.5	-11.4	-82.6	208.9	25.2	6.6	-111.1	29.4	-3.8	-784.6	10.8	25.1
Banks	-67.6	579.0	56.0	61.4	-46.7	-12.7	62.0	1.2	-25.1	5.4	-3.2	-14.9	11.1	11.0
Government, net 4/	4.6	157.9	20.5	-72.8	-261.7	-156.0	-69.5	20.3	-1283.4	81.4	-4.5	-120.4	9.5	76.4
Percentage annual change														
Reserve money	24.5	29.7	6.7	...	...	...	11.6	6.0	...	...	...	...	...	10.0
Broad money	19.9	38.6	5.9	...	...	...	8.0	12.0	...	...	...	...	...	21.0
Credit to the nongovernment sector	1.1	76.2	58.6	...	...	...	15.3	11.0	...	...	...	...	...	25.3
Velocity	5.0	4.1	4.2	3.6	3.8	3.9	4.0	4.1	...	...	...	...	...	3.7
Money multiplier	1.844	1.972	1.957	1.913	1.975	2.107	1.894	2.068	2.292	2.045	2.051	2.051	2.093	2.084
Exchange rate (LVL/US$) 7/	0.556	0.590	0.569	0.590	0.598	0.579	0.583	0.579	0.596	0.579	0.579	0.596	0.596	0.596
NFA total (US$mn)	637.8	734.0	815.2	827.9	931.1	824.4	897.7	904.4	880.8	915.4	948.4	876.4	893.1	909.6

Sources: Bank of Latvia; and staff estimates.

1/ New accounting to include changes instituted in June 1997 by the BOL and is a break in series.
2/ Valued at current exchange rates.
3/ As the Bank of Latvia has almost no medium- and long-term foreign currency liabilities, NFA equals NIR.
4/ Excluding proceeds from foreign loans for balance of payments support.
5/ Includes purchase of Treasury bills and change in government deposits.
6/ Under the assumption that the government will not draw on the external credit lines (US$ 45 million), which was envisaged under the program. This will activate the adjuster on the performance criteria on NIR and on NDA of the Bank of Latvia, as well as on the indicative ceiling on the NDA of the banking system.
7/ Keeping the end-March 2000 exchange rate constant for the remainder of 2000.

Table 6. Latvia: Broad Money and Net Domestic Assets of the Banking System, 1996-2000

(In millions of lats)

	1996	1997	1998	1999					2000					
	Dec.	Dec. New Acct. 1/	Dec	Mar	June	Sept	Dec Prel.	Dec Prog.	Mar Prel.	Mar Prog.	Jun Prog.	Jun Proj. 5/	Sep Rev. Prog.	Dec Rev. Prog.
Broad money (M2X)	628.2	870.9	922.7	920.3	971.0	947.3	996.9	1033.1	1070.3	1069.1	1106.0	1106.0	1161.2	1206.5
Currency held by public	264.0	332.7	340.2	357.6	371.8	351.6	377.4	370.2	372.8	387.6	399.6	399.6	411.1	429.0
Household deposits	67.1	96.4	118.1	108.7	116.6	114.1	121.1	123.5	133.6	128.2	135.0	135.0	146.7	153.9
Enterprise deposits	104.4	170.2	200.1	194.8	211.0	186.5	199.9	229.4	235.5	238.0	250.7	250.7	272.4	285.8
Residents' FC deposits 2/	192.7	271.6	264.3	259.3	271.6	295.1	298.5	309.9	328.5	315.4	320.7	320.7	330.9	337.8
Total deposits	364.2	538.3	582.5	562.7	599.2	595.7	619.4	662.9	697.5	681.6	706.4	706.4	750.0	777.5
Net foreign assets (total) 3/ 4/	445.0	619.0	414.9	416.3	494.4	416.8	363.7	468.9	417.5	475.2	494.3	361.8	500.9	510.7
Convertible net int'l reserves 2/ 4/	439.9	511.8	501.1	497.1	580.0	510.7	497.1	562.8	527.9	569.2	588.3	455.8	594.9	604.7
Nonconvertible reserves 2/ 3/	5.1	107.2	-86.2	-80.8	-85.7	-94.0	-133.4	-94.0	-110.4	-94.0	-94.0	-94.0	-94.0	-94.0
Net domestic assets 4/	183.2	252.0	507.8	504.0	476.6	530.5	633.1	564.3	652.8	593.9	611.7	744.2	660.3	695.8
Domestic credit	366.4	479.0	647.3	675.6	621.5	684.8	745.0	718.5	748.1	748.2	765.9	839.4	884.6	920.2
Credit to the non-government sector	206.5	363.9	577.1	596.2	606.6	625.0	665.1	640.8	712.9	663.1	687.3	753.0	800.6	833.2
Households	21.2	36.6	64.0	69.6	78.7	85.8	94.3	86.9	104.1	89.8	91.9	110.8	119.4	125.1
Enterprises	185.3	327.3	513.1	526.6	527.8	539.2	570.8	553.9	608.8	573.4	595.4	642.2	681.2	708.0
Government, net	159.9	115.1	70.2	79.4	15.0	59.7	79.9	77.7	35.2	85.0	78.6	86.5	84.0	87.0
Restructuring Bonds	53.2	24.1	24.1	24.1	24.1	12.1	6.1	6.1	6.1	6.1	6.1	0.0	0.0	0.0
Other Credit to Government	106.7	91.0	46.1	55.3	-9.1	47.6	73.8	71.6	29.1	78.9	72.5	86.5	84.0	87.0
Other items, net 4/	-183.3	-227.0	-139.5	-171.6	-144.9	-154.3	-111.9	-154.3	-95.2	-154.3	-154.3	-95.2	-224.4	-224.4
Memorandum Items:														
Percentage change from previous quarter														
Broad money(M2X)	4.4	8.1	0.2	-0.3	5.5	-2.4	5.2	9.1	7.4	3.5	3.3	3.3	5.0	3.0
Domestic credit	5.2	12.0	10.8	4.4	-8.0	10.2	8.8	4.9	0.4	4.1	2.4	12.2	5.4	4.0
Credit to the non-government sector	7.2	22.0	0.3	3.3	1.7	3.0	6.4	2.5	7.2	3.5	-3.6	5.6	6.3	4.1
Households	-14.7	17.4	9.7	8.7	13.1	9.0	9.9	1.3	10.3	3.3	-11.7	6.5	7.8	4.8
Enterprises	10.4	22.5	-0.8	2.6	0.2	2.2	5.9	2.7	6.7	3.5	-2.2	5.5	6.1	3.9
Credit to the government, net	2.8	-11.0	705.0	13.1	-81.2	298.9	33.8	30.1	-56.0	9.4	123.5	145.8	-2.9	3.6
Exchange rate (LVL/US$) 6/	0.556	0.590	0.569	0.590	0.598	0.579	0.583	0.579	0.596	0.579	0.579	0.596	0.596	0.596
Total NFA (US$mn) 3/														
Total	800.4	1049.1	729.2	705.6	826.8	719.8	623.9	809.8	700.5	820.8	853.8	607.1	840.4	856.9
of which: comm. Banks 4/	172.0	315.1	-86.0	-122.5	-104.3	-104.6	-273.8	-94.6	-180.3	-94.6	-94.6	-269.3	-52.7	-52.7

Sources: Bank of Latvia; and Fund staff estimates.

1/ New accounting charts that became effective in June 1997, leading to a break in the series.

2/ As of June 1997, residents' foreign currency deposits are deposits in all currencies except lats.

3/ In currencies of OECD countries, valued at the current exchange rates.

4/ 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-March 2000, this equity amounts to LVL 129 million.

5/ Under the assumption that the government will not draw on the external credit lines (US$ 45 million), which was envisaged under the program. This will activate the adjuster on the performance criteria on NIR and on NDA of the Bank of Latvia, as well as on the indicative ceiling on the NDA of the banking system.

5/ Loans to the Privatization Fund.

6/ Keeping the end-March 2000 exchange rate constant for the remainder of 2000.

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

(in percent unless otherwise indicated)

	1996				1997				1998				1999				2000
	March	June	Sept.	Dec.	March	June	Sept.	Dec.	March	June	Sept.	Dec.	March	June	Sept.	Dec.	March
Net foreign assets of the BoL, in millions of U.S. dollars	453	517	558	638	625	690	727	734	780	880	825	815	828	931	824	898	881
Net foreign assets of commercial banks, in millions of U.S. dollars	138	158	178	172	171	273	330	315	240	243	8	-86	-122	-104	-105	-274	-180
Commercial banks total reserves/total deposits	15.6	17.1	15.3	15.8	16.5	16.3	16.4	16.3	15.8	15.5	18.2	16.1	16.3	16.0	15.3	18.9	14.8
Commercial banks excess reserves/total reserves	11.8	12.1	10.6	15.9	12.1	21.1	17.9	18.8	11.4	11.2	18.1	19.3	13.7	8.9	4.4	19.8	8.9
Loans/deposits	53.9	42.2	37.7	40.2	42.3	45.1	49.0	46.4	57.6	55.9	66.8	70.3	74.1	69.9	68.8	65.9	63.5
Loans/total assets	31.9	24.9	22.9	23.7	24.5	25.9	26.2	29.7	34.6	34.6	42.4	43.4	44.2	44.0	44.5	43.4	42.0
Credit to nongovernment/GDP 1/	7.9	6.9	6.6	6.6	8.0	7.9	8.7	9.8	12.5	13.4	14.9	14.8	16.9	16.0	15.3	15.8	17.0
Liquidity test 2/	54.5	69.5	57.1	69.7	64.0	59.9	55.9	77.0	56.7	58.8	36.3	36.6	38.5	39.3	40.1	41.8	43.9
Capital adequacy -- risk-weighted average 3/	26.5	28.1	27.7	24.5	31.1	24.3	22.4	21.0	23.0	21.0	18.0	17.0	18.0	16.0	15.0	16.0	16.0
Loan-loss provisioning/gross loans	26.5	27.9	29.3	25.1	23.2	17.0	14.4	7.4	5.9	4.3	3.3	4.3	4.5	4.8	4.1	4.0	4.0
Return on equity 4/	41.0	30.0	21.0	24.0	24.0	26.0	29.0	26.0	17.0	15.0	-5.8	-12.9	19.8	14.6	13.0	11.0	21.0
Net foreign asset position 5/	179.3	263.4	263.1	349.3	290.2	298.6	292.9	310.5	171.4	188.2	85.9	152.4	111.1	123.2	159.2	245.6	368.6
Nominal interest rate spread 6/	20.4	12.4	15.8	10.9	11.8	6.1	7.9	5.7	8.1	8.8	9.9	7.9	9.5	6.4	5.1	8.4	5.6
Stock market index, level 7/	100.0	154.9	201.3	247.7	469.1	383.6	476.6	345.9	306.3	206.8	113.5	98.0	81.9	83.9	70.9	87.8	116.6
Stock market capitalization/GDP 1/	0.6	1.2	2.1	2.7	7.0	4.9	7.8	5.3	6.6	5.3	3.6	5.8	6.7	6.2	5.4	5.8	7.8

Sources: Bank of Latvia; Fund staff estimates.

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, 1998-2006 1/

	1998	1999	2000	2001	2002	2003	2004	2005	2006
			Projections						
				(In percent of GDP)					
Foreign savings 1/	10.1	9.7	8.7	7.8	7.1	6.6	5.9	5.1	4.4
Gross national savings	17.5	16.6	17.8	19.9	20.8	21.5	22.2	23.2	24.0
Government 2/	3.4	0.8	1.6	3.6	3.8	4.1	4.0	4.0	3.9
Nongovernment	14.1	15.8	16.1	16.3	17.0	17.4	18.2	19.2	20.1
Gross domestic investment	27.6	26.3	26.5	27.7	27.9	28.1	28.1	28.3	28.4
Government 3/	4.2	5.0	3.7	4.5	4.5	4.5	4.4	4.2	4.1
Nongovernment	23.4	21.3	22.8	23.2	23.4	23.6	23.7	24.1	24.3
Memorandum item:									
Nominal GDP (in millions of lats)	3,580	3,662	3,946	4,316	4,712	5,145	5,617	6,133	6,696
Real GDP growth rate	3.9	0.1	4.0	6.0	6.0	6.0	6.0	6.0	6.0
Inflation (annual average rate)	4.7	2.4	3.5	3.2	3.0	3.0	3.0	3.0	3.0
Fiscal balance (in percent of GDP) 2/	-0.8	-4.2	-2.0	-0.9	-0.7	-0.4	-0.4	-0.3	-0.2
External debt/GDP (end-year)	17.8	22.1	19.8	19.2	18.9	18.4	17.9	17.4	17.0

Sources: Latvian authorities; and Fund staff estimates. Compared with previous staff reports, the value of nominal GDP has been lowered to bring it in line with the data published by the Central Statistics Office; as a result the investment and saving to GDP ratios increased.

1/ External current account deficit.

2/ Government revenues do not include privatization receipts.

3/ Including net lending.

Table 9. Latvia: Indicators of Financial Obligations to the Fund, 2000-2005

	2000	2001	2002	2003	2004	2005
	Projections					
Debt service to the Fund (in millions of SDRs)	9.5	9.8	9.6	16.1	20.5	9.9
Repurchases (in millions of SDRs)	7.6	7.6	7.6	14.5	19.6	9.6
Charges (in millions of SDRs)	1.9	2.2	2.0	1.6	0.9	0.3
In percent of exports of goods and services	0.5	0.5	0.4	0.7	0.8	0.3
In percent of convertible currencies debt service	7.5	7.9	7.8	12.4	15.3	8.0
In percent of gross official reserves	1.2	1.2	1.1	1.7	2.1	1.0
Memorandum items:						
Fund credit outstanding 1/						
In millions of SDRs	54.2	52.1	44.5	30.0	10.4	0.8
In millions of U.S. dollars	73.1	72.5	61.9	41.7	14.5	1.1
In percent of quota	42.8	41.1	35.1	23.7	8.2	0.6
In percent of convertible currencies debt	5.2	4.9	3.9	2.5	0.8	0.1
In percent of GDP	1.0	1.0	0.8	0.5	0.1	0.0
U.S. dollar/SDR	1.3	1.4	1.4	1.4	1.4	1.4

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

1/ Projections assume that all drawings are made under the precautionary stand-by arrangement.

Table 10. Latvia: Schedule of Purchases Under the Stand-By Arrangement

Amount of Purchase	Available On or After	Contingent On	Status
SDR 5.5 million (4.3 percent of quota)	Board approval (December 10, 1999)	Board approval	Undrawn
SDR 5.5 million (4.3 percent of quota)	February 15, 2000	Observance of end-December 1999 performance criteria 1/	Undrawn
SDR 5.5 million (4.3 percent of quota)	May 15, 2000	Observance of end-March 2000 performance criteria and completion of program review 1/	
SDR 5.5 million (4.3 percent of quota)	August 15, 2000	Observance of end-June 2000 performance criteria 1/	
SDR 5.5 million (4.3 percent of quota)	November 15, 2000	Observance of end-September 2000 performance criteria and completion of program review 1/	
SDR 5.5 million (4.3 percent of quota)	February 15, 2001	Observance of end-December 2000 performance criteria 1/	

1/ In addition to standard clauses on an overdue financial obligation to the Fund or failure to meet a repurchase expectation, on the exchange and trade system, and the performance criterion on the non-accumulation of external arrears.

LATVIA: FUND RELATIONS

(As of May 31, 2000)

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	159.19	125.5
Reserve position in Fund	0.03	0.0

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Holdings	0.02	N.A.

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent of Quota**
Systemic Transformation	32.41	25.6

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				
	(5/31/00)	2000	2001	2002	2003	2004
Principal	0	5.7	7.6	7.6	7.6	3.8
Charges/interest	0	0.6	1.3	0.9	0.5	0.1
Total	0	6.3	8.9	8.5	8.1	3.9

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 1999 Article IV Consultation on July 28, 1999. At the time of the 1999 Article IV Consultation, Directors commended the authorities for their prudent financial policies and for progress with the substantial structural changes required to establish a market economy. However, they noted their concern with the significant fiscal expansion foreseen under the 1999 Budget Law. They urged the authorities to continue broadening the tax base and improve tax collection, although the primary emphasis on fiscal consolidation should be on containing expenditure pressures. In this regard, they referred in particular to the need to reform the pension system and also the civil service while ensuring appropriate restraint in public sector wages. The exchange rate peg was considered to have served Latvia well and remained appropriate, even though a switch to a euro peg in the medium term appeared to be desirable. Directors agreed that Latvia's external position was broadly sustainable, however they emphasized the essential need to continue to monitor the external situation carefully, particularly in view of the still volatile international situation. Directors noted that the Russian financial crisis had revealed important weaknesses in the Latvian banking system, and urged the authorities to be vigilant for any signs of deterioration in the quality of loan portfolios, to continue raising prudential standards, and to facilitate wherever possible further orderly consolidation of the banking sector. Directors urged the authorities to accelerate their program of structural reform in order to foster sustained economic growth and to move toward their goal of EU accession, emphasizing in particular the importance of completing the privatization process. Other reform areas identified by Directors included further reductions in agricultural tariffs, improving the implementation of laws and regulations, and modernizing the agricultural sector.

WORLD BANK RELATIONS

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 10 projects under implementation totaling US$186.4 million in commitments, of which US$110.5 million have been disbursed as of end of May 2000. In addition, it has two IDF grants under implementation totaling US$0.6 million. The total amount of commitments and debt outstanding, including closed operations, is US$355.4 million, of which US$261.5 million is disbursed.

2. Since 1992, the Bank has financed a variety of loans in the following areas: agriculture, enterprise and financial restructuring, the environment, heating and other municipal services, highway maintenance, and welfare reform. More recent loans include the Rural Development Project (August 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$30 million); and the State Revenue Service Modernization Project (December 1998, US$4.75 million), which supports strengthening the organization and management as well as the operations of the revenue administration. Projects in energy and solid waste management are also under preparation. The Education Improvement Project (May 1999, US$31.1 million) aims to improve education outcomes by strengthening the management of both resource inputs and the learning process. 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 of this year, and US$40.4 million have been disbursed under the first SAL of the program.

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 Assistant Strategy was presented to the board in April 1998. During 1999, the Bank has undertaken a Municipality Finance study and a Poverty Assessment. Currently, a Bank team is working on a second Public Expenditure Review, in close coordination with FAD, to advice 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.

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	Since October 1999	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

1. 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 is a subscriber to the Fund's Special Data Dissemination Standard (SDDS). 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 has taken office since October 1999. Advice on statistical matters is also provided under the EU/EFTA program of statistical technical cooperation with the statistical offices of the Baltic countries.

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 unit value and volume indices. An import price index based on a hybrid method with unit values and pure price data is under development.

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. With the help of Fund technical assistance over the recent past, significant progress has been made in the compilation of balance of payments statistics by the CSB and BoL. However, shortcomings remain in the quality of the published data, and to a lesser extent, its timeliness. In early 2000, the BoL assumed the responsibility for compiling the balance of payments statistics from the CSB.

8. Merchandise trade data are based for the most part on customs data. The implementation by the customs department of transaction-price based valuation reduces previous problems relating to the valuation of goods. With regard to trade, procedures could be strengthened to assure that goods passing through customs warehouses are properly valued and that coverage of exports to Russia and CIS countries is complete. 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. Enterprise surveys have been instituted to collect information on other services items and the income account. Enterprise surveys, supplemented by balance sheet data from banks, are employed to estimate financial account flows. In addition, a specific foreign direct investment survey is recommended. The BoL is in the process of instituting an International Transactions Reporting System (ITRS) among the commercial banks in order to prepare monthly BOP estimates. Foreign liabilities in the international investment position data reported by the authorities are considerably larger than data reported by creditors to the BIS.

The authorities need to identify the sources of this large discrepancy and reconcile the data with assistance from a new balance of payments statistical advisor. The authorities believe that one likely source is duplication in reporting by the government and the private sector of official lending but this needs to be confirmed.

Data dissemination standards

9. 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.

Survey of Reporting of Main Statistical Indicators
(As of May 15, 2000)

	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	May 14	Apr. 30	Apr. 30	Apr. 30	Apr. 30	Apr. 30	Apr. 30	Ql	Q4, 1999	Apr. 30	Q4 1999	Mar. 31
Date received	May 15	May 10	May 10	May 10	May 10	May 15	May 8	May 15	Mar. 29	May 10	Mar. 29	Apr. 20
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	A 1/, C	A 1/ C	A 1/	A, N 1/	A
Mode of reporting	E	C,E	C,E	C,E	C,E	C,E	E	C,E	C,E	C	C	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.

June 15, 2000

Dear Mr. Köhler:

The attached Supplementary Memorandum of Economic Policies describes the policies the Government and the Bank of Latvia intend to follow for the remainder of the program period. This economic program is based on our Memorandum of Economic Policies, dated November 10, 1999, and has been discussed and updated with the staff of the IMF, during the first review of economic developments and policies under the stand-by arrangement.

Our economic policies are focused on ensuring that the recent renewal of economic growth is durable, and that our external position remains sustainable. As such, our program is built on a reduction in the fiscal deficit this year, and a return to fiscal balance over the next several years, combined with measures to enhance the efficiency, effectiveness and transparency of the public sector. At the same time, we are continuing to put in place those structural reforms needed to ensure that Latvia reaches its full economic potential. We continue with our intention to not make any purchases under the stand-by arrangement, but 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. Further, we are committed to taking several actions, discussed in the memorandum and noted in the attached Table 1, prior to IMF Executive Board consideration of the first review. The second review of the program would be completed by end-December 2000. In addition to a comprehensive evaluation of economic performance under the program, this review would focus on public sector reform efforts and financial sector developments and oversight. The program will also be evaluated on the basis of a number of quarterly performance criteria for end-September and end-December and structural benchmarks, which are proposed in the attached Table 2.

Sincerely,

/s/
Gundars Bērziņš
Minister of Finance
Ministry of Finance

/s/
Einārs Repše
Governor
Bank of Latvia

Attachments

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

Supplementary Memorandum of Economic Policies

A. Introduction

1. With the resumption of growth in the second half of 1999, Latvia has emerged from the economic recession triggered by the Russian financial crisis of August 1998. During the course of 1999, appropriate financial and structural policies helped lay the foundation for a return to robust and durable economic growth driven by the private sector. Despite the important gains achieved last year, however, significant risks remain to our continued economic recovery, most notably the persistently large external current account deficit. In this context, we intend to aim our economic program for the remainder of 2000 and over the medium term at a return to a broadly balanced budget and the completion of our structural reform agenda.

2. Following three successive quarters of negative growth, real GDP growth turned slightly positive in the third quarter of 1999, followed by growth of about 3 percent during the last quarter of that year and 4 percent during the first quarter of 2000. At the same time, inflation has remained subdued, with the twelve-month inflation rate at about 3 percent in April 2000. The current account deficit in 1999 remained broadly unchanged from the previous year, at just under 10 percent of GDP. The recent pick-up of exports to the EU and CIS markets, as well as the planned prudent financial policies, point to a moderate narrowing of the current account deficit during 2000, notwithstanding the expected rise in imports resulting from the economic recovery. The promising external outlook is reflected in the decline in the secondary market spread on Latvian Eurobonds to below 130 points, among the lowest for emerging markets.

3. A tightening of fiscal policy in the second half of 1999 contained the general government deficit to about 4 percent of GDP for the year, and the end-December performance criterion under the program was observed. Our fiscal program for 2000 aims, at a minimum, for a halving of this deficit, to below 2 percent of GDP. During the first quarter of this year, a recovery in revenues and continued expenditure restraint allowed the end-March performance criterion on the fiscal deficit to be met with a comfortable margin. With a view to developing the government debt market and providing a benchmark for the emergence of long-term private lending in lats--and taking advantage of historically low interest rates and favorable market sentiments-- the Treasury issued, for the first time, three-year bonds at end-January and five-year bonds at end-March.

4. In line with the restoration of growth and the recovery of the banking system after the financial losses related to the Russian crisis, monetary conditions have returned to normality. Since the beginning of this year, the Bank of Latvia (BoL) has reduced its lending to commercial banks. As a result, net domestic assets of the BoL and reserve money growth have been kept within the respective program ceilings for end-March 2000; both ceilings had been exceeded at end-December 1999 to accommodate banks' demands for lats to guard against potential Y2K-related problems. The BoL also met the performance criterion on net international reserves (NIR) for end-December 1999 and end-March 2000. Commercial bank credit to the non-government sector has been rising at a healthy pace—14 percent in the six months beginning October 1999—aided by a declining interest rate trend. The banking system has returned to profitability, and several banks have succeeded in strengthening their capital, in some cases with foreign

participation. In the meantime, the BoL has implemented new prudential regulations on loan classification and loan-loss provisioning and adopted the capital adequacy directive, in line with commitments under the program.

5. We have continued to make progress on structural reforms. While privatization of the three remaining large public enterprises has continued to face obstacles, important steps have been taken. In March 2000, the cabinet of ministers approved a plan for restructuring and privatizing parts of Latvenergo, and the Law on Concerns—needed for effective restructuring—has recently been passed by parliament. Progress has also been made in reinforcing the regulatory structure for utilities, improving the business climate, enhancing the legal and judicial system, and strengthening the efficiency and transparency of the public sector. Parliament has also adopted legislation to implement the second, fully-funded, tier of the pension system beginning July 1, 2001. Finally, we have abolished the temporary import tariff on pork products, effective June 1, 2000, and otherwise maintained our very liberal trade regime.

B. The Government's Program for 2000-01

Macroeconomic Framework

6. While Latvia's economic prospects have improved with the resumption of growth in late 1999, the persistently large current account deficit, coupled with a lower level of FDI than that prior to the Russia crisis, could pose a risk to a sustainable external position. We are, therefore, committed to strengthening our financial and structural policies with a view to lowering the external current account deficit, reinforcing FDI inflows, and—more generally—creating an environment conducive to private sector activity. Such a policy mix, underpinned by the maintenance of the successful exchange rate peg to the SDR, will also help maintain confidence of the international community in Latvia. We recognize the need to closely monitor external developments, and stand ready to further tighten financial policies as needed to maintain the sustainability of our external position and avoid undue pressure on the exchange rate peg.

7. Against this background, our main macroeconomic objectives for 2000 and 2001 are as follows: (i) real GDP growth at 4 percent and 6 percent, respectively; (ii) inflation at about 3 percent, slightly above the level of EU countries; and (iii) a decline in the external current account deficit to under 9 percent of GDP and under 8 percent of GDP respectively. We also expect that by 2001, more than two-thirds of the external current account deficit will be financed by FDI.

Fiscal Policies

8. Latvia's fiscal policy aims to achieve approximate fiscal balance over the medium-term, on a cyclically-adjusted basis. To this end, we aim to contain the general government fiscal deficit to at most 2 percent of GDP this year. We are committed to retain all revenues above the levels projected under the Fund-supported program for further deficit reduction. Moreover, should data for the first quarter of 2000 provide clear indication that the current account deficit is not on a declining trend, we would seek to quickly implement additional spending cuts. In this context, a joint IMF-World Bank technical assistance mission will visit Latvia in late May to suggest areas in

which expenditure savings could be attained, in both the short- and medium-term, without sacrificing key public service delivery. Prior to the Fund Executive Board's consideration of the first review, we will agree with Fund staff on a series of contingency measures which could be implemented to generate savings of up to 0.5 percent of GDP this year.

9. The government remains fully committed to continuing to enhance the transparency and efficiency of public sector operations. Toward this end, parliament passed, in November 1999, amendments to the Law on Budget and Financial Management which, *inter alia,* will bring all accounts of budget-financed institutions into the Treasury, and introduce a requirement for state institutions to submit annual audited reports to the Treasury as of 2001. Further, the Law on the Institutional Framework for Public Administration and the Law on Public Sector Agencies--aimed at containing the recent proliferation of public agencies, and ensuring the agencies' openness, accountability and transparency--have been presented to parliament, with passage expected this year. We will strictly adhere to the moratorium on the creation of new agencies while awaiting the passage of this legislation. We will also seek to reduce further the use of earmarked taxes in the context of the 2001 budget and, in any case, will neither introduce new earmarked taxes nor expand existing ones. Recent government decisions to effect public spending by cabinet decision directly from the Latvian Privatization Agency (LPA), bypassing the Treasury, have complicated expenditure management and the implementation of macroeconomic policy, and reduced the transparency of fiscal operations. Therefore, we will, prior to consideration by the Fund's Executive Board of the first review, pass a cabinet resolution that all privatization receipts, beyond those covering the administrative costs and reserve fund of the LPA, be transferred to the Treasury.

10. Given the already high tax rates in Latvia, we will refrain from increasing such rates any further in 2000, but will continue our efforts to strengthen tax administration. We are improving our taxpayer audits by basing audits on specific risk factors, centralizing audit decisions, and improving coordination between the State Revenue Service and other national data bases. We are also implementing measures to address difficulties in collecting excises on petroleum products, including by extending fuel taxes to any petroleum product that can be potentially used as fuel, thereby limiting the ability of importers to escape taxes by mixing petroleum products after importation. We will also simplify tax administration with respect to our free ports and tax-free zones by clarifying the tax benefits offered, and eliminating those benefits not consistent with EU regulations. We will, prior to Fund Executive Board consideration of the first review, submit amendments to this effect to Parliament, which we expect to be enacted by end-December 2000.

11. The 2001 budget will seek to achieve a deficit of less than 1 percent of GDP, which would be achieved primarily by further reductions in the expenditure-to-GDP ratio. We recognize the importance of improving our prioritization of public spending, in particular given the pressures for higher spending resulting from the EU accession process. The budget will reflect the impact of the new public sector wage bill and the Civil Service Law, as well as the continued efforts to identify cost-savings, including through functional reviews of ministries.

12. Progress toward eliminating the structural component of the fiscal deficit will require further efforts to improve the sustainability of the Pension Fund. Pension amendments passed in

November 1999 appear to have reversed a substantial portion of the worsening in Pension Fund finances, with the deficit of the fund expected to decline by 0.8 percentage points of GDP over 1999-2000. To further strengthen Pension Fund finances we will, by end-December 2000, submit to parliament amendments to the pension law which will, *inter alia,* gradually reduce the scope for early retirement; and allow individuals to work and receive their full pension. It is expected that the latter will have a significant impact on labor market participation and social tax collections.

Monetary and Exchange Rate Policies and Financial Sector Supervision

13. The exchange rate peg to the SDR has served Latvia well, and we intend to maintain this peg until EU accession. While the recent appreciation of the lats vis-à-vis the euro has affected Latvia's external competitiveness somewhat, other indicators, such as dollar wages and the return of robust export growth during the most recent two quarters, suggest that Latvia remains competitive. We will continue to pursue an appropriately tight monetary policy to support the exchange rate peg and meet our inflation objective.

14. In line with the economic recovery, and supported by the renewed soundness of the banking system, our revised monetary program for the remainder of 2000 is based on the assumption of a continued gradual increase in money demand and in the money multiplier. We will contain the growth of reserve money to 10 percent, relying principally on our open market instruments. In addition, to support this policy stance, the government will keep all proceeds in excess of its financing needs on accounts with the central bank. As, based on current indications, credit to the non-governmental sector could grow by more than 25 percent in 2000, broad money is programmed to expand by 21 percent during the period. To ensure that such credit growth remains sustainable, we will carefully monitor the quality of bank portfolios, the adequate use of collateral, and the appropriateness of loan loss provisioning.

15. In order to foster longer-term lending in lats, and help deepen financial markets, the BoL intends to offer monthly long-term foreign exchange swaps to commercial banks; the first such offer was held in early May. The BoL remains fully committed to ensuring that such swap operations do not adversely effect our ability to meet our inflation and exchange rate objectives. Therefore, we will limit the swap amounts auctioned to a maximum of LVL 10 million per month until October, and will ensure that any excess liquidity in lats is appropriately reduced through open market operations. We will review our experience and seek to agree upon future policies regarding these swaps with Fund staff, in the context of the second review of the program.

16. We currently are in close to full compliance with the Basle Core Principles of Effective Banking Supervision (BCP) and the relevant EU directives, and will continue to modernize our prudential regulations in line with any updates of internationally agreed regulations. We will, by end-June 2000, implement the prudential regulations to cover the market risk. In addition, we will ensure that our high standards of banking supervision will be maintained during and after the transfer of the BoL's Supervision Department to the newly created Unified Financial Sector Supervision Agency, which is expected to become operational by July 1, 2001. In this regard, we will strive to enhance regulation and supervision of non-bank financial institutions, including

insurance companies, pension funds, and securities markets, so that we comply with relevant EU regulation in these areas by the time unified supervision takes effect. In particular, the Securities Market Commission will, by end-September 2000, adopt the directives on capital adequacy and investor protection, for implementation by January 1, 2001. Finally, the BoL will, by end-September 2000, divest its investment in Pirma Latvijas Banka (formerly Rigas KomercBanka).

Structural and Trade Policies

17. We recognize that completion of our program of enterprise privatization will play an important role in continuing to attract foreign direct investment and restructure the economy. Therefore, we will seek to largely complete privatization of the remaining public enterprises by end-March 2001. As a means to address technical difficulties experienced during this last stage of the privatization process, and to ensure best commercial practices and maximum benefits for Latvia, we will appoint international advisors for the divestiture of the Latvian Shipping Company (LASCO) and Latvenergo by end-Setember 2000. In the case of Latvenergo, the government intends to complete restructuring of the enterprise into separate generation, transmission and distribution subsidiaries by end-December 2000, and aim to complete the sale of 49 percent of the government's share in the two Riga Combined Heat and Power Plants early in 2001. We are also studying the possibility of closer cooperation between Latvenergo and the Estonian energy company. As regards Lattelekom, completion of privatization awaits the conclusion of negotiations with the private owner on compensation for relinquishing its monopoly rights earlier than initially agreed. While negotiations have been more protracted than hoped, we anticipate the sale of the remaining government-owned shares in early 2001.

18. The establishment of a strong regulatory framework for public utilities remains a key objective for securing a competitive post-privatization environment. To this end, Parliament will pass by end-September 2000 the Law on Public Service Regulators, which will create a "superregulatory agency" for all public utilities effective January 1, 2001. In addition, we will complete by end-December 2000 the work of the interministerial working group to implement the law and organize the transition and absorption of the currently separate regulatory bodies. The new telecommunications law, to be adopted by end-June 2000, will create an independent telecom regulator by end-December 2000, which would later become part of the new superregulatory agency.

19. Our commitment to maintain a liberal trade regime is unchanged. We have adopted legislation reducing agricultural tariffs in line with our WTO agreements, and lowering all tariff rates above EU levels to EU levels, effective April 1, 2000. Further, we shall not introduce any new specific tariffs or export subsidies.

20. We believe that the policies described above will help ensure that Latvia enjoys durable and sustainable economic growth in 2000 and beyond, and that its external position remains sustainable. We stand ready to adopt any additional measures deemed necessary to meet these objectives.

Table 1. Prior Actions

The following actions will be taken by the Government of Latvia prior to Fund Executive Board consideration of the first review:

1. Agree with Fund staff on a series of contingency measures which could be implemented to generate savings of up to 0.5 percent of GDP in 2000.

2. Pass a cabinet resolution that all privatization receipts, beyond those covering the administrative costs and reserve fund of the LPA, be transferred to the Treasury.

3. Submit amendments to parliament clarifying the tax benefits offered in free ports and tax-free zones, and eliminating those benefits not consistent with EU regulations.

Table 2. Latvia: Quantitative Performance Criteria and Structural Benchmarks Under the 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		54		
January 1, 2000-September 30, 2000: Performance criterion		63		
January 1, 2000-December 31, 2000: Performance criterion		81		
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		-10		
September 30, 2000: Performance criterion		22		
December 31, 2000: Performance criterion		37		
			(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		848		
September 30, 2000: Performance criterion 5/		671		
December 31, 2000: Performance criterion		687		
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	109	75
March 31, 2000: Performance criterion	435	200	150	75
June 30, 2000: Performance criterion	565	200		
September 30, 2000: Performance criterion	565	200		
December 31, 2000: Performance criterion	565	200		
V. Limits on external government debt of up to one year 7/				
September 30, 1999: Indicative		0		
December 31, 1999: Performance criterion		0		
March 31, 2000: Performance criterion		0		
June 30, 2000: Performance criterion		0		
September 30, 2000: Performance criterion		0		
December 31, 2000: Performance criterion		0		

Table 2. Latvia: Quantitative Performance Criteria and Structural Benchmarks Under the 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	
September 30, 2000:	555	
December 31, 2000:	579	
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:	612	
September 30, 2000: 8/	660	
December 31, 2000:	696	
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	
January 1, 2000-September 30, 2000:	943	
January 1, 2000-December 31, 2000:	1290	

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
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

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

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.	
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.	
5. Enact a telecommunications law, as described in paragraph 23 of the MEP dated November 10, 1999.	
By end-September 2000:	
1. The Bank of Latvia to divest its investment in Rīgas Komerc Banka (RKB).	
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.	
4. The Securities Market Commission to adopt the directives on capital adequacy and investor protection, for implementation by January 1, 2001.	
By end-December 2000:	
1. Complete the restructuring of Latvenergo, as described in paragraph 17.	
2. Submit to parliament amendments to the pension law, as described in paragraph 12.	

Table 2. Latvia: Quantitative Performance Criteria and Structural Benchmarks Under the 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 are to be 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).

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).

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).

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

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).

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).

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

Limits on the General Government Fiscal Deficit	Target	Outcome
	(In millions of lats)	
January 1, 1999–September 30, 1999 (indicative)	114	88
January 1, 1999–December 31, 1999	154	153
January 1, 2000–March 31, 2000	26	11
January 1, 2000–June 30, 2000	54	
January 1, 2000-September 30, 2000	63	
January 1, 2000-December 31, 2000	81	

Indicative Targets on Central Government Revenue	Target	Outcome
	(In millions of lats)	
January 1, 1999–September 30, 1999	894	887
January 1, 1999–December 31,	1235	1209
January 1, 2000–March 31, 2000	290	291
January 1, 2000–June 30, 2000	605	
January 1, 2000-September 30, 2000	943	
January 1, 2000-December 31, 2000	1290	

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 domestic and foreign 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 of the Latvian Privatization Agency.

The net claims of domestic and foreign banks, including the Bank of Latvia, on the general government are defined as all claims of these institutions 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 with banks.

To the extent that foreign project financing, including for net lending, exceeds (falls short) of programmed amounts, the limit on the fiscal deficit shall be adjusted upward (downward) by these excess amounts. The programmed amounts are as follows:

January 1–September 30, 1999, lats 12 million; January 1–December 31, 1999, lats 18 million; January 1–March 31, 2000, lats 2 million; January 1-June 30, 2000, lats 7 million; January 1-September 30, 2000, lats 16 million, and January 1- December 31, 2000, lats 21 million..

For the calculation of the indicative target on central government revenue, the central government shall be defined as the basic budget plus the special budgets. Revenue as defined for these purposes excludes the nonbudgeted (self-earned) revenues of individual ministries. For the formulation of revenue targets through end-June, it was assumed that the railway fund was included in the central government special budgets. The revenue floor is calculated as:

Total general government tax revenue
- (minus) local government tax revenue (comprising personal income tax revenues allocated to local governments and real estate and property taxes collected by local government)
+ (plus) other non-tax revenue of the central government basic and special budgets (excluding nonbudgeted revenue)
- (minus) EU grants to central government basic and special budgets.

The limits on the general government fiscal deficit will be adjusted downward by the extent to which the central government revenue exceeds the respective indicative targets.

Monthly data on net claims of the domestic banking system on the general government are taken from the balance sheets of the Bank of Latvia and the consolidated accounts of all commercial banks operating in Latvia. The Ministry of Finance shall provide information on, and confirm the amounts of general government deposits held abroad, disbursements of foreign loans to the general government, net sales of all Latvian State Treasury securities and any other Government debt instruments, borrowing from the nonbank sector, gross privatization receipts and the uses of such receipts, net lending operations of the general government, expenditures under the PIP and any other data regarding the fiscal balance.

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 (issuance of lats plus deposits of commercial banks with the Bank of Latvia (including obligatory reserves)); and (ii) the Bank of Latvia's net international reserves (as defined in Annex III to this memorandum). Both (i) and (ii) will be expressed in lats. 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.

The foreign currency-denominated components of the balance sheet of the Bank of Latvia will be converted into lats at the official exchange rate of the lats to the U.S. dollar prevailing at the end of the respective quarter. The prevailing cross exchange rates will be used to convert items denominated in currencies other than the U.S. dollar. Balance of payments assistance accruing to the government will be converted into lats at the prevailing official exchange rate at the time the loan is disbursed and recorded as a government deposit in the balance sheet of the Bank of Latvia.

The ceilings on net domestic assets are established on the basis of an assumption of disbursements in balance of payments assistance of US$ 75 million in the fourth quarter of 1999, US$ 40 million in the first quarter of 2000, US$ 45 million in the second quarter of 2000, US$ 0 million in the third quarter of 2000, and US$ 0 million in the fourth quarter of 2000. The outcome for the fourth quarter of 1999 was US$ 75 million and for the first quarter of 2000 US$ 40 million. For the derivation of the targets for the third and fourth quarter of 2000, it is assumed that disbursements in balance of payments assistance in the second quarter of 2000 will be US$ 0 million. The net domestic assets ceilings (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 limits indicated in the table below are stock numbers for the respective date and will be monitored monthly from the balance sheet of the Bank of Latvia.

Net Domestic Assets of the Bank of Latvia

	Target	Outcome
	(In millions of lats)	
Ceiling for September 30, 1999	-28	-28
Ceiling for December 31, 1999	-24	3
Ceiling for March 31, 2000	- 7	-42
Ceiling for June 30, 2000	-10	
Ceiling for September 30, 2000	22	
Ceiling for December 31, 2000	37	

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 will be converted into lats at official prevailing exchange rate at the end of the respective quarter. Net foreign assets of the banking system are the sum of all gross claims on nonresidents, *less* liabilities to nonresidents. 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. Beginning with the target for September 30, 2000, in line with international accounting practice, the net domestic assets of the banking system include the amount of foreign equity in Latvian commercial banks, lowering the target accordingly. As of March 31, 2000, foreign equity amounted to LVL 129 million.

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.

Net Domestic Assets of the Banking System

	Target	Outcome
	(In millions of lats)	
Ceiling for September 30, 1999 (actual preliminary)	531	531
Ceiling for December 31, 1999	564	633
Ceiling for March 31, 2000	594	653
Ceiling for June 30, 2000	612	
Ceiling for September 30, 2000 1/	660	
Ceiling for December 31, 2000	696	

1/ As of September 30, 2000, the program definition includes foreign equity of commercial banks, which is recorded in "other net assets".

Target for the Net International reserves of the Bank of Latvia

Net international reserves of the Bank of Latvia consist of gross international reserves *minus* liabilities in all foreign 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 in convertible currencies 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 and excluding claims on residents. Gross international reserves generated from foreign exchange swaps of all maturities will be excluded from the program definitions for end-September 2000 and end-December 2000. For purposes of the program, foreign liabilities will be defined as use of Fund credit, and currency liabilities of the Bank of Latvia, including pledged, collateralized, or otherwise encumbered liabilities.

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

The performance criteria on the floor for net international reserves of the Bank of Latvia are specified below, and will be monitored from information provided monthly by the Bank of Latvia. The floor on net international reserves is established on the basis of an assumption of disbursements in balance of payments assistance of US$ 75 million in the fourth quarter of 1999, US$ 40 million in the first quarter of 2000, US$ 45 million in the second quarter of 2000, US$ 0 million in the third quarter of 2000, and US$ 0 million in the fourth quarter of 2000. The outcome for the fourth quarter of 1999 was US$ 75 million and for the first quarter of 2000 US$ 40 million. For the derivation of the targets for the third and fourth quarter of 2000, it is assumed that disbursements in balance of payments assistance in the second quarter of 2000 will be US$ 0 million. 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.

Net International Reserves of the Bank of Latvia

Minimum	Target	Outcome
	(In millions of U.S. dollars)	
Floor on September 30, 1999	724	824
Floor on December 31, 1999	804	898
Floor on March 31, 2000	815	881
Floor on June 30, 2000	848	
Floor on September 30, 2000 1/	671	
Floor on December 31, 2000	687	

1/ As of September 30, 2000, the program definition excludes gross international reserves generated from foreign exchange swaps.

EXTERNAL DEBT

Cumulative limits on the contracting and guaranteeing of nonconsessional external debt 1/	Maximum Limits			Outcome		
	0-1 year Maturity 2/	Medium- and long-term	of which: 1-5 year Maturity	0-1 year Maturity	Medium- and long-term	of which: 1-5 year Maturity
	(In millions of U.S. dollars)					
From June 30, 1999 to:						
September 30, 1999	0	150	100	0	30	0
December 31, 1999	0	285	200	0	109	75
March 31, 2000	0	435	200	0	150	75
June 30, 2000	0	565	200			
September 30, 2000	0	565	200			
December 31, 2000	0	565	200			

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/ Excluding normal import-related trade credits.

External debt limits apply to external debt of original maturities of up to and including one year and to nonconcessional medium- and long-term external debt of original maturities of more than one year that are contracted or guaranteed after June 30, 1999 by the government, the Bank of Latvia or any other agencies on behalf of the government, with sub-limits for such debt of maturities of more than one year up to and including five years. The stock of medium- and long-term debt was US$ 883 million as of June 30, 1999. The definition of the government is the same as in Annex I. For the purpose of measuring the performance criteria on short-term (0–1 year maturity) external debt, the outstanding stock of this debt, which excludes normal import-related trade credits, was zero at June 30, 1999. Excluded from the limits are use of Fund resources; but other balance of payments support of maturity longer than one year 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 with maturities of up to and including one year, will be reported by the Ministry of Finance to Fund staff.

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

Statement by the IMF Staff Representative
June 30, 2000

The Latvian government has completed the three prior actions required for Board consideration of the first review of the stand-by arrangement.

First, the Minister of Finance has provided a list of contingency expenditure reductions, amounting to 0.5 percent of GDP. These measures would be implemented should the external current account deficit fail to decline in line with projections or foreign direct investment fall significantly short of expectations. The identified measures include reductions in spending on specific goods and services and selected investment projects across a number of ministries and special budgets; allowing selected vacancies to go unfilled; and additional across-the-board spending reductions.

Second, the necessary steps have been taken to reverse backtracking in the area of public expenditure management. In particular, the Ministers of Finance and Economy have submitted letters to Fund staff stating that, from now on, all privatization receipts—other than for those legally earmarked for administrative costs and the reserve fund of the Latvian Privatization Agency and for transfers to local government privatization funds—will be transferred to the Treasury. This policy has also been agreed to by the full cabinet of ministers, which has also approved the Supplementary Memorandum of Economic Policies.

Third, a draft law streamlining tax benefits granted to enterprises in free ports and eliminating benefits not consistent with EU regulations, has been submitted to parliament.

Developments since the issuance of the staff report have been broadly in line with the program. Economic activity continues its recovery, with real growth for the first quarter of the year estimated at 5.3 percent. The 12-month rate of consumer inflation declined to 3.2 percent in May. Preliminary data for end-May indicate a cumulative fiscal deficit of about LVL 25 million, compared with an end-June target of LVL 54 million. In addition, net international reserves at end-May were above the program floor, and net domestic assets of the Bank of Latvia below the program ceiling, for end-June.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 00/48
FOR IMMEDIATE RELEASE
July 11, 2000

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with Latvia

On June 30, 2000, the Executive Board concluded the Article IV consultation with Latvia.[1]

Background

Latvia has succeeded in weathering the external shock and economic slowdown triggered by the Russia crisis owing to its efforts, over a number of years, to cement macroeconomic stability and develop a flexible market-oriented economy. As a result, it is now poised for a strong economic rebound in an environment marked by relatively low inflation and a stable exchange rate regime. This positive outlook is enhanced by the prudent tightening of fiscal policy since mid-1999, the generally cautious monetary policy stance, and continued progress in structural reforms, which are largely aimed at European Union (EU) accession and fostering an environment conducive to private sector development. The spread in the secondary market on Latvian Eurobonds compared to the German benchmark rate has steadily declined to about 100 basis points, among the lowest for emerging markets.

The economy turned around in mid-1999 and grew by 3 percent in the fourth quarter of 1999 compared with the same quarter of 1998. Indications are that the economic recovery has accelerated in early 2000: industrial output and tax revenues rose by about 4 percent year-on-year during the first quarter of 2000, while credit to the private sector has expanded by about 11 percent in the first four months of the year. The recovery appears to be driven by a rebound in exports and transport and transit services, as well as a rise in consumer spending. The unemployment rate fell to 8.8 percent in mid-May 2000, more than 1½ percentage points below its peak in April 1999, while inflation continues to be subdued at about 3½ percent.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

These positive developments notwithstanding, the persistently large external current account deficit, coupled with a decline of foreign direct investment poses a potential risk to Latvia's external sustainability. After having doubled to about 10 percent in 1998, the current account deficit declined only marginally to 9½ percent of GDP in 1999, but current indications point to a further narrowing in the external current account deficit in 2000 and a further pick-up in foreign direct investment. Despite the continued appreciation of the real effective exchange rate vis-à-vis EU trading partners, other indicators, including the recent robust export performance—in the first quarter of 2000, exports grew by 12 percent overall and by 17 percent to the EU compared with the first quarter of 1999—and a marked slowdown in wage growth, indicate a continued competitiveness margin. Important steps have been taken to further liberalize Latvia's already very open trade regime, in line with Latvia's commitments under the World Trade Organization.

While the fiscal position weakened in the wake of the Russian crisis, the return to a path of prudent fiscal policies since mid-1999 was instrumental in narrowing the external current account deficit. The general government deficit in 1999 was limited to 4.2 percent of GDP, primarily by restraining expenditure below the budget appropriations, as tax receipts were broadly as planned and non-tax revenue fell short of expectations. During the first quarter of 2000, the general government fiscal deficit fell to about 1.2 percent of GDP as tax revenue strengthened across the board, while expenditures were held to about 92 percent of their planned levels. In addition, the November 1999 amendments to the pension law have had a positive impact on the fiscal balance of the Social Fund.

The exchange rate peg to the SDR has served Latvia well and remains appropriate, given that Latvia has maintained adequate external competitiveness. Appropriate monetary policy has supported the Bank of Latvia's exchange rate objectives in the aftermath of the Russian crisis. Monetary conditions loosened somewhat in late 1999 to accommodate banks' demands for lats to guard against potential Y2K-related problems, but this liquidity injection was reversed during the first quarter of 2000. Considerable progress has been made in restoring the soundness of the banking system, and the Bank of Latvia's prudential standards are now largely in line with international norms. The authorities are also on track in their preparatory work to create a Unified Financial Sector Supervisory Agency.

Latvia's precautionary stand-by arrangement with the Fund was approved on December 10, 1999 (for more details see IMF Press Release No. 99/58 and the Memorandum of Economic Policies posted at www.imf.org). The program is (i) centered around fiscal consolidation, with the government aiming to achieve a fiscal deficit of about 2 percent of GDP in 2000 and approximate fiscal balance over the medium-term; (ii) anchored by the exchange rate peg to the SDR, which could be maintained until EU accession; and (iii) enhanced by a wide array of structural reforms, such as pension reform, completion of the privatization of the remaining large public enterprises, and targeted measures to improve the business climate.

Executive Board Assessment

Executive Directors noted that the recession triggered by the Russian crisis had come to an end. Latvia had weathered this external shock, owing largely to the appropriate economic policies pursued by the authorities during the transition years in general, and in the wake of the crisis in particular. A long-standing commitment to macroeconomic stability had enabled Latvia to survive the economic downturn without a serious challenge to its exchange rate regime. Furthermore, earlier structural reforms had largely succeeded in creating a flexible market economy, allowing a relatively quick economic recovery.

Directors emphasized that Latvia's growth prospects over the medium term were promising, provided the authorities continue to pursue appropriately tight financial policies, improve further the efficiency of the public sector, and remove the remaining impediments to private sector activity. This approach would also help produce 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.

Directors commended the authorities for their tighter fiscal stance, noting the authorities' commitment to maintaining the fiscal deficit at or below 2 percent of GDP in 2000, and 1 percent of GDP in 2001. Directors viewed these deficits as ceilings rather than targets, and supported strongly the authorities' intention to return to a balanced budget at faster pace than now targeted, if external developments were to prove worse than expected. They welcomed the identification of contingency spending measures to help achieve this objective. They also encouraged the authorities to continue their prudent budget execution, and to implement measures intended to improve tax administration and enhance the efficiency and effectiveness of public spending. They welcomed the authorities' decision to transfer privatization receipts directly to the Treasury, rather than allowing the privatization agency to spend them.

Directors commended the authorities for the progress made in pension reform and for putting the finances of the Pension Fund on a more solid footing. They also commended the authorities for the recent adoption of the second, fully-funded pension pillar and the emergence of private pension funds as the third pension pillar, which, taken together, should help ensure adequate retirement income and encourage private savings.

Directors generally agreed that the current exchange rate regime remained appropriate in present circumstances. They emphasized, however, that this was predicated on structural reforms and the maintenance of sufficiently tight financial policies, and should be carefully weighed against a potential erosion in Latvia's competitiveness that could result from a continued appreciation of the lats against the Euro. Directors observed that the Bank of Latvia's monetary policy had been appropriate in supporting its exchange rate objective. Some Directors expressed reservations about the recently-introduced long-term foreign exchange swaps, which carry inherent risks, and were concerned that these, together with the purchase by the Bank of Latvia of Treasury bonds, could complicate the task of monetary policy.

Directors commended the authorities for their determination in restoring the soundness of the banking system, but emphasized that there was no reason for complacency. In particular, Directors stressed the need to monitor carefully credit expansion by banks so as to ensure that loan quality, the extent of loan loss provisioning, and banks' risk management remained adequate. In the same vein, Directors encouraged the Latvian authorities to continue to monitor carefully the large inflows of deposits from non-residents. They welcomed the considerable progress made in bringing the prudential framework closer to full compliance with the Basel Core Principles of Effective Banking Supervision. Directors stressed that, with the improvement in banking supervision, more emphasis needed to be placed on enhancing the regulatory framework and the supervision of nonbank financial institutions. The forthcoming Unified Financial Sector Supervision Agency would need to maintain the high quality standards set by the Bank of Latvia.

Directors welcomed the government's intention to complete the privatization of the remaining large public enterprises by end-March 2001, establish an adequate regulatory framework for utilities, and remove the remaining impediments to private sector activity so as to create an enabling business climate. While some delays had occurred in these areas, Directors considered the recent steps as appropriate in providing new impetus to completing the restructuring of the Latvian economy. They commended Latvia for its open trade regime, and welcomed the authorities' ongoing trade liberalization efforts.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Republic of Latvia: Selected Economic Indicators

	1996	1997	1998	1999
		Changes in percent		
Real Economy				
Real GDP	3.3	8.6	3.9	0.1
Unemployment rate (end of period)	7.2	7.0	9.2	9.1
Consumer price index (period average)	17.6	8.0	4.7	2.4
		In percent of GDP		
Public Finance				
General government balance	-1.8	0.3	-0.8	-4.2
Total government debt	14.4	12.0	10.5	13.8
External government debt	8.0	6.7	6.5	9.8
		End-period; changes in percent		
Money and credit				
Reserve money	25	30	7	12
Broad money	20	39	6	8
Domestic credit (non-government)	1	76	59	15
		In percent of GDP unless stated otherwise		
Balance of payments				
Trade balance	-15.5	-15.0	-18.6	-16.4
Current account balance	-4.2	-5.1	-10.1	-9.7
International reserves (in months of imports)	3.1	3.0	2.7	3.1
Exchange rate				
Exchange rate regime		Peg to the SDR		
Exchange rate (lats per US$; end-of period)	0.556	0.590	0.569	0.583
Real effective exchange rate (1997 = 100)	95.2	100.0	107.8	127.5

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

Statement by Olli-Pekka Lehmussaari, Executive Director for the Republic of Latvia June 30, 2000

My Latvian authorities wish to thank the staff team for their candid analysis of recent economic developments and balanced policy advice aimed at the reduction of potential risk to external sustainability. Last year was a difficult one for many countries affected by the Russian crisis. However, the Latvian government responded decisively by implementing a number of corrective measures and proved their ability to cope with external shocks in an efficient way. My authorities are delighted that constructive cooperation with Mr. Schiff and his team has developed into a number of important steps to promote economic development.

In May 2000, the Latvian Parliament gave its confidence to a new Government, which has a large parliamentary majority. In a few days a new Declaration on the government's work agenda based on the principle of *continuity* of policies was approved. The government is committed to speed up structural reforms and to continue fiscal consolidation.

Immediately after taking office the new government hosted the Annual Meeting of the EBRD in Riga – perhaps, the most notable financial event in the Baltics during the decade of transition. The EBRD decision to select Riga as the city for its Annual Meeting could be interpreted as an international appreciation of Latvia's progress in the final stage of transition. On the occasion of the Annual Meeting, the Prime Minister assured the business community that his Cabinet is determined to reinforce fiscal consolidation and to bring privatization to the completion point.

The Latvian authorities have put EU membership at the center of their economic and political agenda. Recently (end-March, 2000), in the framework of the EC-Latvia Joint Assessment of Economic Policy Priorities, the government adopted a new version of the medium term economic strategy, which fully corresponds with the program supported by the SBA. In June, during the meeting in Luxembourg, the provisional closing of the five chapters of *acquis communautaire* was confirmed. EU accession provides the strongest incentives for the continued implementation of the SBA supported program.

Recent economic developments and outlook

In 1999, the growth of the Latvian economy was roughly flat, but the economic rebound started to gain momentum in the fourth quarter of 1999. Fostered by export growth, GDP increased by 5.3 percent on a year-on-year basis in the first quarter of 2000, while inflation remained low. The unemployment rate fell to 8.8 percent in mid-May 2000, significantly below its peak of a year ago.

The current account deficit slightly decreased in 1999, and the overall balance of payments remains in surplus. In 1999, FDIs were sufficiently sizeable and, together with net portfolio investment, covered about 70 percent of the current account deficit. The external debt-to-GDP ratio stood at a relatively low level of 22 percent, of which the public debt-to-GDP ratio was only 12 percent. Short-term debt vis-à-vis reserves are at a comfortable level. Latvia is able to successfully compete in international markets. This view is underlined by an adequate level of external competitiveness, as measured by dollar wages, export market shares, and unit labor costs. The authorities will continue to monitor Latvia's competitiveness.

The medium-term outlook is favorable. Economic growth in the EU and revitalization of CIS markets will help to maintain the export-led recovery in Latvia. The recent increase in domestic lending and the pace of structural reforms should promote investments and generate robust growth over the medium term. Inflation is expected to remain low. Faster growth should bring unemployment down.

The key challenge is to bring down the current account deficit, to attract more FDI, and to strengthen Latvian competitive capacity. The authorities are committed to implement the best possible "medicine" against potential external imbalances. Like the staff, they consider that fiscal tightening, coupled with structural reforms, is the only preventive measure to a potential risk to Latvia's external sustainability.

Exchange rate and monetary policies

The fixed exchange rate policy has served Latvia well in bringing down inflation and creating a stable framework for economic growth. The authorities believe that the SDR peg has significantly enhanced the credibility of their anti-inflation policies and have no intention to alter it in the near future. They recognize the benefits of the euro peg, but a shift in the lats peg from the SDR to the euro should take place, at the earliest, at the time of Latvia's accession to the EU. Joining the euro area will require Latvia's membership in the ERM2 mechanism for two years.

Due to the fixed exchange rate regime, the monetary policy of the Bank of Latvia (BoL) incorporates all elements of the currency board arrangements (full backing of the monetary base, free convertibility of the national currency, automatic interventions). However, in its operational practice the BoL acts as a fully fledged central bank, managing the liquidity in the banking system by using its monetary policy instruments. Monetary policy instruments of the BoL are consistent with the monetary policy framework employed by the European System of Central Banks.

Starting from December 1999, the reserve requirement for credit institutions in Latvia was lowered by one percentage point (from 8 to 7 percent). Over the next 5-7 years the BoL intends to gradually lower the reserve requirement ratio to the 2 percent level set by the ECB. This move, on the one hand, is fully consistent with Latvia's integration strategy into the EU and, ultimately, the EMU. On the other hand, it will remove the burden placed on the banking system by reserve requirements which are not remunerated, thus facilitating the financial intermediation and enhancing the stability of the monetary policy pursued by the BoL. After the reserve requirement is brought in line with the ECB requirements it is not envisaged that it will be used as an active monetary policy instrument.

The BoL has always clearly demonstrated its determination to defend the currency and has by now established a high degree of credibility in the financial markets. The credibility in the central bank in Latvia is proved by the fact that there is practically no need of foreign exchange intervention in the BoL day-to-day operations, and the markets always calm down quickly after each shock. At the end of April 2000, net foreign assets of the BoL reached USD 881.2 million, which amounted to 105.8 percent of the monetary base. The amount of net foreign assets covered 3.7 months of imports.

In May 2000, BoL auctioned for the first time foreign exchange swaps with a maturity of two years to foster long-term lending in lats by commercial banks. The auctioned amounts were moderate and the overall amount of auctioned swaps will be strictly limited. The BoL is convinced that operations should not adversely affect its conduct of monetary policy. The experience of the issuance of auctioning foreign exchange swaps will be discussed with the staff during the second review of the program.

Fiscal policy

The key component of the program is fiscal consolidation. My authorities clearly understand that, given the limitations of monetary policy, keeping the current account deficit within sustainable limits requires strong discipline on the fiscal side.

The general government fiscal deficit was in line with the program in 1999 and has declined significantly this year. The government successfully launched bonds with a 3 year maturity in January 2000 and a 5 year maturity in March. The yields on long-term government bonds have been steadily declining.

Reduction of the general government fiscal deficit to at least 2 percent in 2000, 1 percent in 2001, and to a broadly balanced budget over the medium term, are necessary preconditions for improving the external balance. In the short term, the fiscal target is to be achieved primarily by a tight control on the wage bill of the public sector and other expenditure control measures. The efforts to enhance tax administration have intensified as well. All indications show that the fiscal target for this year should be met.

The Latvian authorities do not underestimate the risk of the growing external imbalances and are ready to respond by further budget tightening. In a first public statement after taking office, the Minister of Finance declared his strong commitment to implement "emergency" measures in the event of further worsening of the external stance. Like the staff, he sees the fiscal deficit as a ceiling rather than a target. This is why the Ministry of Finance has created a contingency plan to be implemented immediately if the current account deficit would be higher and/or FDI would be lower than projected. This plan contains one-time measures and the partial use of certain expenditure items.

Following consultations with the staff in May, the Minister of Finance and the Minister of Economy have send letters to the staff confirming that all privatization receipts, excluding administrative costs, transfers to local governments' privatization funds and the reserve fund of Latvian Privatization Agency, will be transferred to the Treasury aiming at enhancing the transparency and efficiency of public sector operations.

The demands of EU accession are likely to put pressure on public expenditure over the medium term. Coupled with the requirement to increase defense spending associated with potential NATO accession, the government will have to find resources to finance a significant upgrading of the country's infrastructure, and, more generally, to comply with the various demands of the EU's *acquis communautaire*. Thus, streamlining and reprioritizing expenditures is the most urgent task. In this context, my authorities highly value the recommendations of the Fund/Bank technical assistance mission on public expenditure policy. With regard to medium-term fiscal planning, significant progress has been achieved in creating a "Latvian National Development Plan" aimed at efficient reallocation of both domestic (public and private) and external resources to meet the set of determined economic policy priorities.

Structural reforms and financial sector policies

According to the new government's Declaration, the large-scale privatization program is to be completed within one year. The authorities believe that the involvement of international advisors for the sale of the Latvian Shipping Company, the major energy company (Latvenergo), the oil company (Ventspils Nafta) and telecommunication operator (Lattelekom) should help ensure the use of best commercial practices and reduce political interference in the process. The privatization of utilities will be accompanied by the implementation of a "superregulatory" agency according to the law, the enactment of which is expected this year.

The authorities are carrying on an aggressive campaign to further improve the business environment. The important part of this campaign is the introduction of a policy of "zero tolerance" for corruption and money laundering, as stated in the government's Declaration. The Corruption Prevention Council, which was established about three years ago, has succeeded in enhancing transparency and cooperation among public institutions to combat corruption.

The banking sector has largely recovered after the Russian crisis and has returned to profitability. The healthiness of the Latvian banking system is justified by a number of facts. Capital requirements for banks were increased this year, reaching EUR 5 million, and all banks comply with the requirements. During 1999, Scandinavian and German banks increased their equity investment in Latvia. The increasing presence of foreign banks has promoted competition between banks and led to higher cost efficiency. Also the recapitalization process of "*Rīgas Komercbanka*" has been completed.

Latvia is the first country which has completed a self-assessment of compliance with the Basle Core Principles Financial of Effective Banking Supervision. The preliminary results show that the BoL fully or largely complies with all Basle Core Principles and relevant EU banking directives.

At present, responsibility for market supervision is shared among several agencies. The central bank supervises the banking sector, while the state insurance supervision agency oversees insurance companies. Equity markets, the Riga stock exchange and investment funds are supervised by the Securities Market Commission. A new act by Latvia's parliament would consolidate supervision of financial institutions under a single agency, which begins operations on 1 July 2001. A politically independent five-member board will be appointed to head the Unified Financial Sector Supervision Agency, and its operations will be funded by the financial institutions themselves.

Latvia has been in the forefront of transition economies in pushing pension reform ahead despite strong resistance from the opposition. In mid-February, the parliament adopted the Law on State-Funded Pensions, which sets forth the principles of the establishment and operation of a state-funded defined contribution second pillar of the pension system, including general provisions for making contributions. Contributions will be collected starting July 1, 2000, gradually rising from 2 percent of income to 10 percent over 10 years. The adoption of the second, fully-funded pension pillar and the emergence of private pension funds as the third pension pillar, should help to ensure adequate retirement income and encourage private sector savings. By this year-end the government intends to submit to parliament additional amendments aimed at reducing the size of the informal labor market and enhancing social tax collection.