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April 2003
IMF Country Report No. 03/113

Republic of Latvia: 2003 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Latvia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with the Republic of Latvia, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **January 29, 2003,** with the officials of the Republic of Latvia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on April 7, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **April 23, 2003** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its April 23, 2003 discussion** of the staff report that concluded the Article IV consultation.

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

The document(s) listed below have been or will be separately released.

Statistical Appendix
Capital Markets and Financial Intermediation in the Baltic States
Competitiveness in the Baltics in the Run-Up to EU Accession

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for
the 2003 Consultation with the Republic of Latvia

Approved by Julian Berengaut and G. Russell Kincaid

April 7, 2003

- The 2003 Article IV discussions were held in Riga, December 5–18, 2002 and January 27–29, 2003. Staff representatives for the first mission were Messrs. Mueller (head), McDonald, Beddies, Xiao (all EU2), and Risager (PDR). Messrs. Mueller and McDonald returned to Riga in January for discussions on the 2002 fiscal outcome. The missions were assisted by Mr. Knöbl (Resident Representative) and Ms. Zunda of the Riga Office, and Ms. Kupča, Assistant to the Executive Director, participated in the meetings. The missions met with Prime Minister Repše, Deputy Prime Minister Slesers, Minister of Finance Dombrovskis, other government members, Bank of Latvia (BoL) Governor Rimšēvičs; other senior government and BoL officials; parliament members; and representatives of the European Commission, EU member and accession states, the Latvian NGO Center, Transparency International, and the financial and business communities.

- The discussions took place shortly after the changeover to a new government, following the October 2002 parliamentary elections. The former center-right government—in office for 2½ years—was replaced in November by a new center-right coalition led by former BoL Governor Repše.

- Latvia accepted the obligations under Article VIII, Sections 2(a), 3, and 4, in 1992, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions. The authorities have expressed their intention to publish this staff report.

- In concluding the 2001 Article IV consultation on January 18, 2002, Directors noted that economic performance had been among the best of the EU accession countries. They welcomed the authorities' fiscal targets for the first half of 2002, which were in line with a modest annual deficit, but noted that the budget law (which envisaged a deficit of 2.7 percent of GDP) implied a substantial loosening later in the year that could exacerbate Latvia's persistent current account deficit. Directors agreed that the exchange rate peg to the SDR—underpinned by sound fiscal and monetary policies—should anchor Latvia's economic strategy in the run-up to EU accession. They noted Latvia's strong medium-term growth prospects, but expressed concern with the continued rapid credit expansion.

- Latvia's Stand-By Arrangement, which the authorities treated as precautionary, expired December 19, 2002. Following a delay in completing the first review due to concern over the 2002 budget law, the first and second reviews were completed on July 12, 2002. Directors urged the authorities to resist pre-election spending pressures and to hold the fiscal deficit to 1.8 percent of GDP. They stressed that fiscal consolidation should continue in 2003 and beyond—recognizing this may require postponing desired tax rate reductions—and urged improved expenditure prioritization and medium-term budget planning in order to meet spending needs associated with EU and NATO accession and other priorities.

- Important data issues regarding balance of payments data and the 2001 fiscal outcome are described in the staff report. A Data ROSC mission, scheduled for September 2003, will look at these and other issues in greater detail.

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Latvia: Basic Data

Social and demographic indicators	
Area	64,589 sq. km.
Population	2.4 million
Urban	68.0 percent
Rate of population growth	-0.8 percent per year
Life expectancy at birth	
Male	65.2 years
Female	76.6 years
Infant mortality rate (per 1,000 births)	11.0
Hospital beds (per 10,000 inhabitants)	82.0
Physicians (per 10,000 inhabitants)	33.0

	1997	1998	1999	2000	2001	2002
Shares of GDP at current prices (excl. subsidies and indirect taxes)						
Agriculture, hunting and forestry	5.4	4.1	4.0	4.5	4.5	4.4
Fishing	0.2	0.3	0.4	0.4	0.3	0.2
Mining and quarrying	0.2	0.2	0.1	0.1	0.1	0.2
Manufacturing	22.3	17.9	15.3	14.6	14.9	14.8
Electricity, gas, and water	5.0	5.3	4.5	3.9	3.7	3.6
Construction	4.8	6.8	7.1	6.7	6.1	6.1
Services	62.1	65.4	68.6	69.8	70.3	70.6
GDP						
Nominal GDP (in millions of lats)	3,269	3,592	3,890	4,348	4,813	5,195
Nominal GDP (in millions of US$)	5,627	6,088	6,649	7,175	7,661	8,412
GDP per capita (in US$)	2,313	2,526	2,781	3,024	3,218	3,586
Real GDP (percentage change)	8.4	4.8	2.8	6.8	7.9	6.1
Unemployment rate (ILO, end of period)	14.4	13.7	14.5	14.6	12.8	11.6
Unemployment rate (end of period)	7.0	9.2	9.1	7.8	7.7	7.6
Consumer prices (percentage change, end-period)	7.0	2.8	3.2	1.8	3.2	1.4
	(In millions of lats, unless otherwise indicated)					
General government finances 1/						
Total revenue	1,352	1,529	1,561	1,623	1,697	1,876
(in percent of GDP)	41.3	42.6	40.1	37.3	35.3	36.1
Total expenditure	1,332	1,554	1,707	1,764	1,804	2,031
(in percent of GDP)	40.7	43.2	43.9	40.6	37.5	39.1
Financial balance	20	-25	-146	-141	-108	-154
(in percent of GDP)	0.6	-0.7	-3.8	-3.2	-2.3	-3.0
Net lending	10	3	7	0	-3	-15
(in percent of GDP)	0.3	0.1	0.2	0.0	-0.1	-0.3
Fiscal balance	10	-27	-153	-140	-105	-139
(in percent of GDP)	0.3	-0.8	-3.9	-3.2	-2.2	-2.7
Money and credit (end-period)						
Net foreign assets	619	415	364	538	534	353
Broad money	871	923	997	1,275	1,540	1,863
Domestic credit	479	647	745	1,062	1,447	2,023
Velocity (level)	4.1	4.0	4.2	3.8	3.4	3.1
	(In millions of U.S. dollars, unless otherwise indicated)					
Balance of payments						
Total exports (GNFS)	2,929	3,174	2,914	3,271	3,403	3,908
Total imports (GNFS)	-3,348	-3,947	-3,605	-3,886	-4,259	-4,853
Current account balance	-287	-595	-654	-493	-735	-659
(in percent of GDP)	-6.1	-10.6	-9.7	-6.9	-9.6	-7.8
Official reserves (in months of imports of goods and nonfactor services)	2.5	2.9	2.9	2.6	3.0	2.9
Exchange rate, lats per US$, period average	0.581	0.590	0.585	0.607	0.628	0.618

Sources: Latvian authorities and Fund staff estimates.

1/ Privatization receipts treated as financing; through 1999, the presentation varies from that of the State Treasury. In addition, expenditures in this table have been adjusted to reflect spending of privatization receipts outside the budget.

EXECUTIVE SUMMARY

Latvia is reaping the benefits of a successful decade of transition. Real per capita GDP now stands more than 50 percent above its 1995 level, while inflation has remained at or below 3 percent since 1998. Political and institutional reform and the transition to a market economy have garnered Latvia invitations to join the EU and NATO. However, recent fiscal developments raise concerns about the direction of Latvia's economic policy, and the government that took office in November 2002 faces several key economic challenges.

Following remarkably strong economic activity in 2000-01, growth moderated in 2002 to 6 percent, while inflation dipped to 1½ percent. The underlying external position deteriorated—the decline of the reported current account deficit to 7.8 percent of GDP reflected improved statistical coverage—although exporters demonstrated resiliency in the face of slow growth in western Europe by finding new markets. Inflows of FDI remained high, helping to hold external debt to moderate levels. The fiscal deficit rose sharply toward end-year, reaching 2.7 percent of GDP for the year as a whole—1 percentage point above the target under the authorities' program. Related to the fiscal loosening, end-year monetary targets were also exceeded. The growth of credit to the private sector moderated somewhat, but its composition shifted away from enterprise borrowing and toward household credit. Key indicators suggest that banks remain well-capitalized, profitable, and liquid.

While Latvia is poised to sustain annual growth rates of 6 percent over the medium-term, the current account deficit—although projected to decline somewhat—remains the main risk to the Latvian economy. In 2003, continued strong domestic demand would help generate growth of some 5½ percent despite projections of a tepid recovery in western Europe, and inflation would remain low. The 2003 budget envisions that the fiscal deficit would widen to 3.2 percent of GDP—partly reflecting reductions in the corporate income tax and social tax rates—significantly higher than that advised by staff. Such a further fiscal loosening would put Latvia in a more difficult position from which to meet future spending needs relating to EU and NATO accession and other priorities, while likely exacerbating the current account deficit. The authorities' monetary policy in 2003 aims to support the exchange rate peg.

Sustaining high growth in the medium-term will depend on a continued stable economic environment—especially fiscal policy—and high productivity growth. Ambitious implementation of the structural reform agenda would underlie productivity gains and would focus on the drive to reduce corruption, the privatization of remaining state enterprises, and completing the deregulation of the energy and telecommunications markets—while maintaining the efficiency and flexibility of Latvia's labor market. The authorities would also need to monitor and be ready to address potential vulnerabilities in the financial sector.

This report takes stock of Latvia's decade of economic transition and IMF membership. This period has included seven IMF Stand-By Arrangements, which the Latvian authorities have treated as precautionary since the mid-1990s.

I. A Decade of Transition

1. **Latvia is reaping the benefits of a successful decade of transition.** Despite a difficult early economic environment and the initial sharp contraction in output, the policy path on which Latvia embarked in the early 1990s—for which the authorities partly credit the Fund's early, active, and persistent involvement—created the stable economic environment critical to structural reform and the revival of economic growth driven by private sector activity. Growth averaged 5¾ percent over the last seven years, and real per capita GDP now stands more than 50 percent above its 1995 level. Inflation has remained at or below 3 percent since 1998. The exchange rate peg to the SDR adopted in 1994—underpinned by sound fiscal and monetary policies—has been key to this success.

2. **Concomitant political, institutional, and structural reforms have enabled Latvia to transition quickly to a market economy and to garner invitations to join the EU and NATO—key priorities of successive governments over the past decade.** The stable macroeconomic environment, together with the establishment of a modern market economy, have helped attract large inflows of foreign direct investment (FDI), which in turn helped finance Latvia's persistent current account deficit. This deficit is both a sign of Latvia's transition process and its key vulnerability.

3. **Recent fiscal policy developments raise warning flags.** The modest pace of fiscal consolidation in 2001—given that the economy grew by nearly 8 percent—gave way to a reversal in 2002, when the deficit target of 1.8 percent of GDP under Latvia's Fund-supported program was exceeded by 1 percentage point. This fiscal weakening contributed to an underlying deterioration in Latvia's external position and leaves Latvia in a more difficult position from which to meet the significant fiscal costs that must be borne to gain the large benefits of EU and NATO membership. The 2003 budget law, which envisions a deficit of about 3 percent of GDP, continues the trend of fiscal weakening at an inopportune time, as domestic demand remains strong and Latvia will soon become subject to the constraints under the Maastricht criteria and the provisions under the Stability and Growth Pact (SGP). In addition to securing macroeconomic stability, the authorities must stand ready to maintain the structural reform momentum and address potential vulnerabilities in the financial sector.

II. Recent Economic Developments

4. **Following remarkably strong economic activity in 2000 and 2001, growth moderated in 2002 to 6.1 percent, reflecting a return to the trend growth rate.** Weakening external demand and a decrease from the very high investment rate of 2001 contributed to this slowdown, partly offset by rapid consumption growth. Sectors such as retail trade have been particularly strong, to some extent reflecting the rapid expansion of consumer credit. The 2002 inflation rate of 1.4 percent was well below the authorities' 3 percent objective, while unemployment fell from 12.8 percent at end-2001 to 11.6 percent at end-2002 (ILO definition).

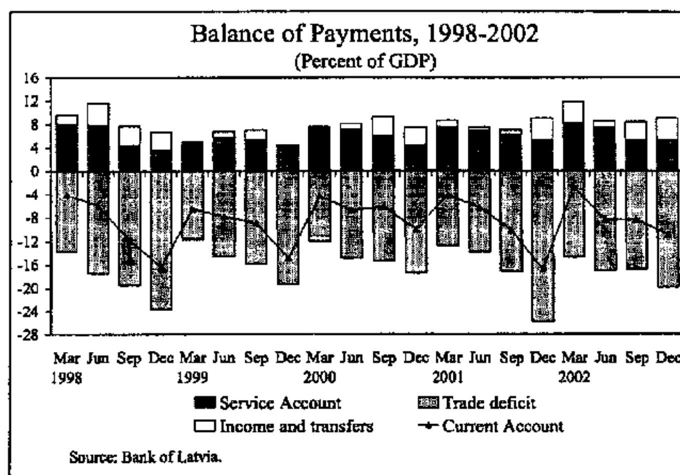
Selected Economic and Financial Indicators, 2000–03

	2000	2001	2002					2003
			Q1	Q2	Q3	Q4	Year	Proj.
Real Sector								
Nominal GDP (millions of lats)	4,348	4,813	1,167	1,276	1,318	1,433	5,195	5,645
Real GDP (annual growth) 1/	6.8	7.9	3.7	4.9	7.4	8.3	6.1	5.5
Unemployment rate (ILO definition, end of period)	14.6	12.8	13.7	13.3	10.8	11.6	11.6	...
Registered unemployment rate (end of period)	7.8	7.7	8.2	7.9	7.8	7.6	7.6	...
Consumer price index (end-period annual change)	1.8	3.2	3.2	0.9	1.0	1.4	1.4	3.0
Real wages (period average, annual change)	3.3	3.9	4.6	7.4	5.6	7.9	6.4	...
General government (in percent of GDP)								
Revenue	37.3	35.3	37.3	37.8	34.8	34.8	36.1	35.9
Expenditure and net lending	40.6	37.5	37.6	37.8	36.5	42.7	38.8	39.0
Fiscal balance	-3.2	-2.2	-0.3	0.0	-1.7	-7.9	-2.7	-3.2
Gross government debt 2/	13.1	15.0	14.4	14.8	14.7	14.6	14.6	...
External sector								
Current acct. (incl. official transfers, percent of GDP) 3/	-6.9	-9.6	-2.8	-8.4	-8.3	-10.8	-7.8	-7.3
Real effective exchange rate index 4/	98.9	97.0	96.0	93.0	93.5	91.8	91.8	...
International reserves (in months of imports)	2.6	3.0	2.6	2.7	2.9	2.9	2.9	3.2
Exchange rate (lats per $US; p.a.)	0.607	0.628	0.640	0.627	0.604	0.602	0.618	...
Money and credit (end-of-period, change in percent)								
Reserve money	7.7	8.8	16.8	13.6	13.9	22.4	22.4	10.0
Domestic credit (non-government)	36.7	50.4	45.3	42.0	43.7	36.5	36.5	27.3
Broad money	27.9	20.8	23.8	21.1	18.7	20.9	20.9	19.0

Sources: Latvian authorities and Fund staff estimates and projections.

1/ The rebasing of national accounts data from 1995 to 2000 was recently completed. Most importantly, GDP growth in 1999 was raised from 1.1 percent to 2.8 percent.
2/ Excluding government guaranteed debt.
3/ The data of 2002Q4 is estimated on the basis of preliminary monthly data.
4/ CPI-based (e.o.p., 2000 average=100).

5. **Latvia's underlying external position deteriorated in 2002.** While the current account deficit fell by 2 percentage points (Table 2), this reflected the impact of improved statistical coverage that helped raise private transfers from 0.7 to 2.7 percent of GDP and captured previously unrecorded textile exports equivalent to 0.7 percent of GDP.[1] Strong export growth in foodstuffs, furniture, and machinery that re-emerged in the third quarter, particularly to Russia, Lithuania, and the Scandinavian countries, helped offset continued strong import growth. The redirection of Russian oil exports away from Latvia's Ventspils oil terminal led to a dramatic decline in transport receipts, which roughly offset strength in other service sectors. The accompanying staff

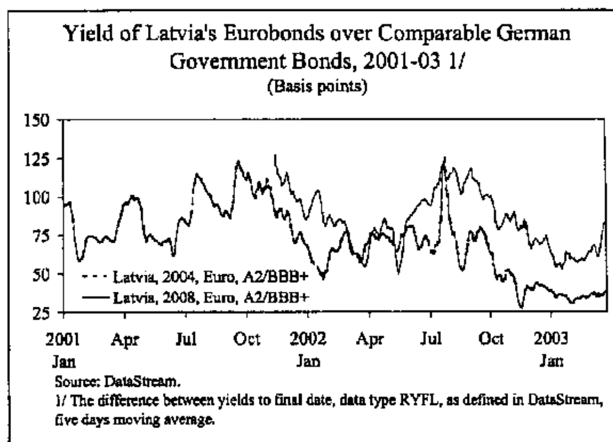


Source: Bank of Latvia.

[1] See section III. G and Appendix III.

background study on "Competitiveness in the Baltics in the Run-Up to EU Accession" does not point to competitiveness as a key factor explaining Latvia's external position (Box 1).

6. **Strong FDI inflows have helped to keep debt indicators at moderate levels.** Net FDI covered three-fifths of the current account deficit in 2002. The reserves to short-term debt ratio stabilized at around 0.34 in 2002, and excluding nonresident deposits (which account for much of Latvia's short-term debt) it remained above the benchmark level of 1.0.[2] Latvia's Eurobond spreads are well below those of typical emerging markets and key ratings agencies upgraded Latvia in the second half of 2002.



Source: DataStream.
1/ The difference between yields to final date, data type RYFL, as defined in DataStream, five days moving average.

Indicators of External Debt and Vulnerability, 1999–2002

	1999	2000	2001	2002			
				Q1	Q2	Q3	Q4
Gross external debt (in millions of U.S. dollars)	3,821	4,714	5,570	5,717	6,092	6,376	...
(in percent of GDP)	57.5	65.7	72.7	74.3	77.7	78.5	...
of which:							
Public sector external debt (in millions of U.S. dollars)	708	706	859	854	875	924	...
(in percent of GDP)	10.6	9.8	11.2	11.1	11.2	11.4	...
Short-term external debt (in millions of U.S. dollars) 1/	2,344	2,818	3,341	3,503	3,675	3,880	...
(in percent of GDP)	35.2	39.3	43.6	45.5	46.8	47.8	...
of which:							
Nonresident deposits	1,240	1,824	2,267	2,434	2,537	2,726	...
(in percent of GDP)	18.6	25.4	29.6	31.6	32.3	33.6	...
Net external debt (in millions of U.S. dollars)	764.7	1,008.9	1,523.1	1,492	1,631	1,795	...
(in percent of GDP)	11.5	14.1	19.9	19.4	20.8	22.1	...
Gross official reserves (in millions of U.S. dollars)	944	919	1,218	1,204	1,225	1,309	1,327
(ratio to short-term debt)	0.40	0.33	0.36	0.34	0.33	0.34	...
(ratio to short-term debt less non-resident deposits)	0.86	0.93	1.13	1.13	1.08	1.13	...
(ratio to reserve money)	1.05	0.99	1.26	1.22	1.11	1.21	1.05
Bond market indicators							
Foreign currency long-term debt rating 2/ 3/	BBB	BBB	BBB	BBB	BBB	BBB+	BBB+
Spread of benchmark bond (basis points) 4/	184	94	68	70	79	77	41

Sources: Latvian Authorities, Datastream, Standard & Poor's.

1/ Remaining maturity basis.
2/ Standard & Poor's. In August, Latvia was upgraded from BBB to BBB+.
3/ In November, Moody's raised Latvia's rating by three grades, from Baa2 to A2.
4/ End-of-period spread of Eurobond maturing in 2004.

[2] See Annex I and SM/01/366, Box 5.

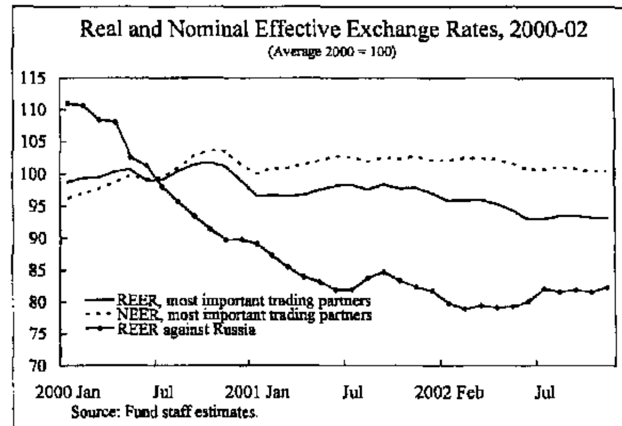
Box 1. External Competitiveness

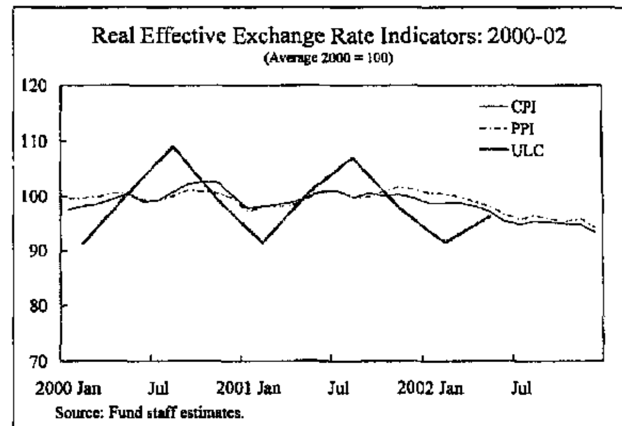
The issue of whether Latvia's large and persistent current account deficits reflect weak external competitiveness, an overvalued exchange rate, or other factors is being closely examined as Latvia approaches EU accession and participation in ERM II, which will require the choice of a central parity vis-à-vis the euro. Based on a review of indicators contained in the staff background study, Latvia appears to have maintained its competitiveness:

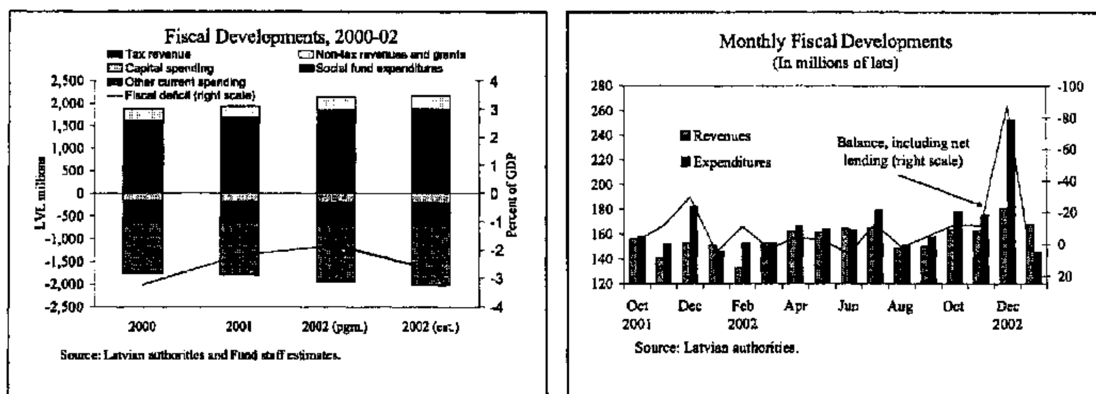
- **Real Effective Exchange Rate (REER):** After appreciating in the mid- and late-1990s, various REER measures have leveled off or depreciated since 2000, reflecting the strengthening of the euro against the dollar. The REER based on unit labor costs, the measure perhaps most closely associated with competitiveness, was 3¾ percent lower in mid-2002 than the average of 2000.

- **Export Performance:** Latvia has expanded the share of its exports in the EU market by 16 percent since the Russian crisis. Exports rebounded strongly in the second half of 2002, notwithstanding the low growth in western Europe.

- **Productivity Growth:** GDP per capita and per worker growth rates averaged 6.9 percent and 6.1 percent from 1994–2001, more than double the EU average, and tradables sector productivity has outpaced that of nontraded goods, allowing for real appreciation without a loss of competitiveness. Productivity has outpaced real wage growth, and dollar-based unit labor costs declined, aided by flexible labor markets (Box 3, EBS/01/44). Overall, labor costs in Latvia remain well below the average of EU accession countries.







7. **Despite strong economic growth, the general government fiscal deficit rose to LVL 139 million (2.7 percent of GDP) in 2002, well above the 1.8 percent target under the SBA (Tables 1a and 3).** The outcome slightly exceeded the deficit ceiling in the original 2002 budget law, but was below the ceiling of 3 percent of GDP under the supplementary budget adopted by the outgoing parliament in November.[3] [4] This largely reversed the fiscal consolidation achieved in 2001 (Box 2). Moreover, fiscal developments within the year were quite uneven. The deficit for the first nine months of 2002 had been held to just LVL 27 million (0.7 percent of GDP), easily meeting the September performance criterion, but a surge in central government spending was recorded as the fiscal year closed in December. Most of this surge reflected the supplementary budget and other actions initiated under the previous government. By shifting expenditure authorizations from areas where they were unlikely to be fully used (e.g., capital spending), it appears to have raised the actual deficit outcome by about 0.6 percent of GDP. Line ministries were well-prepared to execute the new authorizations in December, accounting for most of the late-year spending surge. Additional factors driving the deficit in December were the City of Riga (0.3 percent of GDP) and advance payments of pensions (0.1 percent of GDP). But also the new government, although hampered by weaknesses in expenditure monitoring and control, may

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[3] The deficit outcome reflects the treatment of UMTS telecom license receipts (0.2 percent of GDP) as financing rather than revenues. It *excludes* spending of privatization receipts equivalent to 0.3 percent of GDP that was mandated by Cabinet decrees, effected through the Latvian Privatization Agency (LPA), and did *not* pass through the Treasury. The 2002 fiscal deficit including such spending was LVL 153 million (2.9 percent of GDP).

[4] The supplementary budget also brought spending of privatization receipts based on Cabinet decrees that *did* pass through the Treasury into the budget; slightly increased the local government borrowing limit; and authorized additional loan guarantees, some of which the new government has declined to bring into force.

have missed opportunities to curtail 2002 spending (such as the unusually high wages paid in December) as it focused its attention on the 2003 budget.[5]

Box 2. Revised 2001 Fiscal Deficit Outcome and Misreporting Considerations

In completing the first and second reviews under the SBA in July 2002 (EBS/02/118), the Executive Board granted Latvia a waiver of nonobservance with respect to the December 2001 fiscal deficit performance criterion. However, the information available to the Board at that time, which served as the basis for the waiver, was erroneous.

The Latvian authorities informed the January 2003 mission that their December 2001 Treasury Report had improperly classified local government privatization receipts as revenue rather than financing. The impact of this one-time deviation from usual practice and from requirements under Latvia's SBA was an underreporting of the 2001 fiscal deficit by LVL 11.5 million (0.2 percent of GDP).

According to LEG, this reporting of inaccurate information by Latvia did not give rise to a breach of its obligations under Article VIII(5) of the Fund's Articles of Agreement, because Latvia, in the context of its regular GFS submission to the Fund's Statistics Department, had submitted accurate data to the Fund two weeks prior to the July 12, 2002 Board meeting. However, while the GFS data were accurate, the GFS format and presentation do not allow effective monitoring of the program. In addition, the Latvian authorities did not indicate at the time that data revisions had taken place. The Fund's misreporting guidelines did not apply because Latvia did not make any purchases under its SBA.

The results in Latvia's official audited reports reflect the necessary corrections and the staff has revised its figures accordingly.

8. **The government did not encounter any problems in financing the larger-than-anticipated deficit in late 2002.** This was largely achieved by drawing down the ample stock of deposits. Such deposits were replenished in February and March 2003 by Latvia's initial issues of 10-year bonds, which proved extremely popular.

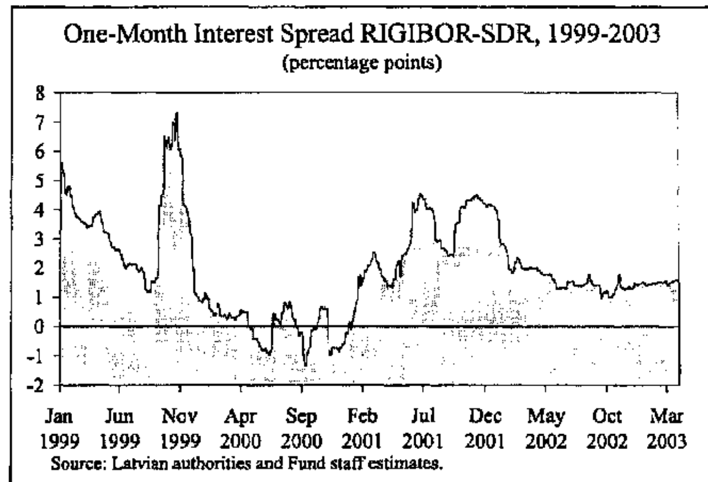
9. **Tax revenues performed broadly as expected in 2002, with a shortfall in VAT receipts being offset by strong corporate income, personal income, and social tax receipts.** Dividends and other payments from state enterprises and the central bank contributed to strong non-tax revenues, while surpluses of 0.3 percent of GDP emerged on EU grant balances, holding down the fiscal deficit. The wage bill rose by ½ percent of GDP, reflecting the multi-year program of teacher salary increases, vacation pay requirements under the new Labor Law (some of which have since been reversed), and end-year wage bonuses. The performance of the Social Fund—with a modest surplus—was a positive development.

[5] During the December 2002 discussions, the authorities were confident of meeting their program target of 1.8 percent of GDP.

10. **Local government deficits amounted to LVL 33 million (0.6 percent of GDP), exceeding the LVL 15 million limit under the budget law.** Amendments to the Law on Local Government Budgets that took effect in November 2002 have not strengthened control over local government fiscal deficits. Riga financed its annual deficit of 0.5 percent of GDP outside the local government borrowing framework by borrowing from commercial banks and municipal enterprises.

11. **The outgoing government—in contrast to intentions under the SBA—continued to issue decrees authorizing spending of privatization receipts outside the budget framework, particularly following the election.** It also approved a third company for corporate income tax exemptions under provisions for large-scale investments. On the more positive side, the authorities met the outstanding structural benchmarks under the SBA (Table 1b).

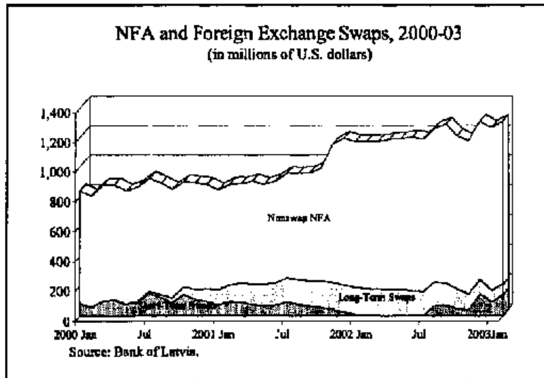
12. **Monetary policy during the first three quarters of 2002 remained on track (Tables 1a and Table 4).** Nonetheless, a loosening toward end-year (reflecting unexpectedly large government spending) caused the nonobservance of the end-December targets. BoL foreign reserves remained at an adequate level, and no pressure was observed in the foreign exchange market. The LVL/SDR short-term money market rate spread narrowed somewhat, reflecting ample bank liquidity for the better part of the year.

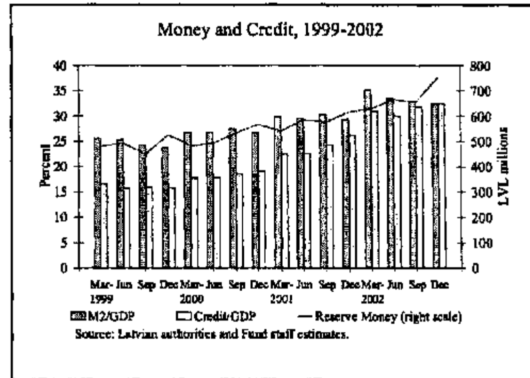


Source: Latvian authorities and Fund staff estimates.

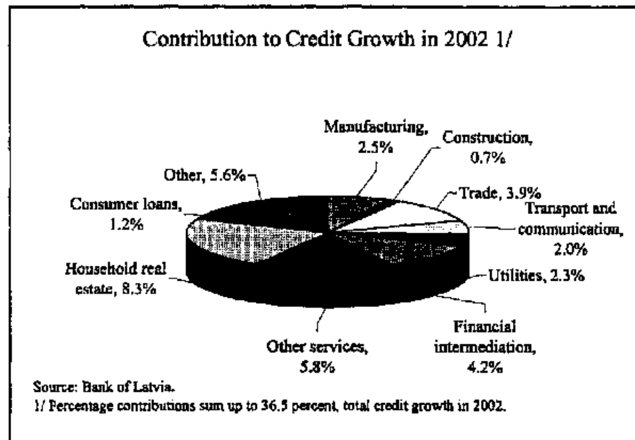
13. **The BoL made active use of its short-term foreign exchange swap facility.** This was done in response to difficulties in commercial banks' liquidity management in August and in an effort to meet end-year program targets, which, however, could not compensate for the impact of the fiscal loosening. On both occasions, such swaps rose significantly (to about $115 million and $149 million, respectively), which is well in excess of the $40 million staff considered appropriate for monetary fine-tuning purposes.[6] To encourage borrowing in lats, the BoL reduced rates on its standing facilities by ½ percentage point in September; however, this move took place at a time of strong domestic demand and rapid credit growth.

[6] See SM/01/366.





14. **After abating earlier in the year, private sector credit growth reached 37 percent in 2002, compared to 50 percent in 2001.**[7] While overall credit growth was broad based, a doubling of household mortgage lending accounted for a quarter of private credit growth, and total household credit rose 80 percent. Enterprise loans grew a more modest 27 percent, compared to 50 percent in 2001. With domestic funding opportunities limited, some banks turned increasingly to credit lines from foreign parents and (more recently) nonresident deposits for financing.



15. **Key indicators suggest that banks currently are well-capitalized, profitable, and liquid.** The acquisition of the Riga Stock Exchange by the Helsinki Stock Exchange in August 2002 portends a more efficient market infrastructure and better visibility for Latvian companies, although stock market capitalization and turnover remain small (see the staff background paper on "Capital Markets and Financial Intermediation in the Baltic States").

[7] Excluding the impact of a December 2001 restructuring operation related to a leasing company, credit growth was 40 percent in 2001 (EBS/02/118).

Selected Financial Sector Indicators, 1999-2002
(In percent, unless otherwise indicated)

	1999	2000	2001	2002			
				Q1	Q2	Q3	Q4
Capital adequacy—risk-weighted average 1/	16.4	14.3	14.2	14.9	14.2	14.0	13.1
Liquidity ratio 2/	42.9	44.2	32.0	33.3	31.2	30.8	39.8
Liquidity ratio (FCMC Definition) 3/	64.1	66.4	65.5	66.0	64.9	61.6	62.1
Asset quality							
Nonperforming loans/total loans	6.2	4.6	2.8	2.8	2.6	2.3	2.0
Loan-loss provisioning/gross loans	4.2	2.9	1.7	1.9	1.7	1.7	1.5
Loan-loss provisioning/nonperforming loans	87.9	81.9	81.9	81.6	83.0	92.0	95.5
Profitability							
Return on equity	11.2	18.6	19.0	15.3	14.5	15.6	16.4
Return on assets	1.0	1.6	1.5	1.4	1.3	1.4	1.5
Income from fees/total income	23.5	26.2	23.1	23.3	24.0	24.6	24.6
Loans and deposits							
Loans/deposits	65.9	58.3	70.3	67.8	68.9	70.6	69.2
Loans/total assets	43.4	40.3	47.3	47.0	47.9	48.2	48.1
Nonresident deposits as a share of total deposits	47.8	51.9	51.9	52.2	49.9	52.3	54.3
Memorandum Items							
Credit to nongovernment/GDP 4/	15.8	19.6	26.2	31.0	30.0	31.9	32.6
Stock market index, level 5/							
DJRSE 6/	87.8	139.2	200.4	173.0	172.9	170.5	161.1
RICI	170.8	174.1	162.6	188.7	209.6	204.4	207.1
Stock market capitalization/GDP 4/	5.4	7.8	8.4	7.9	8.6	8.0	7.3
Stock market turnover/GDP 4/	0.7	11.7	10.3	1.9	2.0	1.3	0.7

Source: Bank of Latvia and Financial and Capital Market Commission.

1/ Year-end data is based on audited financial statements.
2/ (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/ Liquid assets [vault cash + claims on the Bank of Latvia + claims on credit institutions + liquid securities] /current liabilities (with residual maturity up to 30 days) [liabilities to credit institutions + deposits + liabilities for issued debt securities + cash in transit +other current liabilities + off-balance sheet liabilities].
4/ GDP is calculated using annualized quarterly data.
5/ End of period data. Unlike the RICI index, the DJRSE index is capitalization weighted.
6/ A rise in the capitalization-weighted DJRSE index in 2001 was primarily due to the privatization of Latvijas Gaze through the stock exchange.

III. Report on the Discussions

A. Retrospection

16. **Present and former Latvian authorities assessed positively past Latvia-Fund cooperation, both under surveillance and the seven Stand-By Arrangements undertaken since Latvia joined the Fund in 1992.**[8] They stressed the crucial role of the Fund and its resident representatives in pointing toward a proper policy course and in

[8] Latvia has been cited as an example of highly effective prolonged Fund support (IMF IEO, "Evaluation of Prolonged Use of IMF Resources: IMF Staff Response," 2002).

building capacity in the early transition years, and in providing vital technical assistance, notably during Latvia's 1995 banking crisis. The quality of the policy dialogue with the Fund was viewed as consistently high, and the few disagreements that arose were related to isolated issues (e.g., the use of long-term foreign exchange swaps) and dealt with in a constructive way. The authorities also stressed that the close cooperation with the Fund helped them to develop macroeconomic policies in a consistent framework and to establish a dialogue between the various policy makers.

17. **The authorities felt the Fund could have done more to warn about the risks that external borrowing from official sources in the early transition years could overwhelm the capacity for its effective and well-governed use.** Some, who saw high credit growth and current account deficits as signs of an advanced transition, felt that the framework for Fund advice had sometimes been rigid. With respect to the stand-by arrangements, which they had treated as precautionary since 1995, the authorities, in hindsight, would have liked more flexibility in program design—for example, by introducing elements of averaging in defining monetary targets, which in the staff's view could have been accommodated. The authorities stressed that the Fund-supported programs helped them to maintain discipline in policy making and to stay on course in difficult times. They also reiterated that they understood the reasons behind the occasional delays in the completion of program reviews.

B. Focus of the 2003 Article IV Discussions

18. **Discussions focused on areas of core Fund surveillance, such as external sustainability and vulnerabilities to balance of payments or currency crises, and on issues relevant to macroeconomic stability.** The staff's background paper on competitiveness and its assessment of external sustainability (see Annex I) guided discussions in these areas. Other main issue areas included: (i) prospects for and factors determining growth; (ii) the 2003 budget law, the medium-term fiscal stance, and tax policy; (iii) the monetary framework and exchange rate regime in the run-up to EU and EMU accession; and (iv) potential financial sector vulnerabilities stemming from rapid credit growth and nonresident deposits.

C. Recent Achievements and Main Challenges

19. **Two key factors helped Latvia sustain high growth and low inflation in 2002 despite adverse developments in western Europe and the risks of contagion associated with crises in other emerging markets.** Foremost, a flexible economy enabled the rapid reorientation of exports, beginning mid-2002, following an initial lapse. In addition, the positive economic outlook reflecting Latvia's generally favorable macroeconomic policy record contributed to high investment activity, underpinning much of the recent growth.

20. **Latvia faces several medium-term policy challenges if it is to sustain its high growth rates.** Foremost, as the private saving-investment imbalance is expected to remain large, containing the persistent external current account deficit requires redoubling efforts to return to a path of fiscal consolidation—a need that is reinforced by the upcoming costs

associated with EU and NATO accession. Strengthening the medium-term fiscal position will also help to promote private sector activity and avoid the risk of a possibly pro-cyclical fiscal consolidation to meet, within a short period, the Maastricht and SGP criteria. Moving toward a balanced budget over the medium term will require progress in implementing medium-term budget planning, enhancing expenditure monitoring and control systems, and controlling local government finances. On a positive note, the staff's fiscal and external sustainability analyses indicate no significant concerns regarding fiscal or external sustainability at this time; this largely reflects Latvia's low to moderate debt levels (Annexes I and II).

21. **In addition, scrutinizing financial sector developments for signs of excesses that sometimes accompany rapid growth is critical.** The authorities must closely monitor the economy for indicators such as rapid growth of asset prices (for example, in housing) and exchange rate exposure of households and enterprises, and be prepared to respond promptly and aggressively in their supervision of financial institutions. This, together with an appropriate fiscal adjustment, will help maintain confidence.

22. **Achieving the productivity improvements that must drive Latvia's medium-term growth cannot rest on macroeconomic stability alone.** This will also depend on reducing corruption, deepening structural reforms, attracting FDI, and harnessing the advantages associated with EU accession. If these prerequisites are met, Latvia can be expected to sustain an annual GDP growth rate of 5½ to 6 percent in the medium term, based on international experience and the key features of the Latvian economy. Continued productivity growth will be the key in this regard, aided by capital deepening and human capital accumulation (Annex III).

23. **Despite recent improvements, unemployment remains high.** This obduracy mainly reflects factors such as regional immobility and a mismatch of skills, as Latvia's labor market institutions and policies are reasonably flexible (SM/01/169). Though the government is piloting some labor market measures, it could focus more actively on the fundamental causes of unemployment and on its economic and social consequences, while avoiding potentially costly and counterproductive activist labor market policies. In this respect, the joint Latvian-European Commission assessment completed in February 2003 is a welcome step to identify priorities,[9] while a forthcoming World Bank study will provide further analysis and propose concrete policy measures.

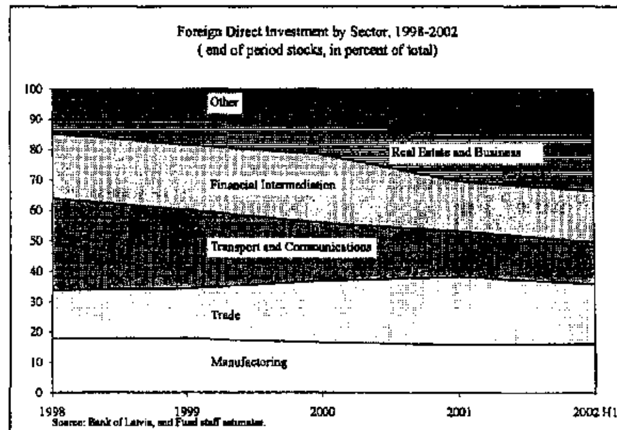
24. **The key economic policy challenge for 2003 is to avoid a pro-cyclical fiscal stimulus that could overheat domestic demand, cause an undesired real appreciation of the lats, and exacerbate the current account deficit.** The staff projects continued strong

[9] The assessment emphasized, among other things, the need to raise skills and qualification levels; keep wage growth in line with increases in productivity; examine the unemployment benefit system to identify possible disincentives; and improve the targeting of active labor market programs.

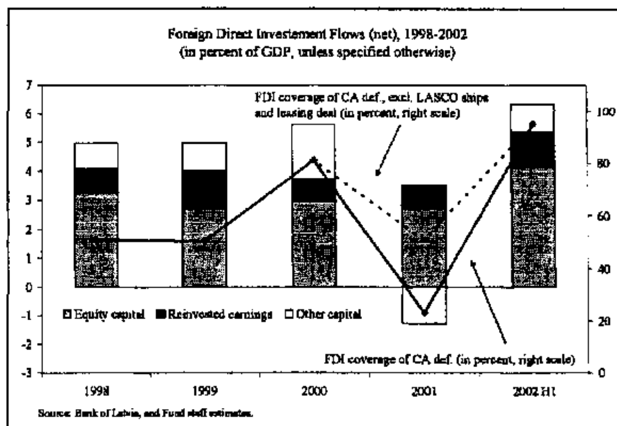
private domestic demand underpinning growth of 5½ percent, along with a gradual reduction of the current account deficit. Most of the current account deficit would continue to be financed by FDI, although the role of other financing would increase (Box 3). However, there are significant downside risks associated with this scenario, as it hinges on (i) a recovery in oil transit, and (ii) a recovery in Germany and other export partners and an absence of significant turmoil in global markets.[10] So long as domestic demand remains buoyant, the balance of risks favors a more cautious fiscal policy.

Box 3. Foreign Direct Investment

Backed by a stable economy, low to moderate taxes and a liberal trade and capital account regime, Latvia has raised its FDI stock from 9 to 29 percent of GDP since 1995. FDI inflows have been diversified across sectors and averaged 4.7 percent of GDP since the Russia crisis—exceeded among EU accession countries only by the Czech Republic (8.4 percent) and Estonia (6.1 percent)—even though privatization has not been a major factor recently. FDI has spurred growth by raising investment levels, fostering technology transfer and financial market deepening, and helping to develop Latvia's export potential.



However, FDI flows—particularly reinvested earnings and loans from parent companies—can be volatile. This volatility was highlighted in 2001 when a foreign-owned bank consolidated its banking and leasing operations in Latvia, requiring a large loan repayment to the foreign parent. The corresponding outflow of 1.9 percent of GDP resulted in a 23 percentage point drop of the FDI coverage of the current account deficit.



Maintaining steady FDI inflows is a key challenge for Latvia. Both export and domestic-oriented industries have attracted FDI in the past, but recently FDI has tilted toward the nontradeables sector. With few large-scale privatizations remaining, attracting new investment—particularly in areas that will enhance Latvia's export capacity and help to improve Latvia's large trade imbalances—takes on increased importance.

[10] Changes in oil transit fees, which depend partly on oil prices, have typically offset other impacts of oil prices on Latvia's balance of payments. Should the role of oil transport be reduced, Latvia's balance of payments will become more sensitive to oil price changes.

D. Medium-Term Economic Strategy

Fiscal Policy and EU Accession

25. **The new government reaffirmed Latvia's commitment to a medium-term balanced budget objective,[11] but was not yet able to elaborate a pace of fiscal consolidation.** The authorities' fiscal strategy concentrated on sustained improvements in revenue collection and significant adjustments to inefficient or low-priority expenditures, which they felt would pay off considerably in the coming years; however, they recognized that identifying and cutting low-priority spending would be a lengthy and contentious process. The authorities had not yet developed a tax policy strategy, but some officials were inclined toward further reducing the corporate tax rate and relaxing eligibility for corporate tax incentives. Expenditure priorities included EU and NATO accession, as well as public sector wages (particularly where low pay could foster corruption) and fulfilling the remaining schedule of teacher salary increases.[12] The authorities felt that their fiscal strategy could be accommodated while still moving toward a balanced fiscal position, but saw little scope for substantial deficit reduction in 2003–04 because of spending associated with EU and NATO accession and the scheduled tax rate reductions.

26. **The staff argued that fiscal consolidation was critical under the current circumstances of high growth and persistent, large current account deficits.** In the staff's view, tax rate reductions should be delayed until Latvia's fiscal performance had improved—at which time reducing payroll taxes warranted higher priority than reducing corporate taxes, which were already comparatively low. Staff also cautioned against relying too heavily on projected gains from tax efficiency improvements or reducing wasteful spending.

27. **The completion of EU accession negotiations had brought into focus the expected financial flows between Latvia and the EU for 2004–06 (Box 4).** Flows will depend on Latvia's ability to implement related projects and other factors. The staff urged the authorities to develop their medium-term budget planning framework, which could anchor expectations by helping the government to credibly commit to its desired medium-term path of fiscal aggregates and would provide improved budget discipline.

28. **The authorities and staff continued to see a need to place local government financing on a more solid basis.** Budget officials from Riga, which had accounted for most of the overall local government deficits, were optimistic that its fiscal deficits would decline after 2003, as a period of intense public investment wound down. Some of this decline, however, would result from shifting investment expenditure to municipal enterprises and the

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[11] See "The Baltic Countries: Medium-Term Fiscal Issues Related to EU and NATO Accession", IMF Occasional Paper 213.

[12] Some counterparts also foresaw a rather spectacular increase in health care spending as part of a health care system overhaul.

Box 4: EU Accession and Latvia's Medium-Term Fiscal Position

The agreement reached in December 2002 at the Copenhagen summit and other recent information provide a clearer sense of the expected financial flows between the EU and Latvia for 2004–06 (for background, see also IMF Occasional Paper 213). Pre-accession grants from the EU (Phare, ISPA and SAPARD)—which in the past have fallen short of projections, mainly due to capacity constraints within Latvia—are expected to peak in 2003 at 1.5 percent of GDP. Inflows of post-accession instruments would begin upon accession in May 2004 and rise to 3 to 4 percent of GDP, while special budget support would be ½ percent of GDP in 2004 and about 0.3 percent of GDP in 2005–06. Upon accession, annual contributions to the EU budget would be equivalent to about 1¼ percent of GDP. Although the staff projects the net cash flow into Latvia to rise to about 3½ percent of GDP in 2006, spending associated with EU grant programs—most of which are subject to co-financing requirements—would rise to about 5½ percent of GDP. Under existing EU rules, Latvia would need to make advance payments for agriculture in 2004; moreover, it may choose to "top up" EU farm subsidies for the first few years of EU membership, until it is eligible for full CAP support.

While the staff foresees large benefits for Latvia of the EU grant programs and of EU accession more generally, accession will be accompanied by some negative fiscal impact. Indeed, this has been a key point of the Fund's earlier policy advice to Latvia, which stressed the need to reduce expenditures in non-priority areas, including in the social area, in preparation for EU (and NATO) accession. In the event, however, the 2002 outcome and the 2003 budget law—both with deficits near 3 percent of GDP—provide Latvia with limited flexibility.

Based on the staff's projections, a contraction in discretionary spending (in terms of GDP shares) may be needed in 2003–04 if Latvia is to hold the fiscal deficit below 3 percent of GDP. With 6 percent real growth, moderate fiscal consolidation in 2005–06 would still allow for a modest real increase in discretionary spending in 2005, before greater flexibility becomes possible in 2006.

Latvia: Fiscal Impact of EU Accession
(Percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005	2006
Grants	0.5	1.5	3.0	4.3	4.5
Budget support	...	...	0.5	0.3	0.3
Pre-accession instruments	0.5	1.5	1.1	0.9	0.5
Post-accession instruments	...	...	1.4	3.1	3.7
of which: Agriculture	...	...	0.5	1.2	1.6
Contributions to the EU budget	...	...	0.8	1.2	1.2
Memo: Net cash flow with the EU	0.5	1.5	2.2	3.1	3.4
EU-related expenditure 1/	0.4	2.0	4.5	5.4	5.7
Spending of pre-accession grants	0.3	1.6	1.2	1.0	0.6
Co-financing for pre-accession grants	0.1	0.4	0.4	0.3	0.2
Spending of post-accession grants	...	...	1.9	3.1	3.7
Advance payments for agriculture	...	...	0.5	...	...
Co-financing for post-accession grants	...	...	0.5	0.9	1.1
Memoranda:					
General government revenue and grants	36.1	35.9	37.0	38.4	38.8
General government expenditures and net lending	38.8	39.0	40.0	40.3	40.1
o/w: EU-related and contributions to EU budget	0.4	2.0	5.3	6.5	6.8
General government fiscal deficit	-2.7	-3.2	-2.9	-1.9	-1.3
Discretionary spending (LVL millions)	1351	1367	1408	1472	1594
Discretionary spending 2/	26.0	24.2	22.8	21.9	21.7
Discretionary spending (percent real growth) 2/	...	-1.8	0.0	1.6	5.2

Source: Latvian authorities and IMF staff estimates and projections.

1/ Excludes EU-related spending that is not supported by EU transfers.
2/ Defined as total expenditure less EU-related spending, Social Fund expenditures, defense spending, and interest.

use of public-private partnership schemes, such as concessions, for financing infrastructure. Staff urged the authorities to include realistic projections for local government deficits in their fiscal planning and their budget development. Staff also proposed that the authorities may want to consider allowing local governments to independently set (within limits) real estate and personal income tax rates, which could make it more palatable to local governments to agree to firmer control on their borrowing.

Monetary and Financial Sector Policies: Maintaining the SDR Peg

29. **The exchange rate peg to the SDR has served Latvia well in maintaining low inflation, supporting confidence, and creating an enabling framework for financial sector activity.** BoL officials concurred with the findings of the staff background study on competitiveness, which supported their own research. They reiterated that the peg sends a strong positive signal regarding the BoL's policy stance, and that the SDR broadly reflects the currency composition of Latvia's trade.

30. **Staff supported the BoL's intention to seek ERM II membership shortly after EU accession and, ultimately, adopt the euro upon completion of the minimum two years under ERM II.** This strategy implies an exit from the SDR peg, as the EU has determined that pegs against anchors other than the euro are incompatible with ERM II. Entry into the ERM II would require agreement with EU authorities on a central parity based on an assessment of Latvia's competitiveness and the sustainability of the framework.[13] The authorities indicated that they intend to *unilaterally* adopt a narrower band around the central parity than the standard ± 15 percent band under ERM II.[14] The authorities and staff agreed that the shift should be conducted in an orderly way, allowing sufficient time to: (i) adjust reserve management and reserves composition, (ii) assess market participants' foreign exchange exposures, and (iii) minimize uncertainty through transparency. Finally, the staff and authorities discussed Latvia's ongoing program to align its monetary policy instruments with those of the ECB, including the reduction of reserve requirements to the 2 percent ECB rate by January 2004.[15]

E. Macroeconomic Policies for 2003

The Fiscal Deficit and the Impact of Tax Policy Changes

31. **The staff urged the new government to ensure that its 2003 budget submission fully reflected its priorities and policies, without a need to take recourse to a supplementary budget later on.** This was particularly important given that recent experience highlighted the difficulties of implementing a budget significantly tighter than the original budget law. The staff urged the new government to restore fiscal discipline, which had been eroded by the political environment surrounding the elections and by the

[13] The staff background study on competitiveness addresses these issues. It also provides an estimate of the Balassa-Samuelson effect on inflation differentials against the euro area of up to 0.7 percentage points, which bodes well for Latvia's ability to meet the Maastricht inflation criterion.

[14] The current band under the SDR peg is ± 1 percent.

[15] Reserve requirements were lowered from 5 percent to 3 percent effective January 24, 2003, with an estimated liquidity impact of LVL 15-20 million.

breakdown of expenditure control late in 2002. Against this background, staff supported the authorities' decision to revise the timetable for budget submission (which had allowed just two months for a new government to finalize the budget), leading to Saeima approval in late-February 2003.

32. **The 2003 budget law sets a general government deficit of LVL 178 million, or 3.2 percent of staff's projected GDP (Table 3).**[16] The budget may reflect somewhat cautious tax revenue projections; however, its assumption that local government deficits will be contained to well below 2002 levels appears optimistic. Key officials have indicated their dissatisfaction with the budgeted deficit; the government intends to propose a mid-year tightening through a supplementary budget, but past experience suggests this will be extremely difficult.

33. **The staff felt the general government fiscal deficit for 2003 should not exceed 1.8 percent of GDP.** Strong private sector demand, expected to continue in 2003, and a widening of the underlying current account deficit in 2002, favored withdrawing fiscal stimulus. Moreover, the staff urged that the deficit in 2003—the final full year before EU accession—be kept well below the Maastricht limit of 3 percent of GDP, leaving room to accommodate higher EU-related spending beginning in 2004 while returning to the path of fiscal consolidation. The staff stressed that implementation of the rate cuts for the corporate income tax and the social tax as scheduled (from January 2003)—with a resulting revenue loss of nearly 1 percent of GDP—would make the task of achieving an appropriate budget difficult (Box 5). It urged that the tax cuts be postponed while the new government formulates its own tax strategy. Most counterparts agreed that the scheduled tax reductions would greatly complicate future fiscal consolidation. Others argued that the reductions would stimulate investment and boost compliance, with little revenue loss; they hoped to further reduce the corporate tax rate to below 15 percent. In the event, the corporate and social tax rate reductions took effect in January 2003; the authorities intend to consider other staff recommendations later in 2003.

34. **The government and the BoL shared the staff's macroeconomic assessment.** Nonetheless, government leaders resisted delaying the tax cuts, citing among the factors their desire to demonstrate stability in economic policy. The new government reversed certain spending initiatives of the previous government, including the postponement to 2004 of a civil service pay reform plan that would have cost 0.4 percent of GDP in 2003. On the other hand, the government attached a high priority to wage increases in areas such as law enforcement, where inadequate wages were perceived to foster corruption. Staff expressed concerns over the rapidly increasing wage bill, which would complicate fiscal consolidation. The authorities also decided to raise the monthly minimum wage from LVL 60 to LVL 70; they felt this step would have a neutral or slightly positive impact on the fiscal balance, estimating that additional revenues from an "enforcement effect" (legitimizing existing under-the-table wage payments) would outweigh other effects. While initially skeptical, the

[16] The authorities' GDP projection would imply a 3 percent deficit.

staff agreed this could be achieved if other steps underway to improve tax administration and enforcement received adequate attention. Nevertheless, staff stressed the need to move carefully on the wage front both for fiscal reasons and to maintain Latvia's competitiveness.

Box 5. Tax Policy Discussions

Tax changes scheduled under existing law threatened Latvia's fiscal goals, prompting the staff to advise the following:

- Repeal scheduled corporate tax rate reductions to 19 percent (2003) and 15 percent (2004). Staff stressed Latvia's success in attracting investment under its existing regime, the expected revenue loss (0.3 percent of GDP in 2003), and the divergence from the (25 percent) personal income tax (PIT) rate. Introducing a withholding tax on dividends paid to resident individuals could substitute for a repeal of the rate reduction.
- Substitute a deduction for the extremely generous 85 percent corporate tax credit for charitable contributions and eliminate the 40 percent tax credit for selected large investment projects.
- Postpone the 2 percentage point reduction in the social tax rate scheduled for 2003 that would reduce revenues by 0.7 percent of GDP.
- Begin broadening the property tax base as scheduled in 2004 to include residential buildings, while reducing the tax rate from 1½ to 1 percent (raising revenues by 1 percent of GDP).
- Target relief by raising PIT taxpayer/dependent allowances—last raised in 1997—and broaden the PIT base to cover more benefits, such as use of company vehicles.

Monetary Policy and Guarding Against Banking Sector Vulnerabilities

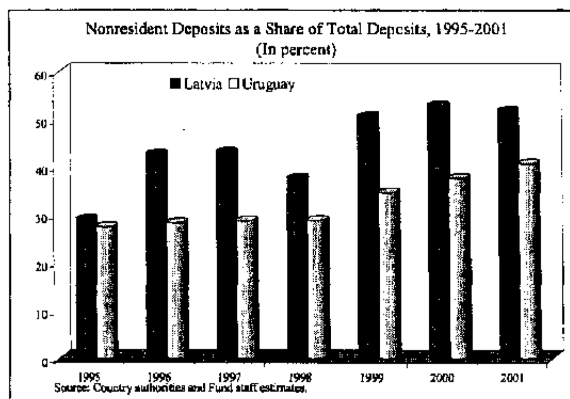
35. **Staff urged the authorities to proceed cautiously regarding interest rates within the limited flexibility under the fixed exchange rate regime.** While seeing the merit of tilting interest rates to encourage lending in lats, continued strong domestic demand, which puts Latvia in a different cyclical position than Western countries, and continued rapid credit growth, do not warrant further reductions in interest rates anytime soon. The BoL seemed to have taken staff's concerns on board and agreed to a 2003 monetary framework that is consistent with supporting the exchange rate peg and controlling credit expansion (Table 4).

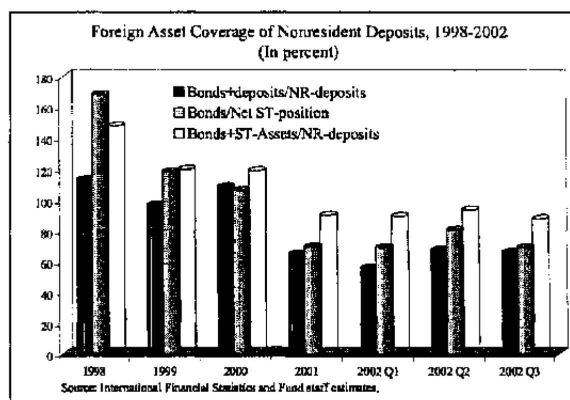
36. **Both the BoL and the Financial and Capital Markets Commission (FCMC) agreed on the need to closely monitor bank lending.** This applies particularly to the sectoral distribution of credit, the growing share of mortgage lending, and the funding of credit (see also Box 6, SM/01/366). The financial system operates on a sound footing under FCMC supervision, but these achievements need to be protected through proactive vigilance and close cooperation with financial sector participants. While the authorities and bankers considered the ongoing credit expansion as a healthy catch-up, staff detected signs of complacency regarding the increasing reliance on foreign funding for loans and the high share (over 50 percent) of lending done in foreign currency. The BoL and FCMC are committed to addressing these and related issues through on- and off-site supervision and a new initiative that includes a regular financial sector stability report that assesses vulnerabilities (Box 6). The authorities should also expand their analysis into areas such as asset price developments and the exchange rate exposure of households and enterprises.

Box 6. Dollarization: Could the "Uruguay Effect" Happen in Latvia?

Financial turmoil in Latin America has sparked debate over the effects of dollarization on financial sector stability. Uruguay's recent experience highlighted the systemic risks posed by financial sector balance sheet dollarization as a channel of contagion, after the Argentine financial crisis triggered outflows of (mostly Argentine) nonresident (NR) foreign exchange (FX) deposits from Uruguayan banks and a bank run by residents. With insufficient FX resources themselves, banks required central bank liquidity support, straining official reserves.

Do Latvian banks' high shares of NR deposits (80 percent of which are demand deposits) leave them similarly vulnerable? While most Latvian NR deposits are invested abroad in liquid, high-quality securities and deposits, some banks have begun to intermediate NR deposits domestically. As a result, coverage of short-term liabilities (primarily being NR deposits) by foreign assets fell below 100 percent in 2001. However, the drop in coverage partly also reflects actions of larger players that are *not* engaged in the NR business, as they have begun funding domestic credit by reducing their foreign assets. Additionally, staff was told that banks that intermediate NR deposits know their clients well or use analytical methods to estimate the stable share of NR demand deposits.





Broadly matching NR deposits with liquid, high-quality foreign assets reduces the risks associated with deposit outflows. Moreover, given Latvia's role as a financial hub and safe haven for CIS residents,[1] such deposits have been resilient to regional crisis, actually increasing by 57 percent in 1999, after the Russian crisis.

Nonetheless, risks remain, and should domestic leakage of NR deposits become more pronounced, a sudden withdrawal of such deposits could threaten financial stability. To this end, the BoL and FCMC now prepare regular financial sector stability reports, which include confidential assessments of vulnerabilities associated with NR deposits. The first draft report indicates that only one small and one medium-size bank could possibly face liquidity problems if their NR deposits were withdrawn.

Other risks must also be considered. First, notwithstanding the fairly small open positions of Latvian banks, the sizable FX lending (54 percent of all domestic credits were in FX at end-2002) renders banks vulnerable to *indirect* balance sheet effects if domestic borrowers are not sufficiently hedged. However, Latvia's FSAP (and SM/01/366) stressed the sound risk management tools employed by larger foreign-owned banks. Second, while a withdrawal of foreign credit lines could strain liquidity, these credit lines are largely sourced from parent banks, limiting this risk.

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[1] While about half of NR deposits continue to be received from the United States, most of these deposits are believed to originate in the CIS.

37. **The authorities have made remarkable progress in strengthening their supervisory framework.** Moreover, a December 2002 EU Peer Report identified no major weaknesses in Latvia's financial system, reinforcing findings of the 2001 FSAP. The FSSA recommendations have been largely implemented or are in the 2003 FCMC Action Plan, such as introducing rating systems for banks and insurance companies, broadening the scope of consumer protection measures, and harmonizing the legislative and regulatory framework across sectors and with EU directives. Staff discussed with the authorities measures to diversify opportunities for second- and third-tier pension funds.[17] The FCMC noted that investment restrictions for third-tier funds had been removed, allowing investment in foreign assets subject to prudential limits on open positions, while foreign investments by second-tier pension funds are still restricted by a rule requiring 70 percent currency matching between assets and liabilities.

AML/CFT Frameworks

38. **Staff welcomed efforts to align Latvia's anti-money laundering (AML) and combating the financing of terrorism (CFT) frameworks with FATF, EU, and UN requirements.** Latvia has in place a relatively comprehensive system to address both issues, including mechanisms for the international exchange of information. The authorities are continuing to refine this system through, for example, already adopted and new draft amendments to legislation to strengthen CFT provisions, refinement of the indicators of unusual financial activity, and an increase in the resources made available to the Financial Intelligence Unit. Following June 2002 legislative amendments to strengthen Latvia's CFT framework, and building on IMF and U.S. advice, additional amendments under consideration (expected to take effect by mid-2003) are expected to bring Latvia into full observance of international AML and CFT standards. Nonetheless, enforcement requires further strengthening. Two recent cases of financial crime involving Latvian banks demonstrate the importance of safeguarding the reputation of Latvia's financial sector.

F. Agenda for Institutional and Structural Reforms

Anti-corruption, Privatization, and Other Key Structural Reforms

39. **The authorities have moved forcefully to battle corruption, including through the December 2002 adoption of a national anti-corruption strategy.** The government expressed strong support for the newly established anti-corruption office (KNAB), which is intended to become the central institution leading anti-corruption actions, investigating conflict of interest cases, and supervising political party financing. The business community and NGOs strongly supported the new government's efforts in this area, but felt the influence

[17] Pension reform has been completed in Latvia, and the second and third pillars are fully operational.

of vested interests on the political decision-making process (state capture) needed to be tackled more forcefully.

40. **The authorities cited the implementation of the *Action Plan to Improve the Business Environment* as an example of successful cooperation between the private and public sector generating an environment conducive to high growth.** The *Plan* is constantly evolving, and a new *Plan* is to be adopted by mid-2003 on the basis of an assessment of remaining administrative barriers and other obstacles to doing business. The privatization process has regained momentum with the divestiture of Latvijas Gaze and the Latvian Shipping Company (LASCO); remaining tasks include the privatization of Ventspils Nafta, Krajbanka, and—once a pending arbitration has been resolved—the divestiture of the government-owned shares in Lattelekom. New tariff-setting principles aiming to create regulated competitive markets in the public utility sector are expected to be adopted by mid-2003; however, the restructuring of the electricity company, Latvenergo, is delayed while the new government evaluates the existing restructuring plan. In September 2002, the World Bank Board approved the PSAL II in the amount of US$ 20 million; the Bank plays a leading role in the above policy areas.

Public Sector Reforms

41. **The unexpected spending surge in December 2002 suggests weaknesses in Latvia's present expenditure monitoring and control systems.** Cash expenditure monitoring is timely and of high quality. However, the lack of any regular, centralized monitoring of commitments or limits on making advance payments can leave the authorities unaware of impending cash spending surges that may interfere with fiscal and monetary management. The staff and authorities had initial discussions on how the system could be broadened to track commitments and impose discipline on advance payments, with the staff noting that improvements would also help Latvia move toward accruals accounting and reporting under ESA 95 and the revised GFS Manual.

42. **The authorities recognized that the public sector reform momentum needs to be revitalized.** The encouraging results with the Ministry of Agriculture pilot budget planning exercise (which had streamlined programs and raised spending efficiency) warrant extending these exercises to several more ministries in time to influence the 2004 budget process. The enhanced targeting of social welfare benefits began in early 2003. The process of territorial reform and consolidation of local governments needs to be reinvigorated.

G. Statistical Issues

43. **Latvia's economic statistics are adequate for effective surveillance.** Nevertheless, methodological improvements are ongoing and have in particular affected the coverage of the recorded external current account. As discussed above, new survey techniques raised

estimates of inflows of private transfers and the recording of private textile exports.[18] Although it appears that transfers and exports were similarly underestimated in recent years, the authorities have not undertaken to estimate the extent nor to revise earlier data. Against this background, the data ROSC was advanced to September 2003 to provide a diagnostic of data issues in Latvia.

IV. Staff Appraisal

44. **Latvia's decade of transition has been impressive.** Following a quick economic stabilization in the early transition years, a sound fiscal and monetary policy mix—anchored by the strong and credible peg to the SDR—has led to a remarkable growth and inflation performance since the mid-1990s, among the best of EU accession countries. In addition, institutional and structural reforms have allowed a relatively quick transition to a market economy. The Fund has accompanied Latvia in this process through a series of mostly precautionary programs, the last of which expired in December 2002. While the formulation of macroeconomic and structural policies will increasingly be shaped by the EU's institutional arrangements and requirements, Latvia's general medium-term policy direction, geared toward sustaining high-quality growth and safeguarding its external position, is not expected to change.

45. **Nevertheless, recent policymaking demonstrates elements of complacency.** Strong activity was sustained in 2002 despite an adverse external environment, reflecting both the flexibility of the Latvian economy and its exporters, and the positive economic outlook resulting from a tradition of stable macroeconomic policies. However, in the face of a weak external current account and already high domestic demand, a spending surge in late 2002, significant tax reductions in early 2003, and a further fiscal loosening with the adoption of the 2003 budget law are cause for concern. Moreover, continued rapid credit expansion that has increasingly focused on consumers—while currently not threatening banking sector stability—was partly fueled by the September interest rate reduction and is contributing to high consumption growth.

46. **Latvia's present fiscal policy direction runs counter to more positive developments in its Baltic neighbors.** It points away from the emerging Baltic tradition of fiscal discipline that fosters the macroeconomic stability integral to a vibrant, growing economy, and toward the recent experience of many non-Baltic EU accession countries with more lax fiscal policies and a noticeably slower growth path.

47. **The staff recognizes Latvia's good record of responding to the IMF's advice from past Article IV consultations.** In the fiscal area, internal debate has recognized the constraints associated with persistently high current account deficits. Although significant slippages have occurred—particularly around the election cycle—Latvia has generally

[18] See Appendix III for a more detailed description.

returned to adequate fiscal positions. Recent policy developments threaten this record, and Latvia needs to quickly resume the path of fiscal consolidation. In this context, staff urges a redoubling of efforts to address the following areas: (i) durably reducing non-priority expenditures to make room for spending needs associated with priorities such as EU and NATO accession; (ii) moving cautiously with respect to tax rate reductions; (iii) strengthening control over local government fiscal positions; (iv) halting off-budget spending; and (v) curtailing tax exemptions. Staff urges the authorities to focus greater efforts on improving their medium-term budget planning, the monitoring of expenditure commitments, and discipline over advance payments.

48. **The authorities have operated a broadly appropriate monetary policy in support of the exchange rate peg.** They have also brought their regulatory and supervisory framework largely in line with international standards, exercised effective monitoring of rapid credit growth, and strengthened the AML/CFT regime. The staff commends Latvia's particularly strong record of implementing past Article IV policy advice with respect to monetary and financial sector policies. Nevertheless, the BoL continues to resort occasionally to short-term swaps in amounts that the staff views as excessive. In addition, the staff believes the September 2002 interest rate reduction was ill-timed, in view of strong domestic demand and high credit growth, and urges the authorities to move more cautiously before making such moves in the future.

49. **Latvia's exchange rate regime and the level of the lats are appropriate.** The SDR peg continues to serve Latvia well by fostering price stability, while various indicators suggest that competitiveness is adequate. These views were shared by the authorities and by most private sector representatives. In the staff's view, Latvia's strategy to move toward ERM II membership and, eventually, adopt the euro is sensible.

50. **Substantial progress against corruption and state capture is needed if Latvia is to fulfill its growth potential.** The staff welcomes the authorities' dedication to addressing these areas. Overall, progress on structural issues is encouraging and is expected to continue in 2003–04, spurred on by EU accession.

51. **Recent developments in the labor market have been encouraging, although unemployment remains high.** Reducing unemployment while preserving Latvia's flexible labor market institutions and policies will be key to ensuring Latvia's sustainable development. In this context, staff urges the authorities to contain wage growth to improvements in productivity so as to safeguard Latvia's external competitiveness.

52. The staff welcomes Latvia's decision to publish this Article IV staff report and recommends that Latvia remain on a standard 12-month consultation cycle.

Table 1a. Latvia: Quantitative Performance Criteria and Indicative Targets Under the Stand-By Arrangement, 2002 1/

Variable and Periods		Adjusted Target		Outcome
				(In millions of lats)
I. Ceilings on the general government fiscal deficit 2/				
From January 1, 2002 to:				
March 31, 2002: Indicative		20		3
June 30, 2002: Indicative		46		4
September 30, 2002: Performance criterion		73		27
December 31, 2002: Indicative		94		139
II. Ceilings on net domestic assets of the Bank of Latvia 3/				
March 31, 2002: Indicative		-47		-102
June 30, 2002: Indicative		-111		-60
September 30, 2002: Performance criterion		-93		-124
December 31, 2002: Indicative		-91		-20
				(In millions of US$)
III. Floor on convertible net international reserves of the Bank of Latvia 4/				
March 31, 2002: Indicative		1,048		1,198
June 30, 2002: Indicative		1,092		1,137
September 30, 2002: Performance criterion		1,102		1.225
December 31, 2002: Indicative		1,124		1,214
IV. Ceilings on contracting and guaranteeing of medium-and long-term nonconcessional external debt 5/ 6/	Total	Of which: maturity of more than 1 and up to 5 years	Total	Of which: maturity of more than 1 and up to 5 years
Reference point: December 31, 2001				
March 31, 2002: Indicative	0	0	0	0
June 30, 2002: Indicative	150	0	2	0
September 30, 2002: Performance criterion	200	60	22	0
December 31, 2002: Indicative	300	60	43	0
V. Ceilings on contracting or guaranteeing of external debt of up to and including one year 5/ 6/				
March 31, 2002: Indicative		0		0
June 30, 2002: Indicative		0		0
September 30, 2002: Performance criterion		0		0
December 31, 2002: Indicative		0		0
VI. Indicative ceilings on reserve money 7/				
March 31, 2002:		656		632
June 30, 2002:		650		666
September 30, 2002:		674		657
December 31, 2002:		691		754

Table 1a. Latvia: Quantitative Performance Criteria and Indicative Targets Under the Stand-By Arrangement, 2002 1/

Variable and Periods		Adjusted Target	Outcome
			(In millions of lats)
VII.	Indicative ceilings on net domestic assets of the banking system 3/ 8/		
	March 31, 2002:	1,000	1,149
	June 30, 2002:	1,216	1.195
	September 30, 2002:	1,306	1,279
	December 31, 2002:	1,387	1,509
VIII.	Zero ceiling on the non-accumulation of external arrears by the general government	Continuous	0

1/ Definitions of the performance criteria and indicative targets are included in the Annexes to the Supplementary Memorandum of Economic Policies (SMEP). The targets for end-December 2002 are indicative as they fall after the expiration of the stand-by arrangement on December 19, 2002.
2/ The ceilings on the general government fiscal deficit will be adjusted downward by the amount by which central government tax revenue exceeds the indicative targets mentioned in Annex I of the SMEP.
3/ The ceilings will be adjusted upward (downward) for any shortfall (excess) from programmed levels of disbursements of foreign balance of payments assistance (see Annex II of SMEP). For June, September and December, this adjustment amounted to LVL 57 million, 57 million, and 70 million, respectively, due to the non-issue of the Eurobond and Latvia's decision to opt for the Deferred Drawdown Option (DDO) for the World Bank PSAL II.
4/ The floors will be adjusted downward (upward) for any shortfall (excess) from programmed levels of disbursements of foreign balance of payments assistance (see Annex III of SMEP). For June, September and December, this adjustment amounted to US$ 90 million, 90 million, and 110 million, respectively, due to the non-issue of the Eurobond and Latvia's decision to opt for the Deferred Drawdown Option (DDO) for the World Bank PSAL II.
5/ Applies to the general government or any other agencies acting on behalf of the government.
6/ The performance criteria on debt ceilings apply not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274 – (00/85), adopted August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received. Because of difficulties in ensuring effective monitoring of leasing and import financing by local entities, such transactions by local governments are not included under the external debt limits (see Annex IV of SMEP).
7/ The program definition excludes time deposits of commercial banks and deposits of other financial institutions held with the BoL (see Annex II of SMEP).
8/ The program definition includes foreign equity of commercial banks, which is recorded in "other net assets" (see Annex II of SMEP).

Table 1b. Latvia: Structural Benchmarks
Under the Stand-By Arrangement, 2001-02

By end-June 2001:		
1.	Submit to Parliament amendments to the pension law, as described in paragraph 24 of the Memorandum of Economic Policies (MEP).	Observed
2.	Complete the transfer of all accounts of budget-financed institutions (BFI) directly financed by the budget from commercial banks to the Treasury, as described in paragraph 15 of the MEP.	Not observed 1/
3.	Parliament to pass the amendments to the Excise Tax Law, as described in paragraph 23 of the MEP.	Observed
By end-September 2001:		
1.	The Cabinet of Ministers to adopt supporting regulations for the implementation of the Law on Public Agencies, as described in paragraph 16 of the MEP.	Observed on September 3, 2002
2.	Submit to Parliament the 2002 budget documents providing the information described in paragraph 15 of the MEP.	Observed on October 18, 2001
3.	Submit to Parliament the amendments to the Law on Credit Institutions, as described in paragraph 30 of the MEP.	Observed on October 12, 2001
By end-March 2002:		
1.	The Bank of Latvia to discontinue two-year foreign exchange swaps, as described in paragraph 29 of the MEP.	Observed
By end-September 2002:		
1.	Complete the review of all current tax exemptions under the corporate income tax law, as described in paragraph 11 of the Supplementary Memorandum of Economic Policies (SMEP).	Observed
2.	Cabinet to adopt the framework for implementing strategic planning reviews in line ministries, as described in paragraph 12 of the SMEP.	Observed

1/ As discussed in Box 4 in EBS/02/118, a small number of accounts of BFIs remain outside the Treasury, but the staff believes that the objective of this measure has been fulfilled and that no further action is required.

Table 2. Latvia: Balance of Payments, 2000-07

	2000	2001	2002	2003	2004	2005	2006	2007
						Projections		
				(In millions of U.S. dollars)				
Current Account	-493	-732	-659	-700	-709	-687	-701	-730
excluding official transfers	-529	-756	-704	-841	-938	-1039	-1118	-1146
Goods	-1058	-1351	-1444	-1632	-1820	-2005	-2190	-2374
Exports	2058	2216	2576	2893	3251	3658	4116	4630
Imports	-3116	-3567	-4020	-4525	-5071	-5664	-6306	-7005
Services	443	496	545	568	657	744	864	1020
Transportation	559	561	512	512	580	638	723	826
Travel	-117	-105	-90	-83	-80	-74	-67	-58
Other	1	40	123	139	157	181	209	252
Income	24	45	-19	-4	-9	-30	-44	-64
Current transfers	98	78	260	368	463	603	670	689
Official	36	24	45	141	229	352	417	417
Private 1/	62	54	215	228	234	251	253	273
Capital and Financial Account	548	999	723	1022	773	839	854	910
Capital Account	29	44	17	19	20	20	21	24
Financial Account	519	956	706	1004	753	819	832	886
Direct Investment	400	170	388	448	444	425	427	430
Portfolio investment 2/	-319	133	-228	-49	-358	-306	-336	-370
Other Investment	437	653	546	605	667	699	741	826
Trade Credits, Loans and Other	274	358	...	...	...	...	...	...
Deposits	163	295	...	...	...	...	...	...
Errors and omissions	-27	47	-62	0	0	0	0	0
Overall Balance, Net reserve assets	28	314	2	322	64	152	153	180
Memorandum items:				(In percent of GDP, unless otherwise indicated)				
Current account balance	-6.9	-9.6	-7.8	-7.3	-6.8	-6.0	-5.6	-5.3
Trade balance	-14.8	-17.6	-17.2	-17.0	-17.3	-17.5	-17.5	-17.4
Merchandise exports	28.7	28.9	30.6	30.1	31.0	31.9	32.9	33.9
Merchandise imports	-43.5	-46.6	-47.8	-47.1	-48.3	-49.4	-50.4	-51.3
Services, income & transfers balance	7.9	8.1	9.3	9.7	10.6	11.5	11.9	12.0
Gross official reserves (millions of US$)	919	1,218	1,327	1,639	1,698	1,850	2,003	2,183
in months of GNFS imports	2.6	3.0	2.9	3.2	3.0	2.9	2.9	2.8
Value growth of merchandise exports (percent) 3/	9.0	7.6	16.3	12.3	12.4	12.5	12.5	12.5
Value growth of merchandise imports (percent)	6.9	14.4	12.7	12.6	12.1	11.7	11.3	11.1
Terms of Trade, GNFS (percent)	-3.0	0.0	-2.3	-0.6	0.5	-0.4	-0.3	0.6
Net FDI / Current Account, percent 4/	81	23	59	64	63	62	61	59
Net FDI / GDP	5.6	2.2	4.6	4.7	4.2	3.7	3.4	3.1
Gross external debt 5/	65.7	72.8	75.3	78.4	81.3	85.3	88.4	89.1
Net external debt 5/	14.1	19.9	21.9	22.6	24.1	25.4	26.6	28.9

Sources: Latvian authorities and staff estimates.

1/ Estimates of private transfers received were increased substantially following the introduction of a new survey methodology in 2002.

2/ The large swings in portfolio investment reflect to a large extent a planned Eurobond issue of 300 million in 2003 and an amortization of 225 million in 2004.

3/ Methodological changes in the recording of textile exports in 2002 account for 2.6 percentage points of total export growth.

4/ Without LASCO's import of three ships in 2001, the FDI coverage of the current account deficit would be 28 percent, and 51 percent if a loan repayment from a leasing subsidiary to its foreign parent (resulting from a restructuring of the concern) in December 2001 is also excluded.

5/ Debt data for 2002 are estimates.

Table 3. Latvia: Consolidated General Government, 2000-06
(In millions of lats, unless stated otherwise)

	2000	2001	2002			2003	2004	2005	2006
				Q1-Q3					
	Act.	Act.	Prog.	Act.	Act.	Budget	Projections		
Revenue 1/	1623	1697	1860	1377	1876	2025	2283	2582	2849
Tax revenue	1365	1450	1575	1157	1582	1654	1781	1949	2138
Direct taxes	801	865	931	702	960	969	1040	1138	1248
Corporate income tax	74	98	99	83	110	105	92	103	114
Personal income tax	261	285	315	232	321	334	365	398	438
Social taxes 2/	466	481	517	387	529	530	583	637	695
Indirect taxes	560	573	638	454	622	667	741	811	890
Taxes on goods & services	516	527	589	418	576	624	693	759	833
VAT	338	351	397	276	383	415	456	499	548
Excises	164	161	175	131	178	194	222	244	269
Customs duty	14	15	16	11	15	15	16	16	16
Property taxes	44	47	49	36	47	43	47	52	56
Other (incl. taxes in transit)	3	12	6	1	0	18	0	0	0
Non-tax revenue	258	247	285	220	294	371	502	633	712
of which: EU grants	21	31	39	21	28	84	182	284	329
Expenditure	1764	1804	1965	1421	2031	2200	2463	2712	2944
Current expenditure	1591	1623	1766	1289	1815	1959	2143	2308	2504
Wages & salaries	397	425	457	345	495	536	585	639	697
of which: soc sec contributions	82	85	97	70	103	104	113	124	135
Goods & services	305	315	326	236	334	370	338	336	361
Contributions to the EU budget	...	...	...	...	...	...	48	78	84
Interest	49	40	49	32	44	67	78	76	82
Subsidies & transfers	820	839	934	669	941	986	1093	1180	1280
Transfers to households	604	590	612	455	628	661	701	742	785
Other	216	248	322	214	313	325	344	360	411
Other expenditure 3/	20	3	0	7	0	0	0	0	0
Capital expenditure	173	182	199	132	215	241	320	404	440
Financial balance 4/	-141	-108	-105	-45	-154	-175	-180	-130	-95
Net lending (+)	0	-3	-12	-18	-15	3	0	0	0
Fiscal balance 4/	-140	-105	-94	-27	-139	-178	-180	-130	-95
Financing	140	105	94	27	139	178	180	130	95
Privatization receipts	25	32	27	18	37	3	20	20	20
Domestic	126	-35	-7	15	111	-26	305	115	95
Banks	99	-81	-80	-4	102	-107	...	...	...
BOL	49	-99	-45	-14	97	-124	...	...	...
Commercial banks	50	18	-35	10	5	16	...	...	...
Other domestic	27	46	73	-92	9	81	305	115	95
Foreign	-11	108	73	-7	-9	201	-145	-5	-20
Memorandum items:				(In percent of GDP)					
Revenue, *of which:*	37.3	35.3	36.2	36.6	36.1	35.9	37.0	38.4	38.8
Tax revenue	31.4	30.1	30.7	30.8	30.4	29.3	28.9	29.0	29.1
EU grants	0.5	0.6	0.8	0.6	0.5	1.5	3.0	4.2	4.5
Expenditure, *of which:*	40.6	37.5	38.3	37.8	39.1	39.0	40.0	40.3	40.1
Wages & salaries (net of social taxes)	7.2	7.1	7.0	7.3	7.6	7.7	7.7	7.7	7.7
Transfers to households	13.9	12.3	11.9	12.1	12.1	11.7	11.4	11.0	10.7
Capital expenditure	4.0	3.8	3.9	3.5	4.1	4.3	5.2	6.0	6.0
EU-related and contributions to EU budget	...	...	...	...	0.4	2.0	5.3	6.5	6.8
Non-EU related	...	...	...	...	38.7	36.9	34.7	33.8	33.3
Net lending	0.0	-0.1	-0.2	-0.5	-0.3	0.1	0.0	0.0	0.0
Fiscal balance 4/	-3.2	-2.2	-1.8	-0.7	-2.7	-3.2	-2.9	-1.9	-1.3
Including spending via the LPA 5/	...	...	...	-1.0	-2.9	...	...	...	...
Social Budget 6/				(In millions of lats)					
Revenues (social taxes)	466	481	517	387	529	530	583	637	695
Transfers to individuals	486	478	507	373	511	540	562	595	627
Pensions	445	439	426	339	464	0	0	0	0
Balance	-19	3	10	13	18	-10	21	41	68
In percent of GDP	-0.4	0.1	0.2	0.4	0.3	-0.2	0.3	0.6	0.9

Sources: Ministry of Finance; and Fund staff estimates.

1/ Revenues exclude receipts from privatization.

2/ Excluding social tax revenue channeled to the second pension pillar.

3/ "Other expenditure" consists of spending by the Latvian Privatization Agency (LPA) as directed by Government decree that is effected through the Treasury and not recorded in the fiscal accounts.

4/ UMTS license receipts of LVL 8 million in 2002, treated as revenues in the authorities' presentation, here are treated as financing.

5/ Additional LPA spending directed by decrees that is *not* effected through the Treasury.

6/ Revenues include only first pillar social taxes; expenditures include only transfers to households.

Table 4. Latvia: Monetary Developments, 2000-03
(In millions of lats)

	2000	2001	2002					2003
	Dec.	Dec.	Mar.	Jun.	Sep.	Dec. Prog.	Dec.	Dec. Proj.
Bank of Latvia								
Reserve money	566.7	616.4	631.9	665.7	657.1	690.6	754.4	830.2
Currency	482.3	556.0	532.8	546.1	569.0	582.9	622.6	684.9
Reserves	84.4	60.4	99.2	119.6	88.1	107.7	131.8	145.3
Net foreign assets 1/	542.0	762.0	751.1	726.2	782.3	851.3	779.2	963.3
Net domestic assets 1/	24.7	-145.6	-119.2	-60.5	-125.2	-160.7	-24.8	-133.1
Domestic credit	70.1	-57.4	-28.5	-3.8	-55.6	-90.7	44.7	-63.6
Banks	42.5	18.8	14.6	22.7	40.1	37.3	30.7	52.3
Government (net)	27.5	-76.3	-43.1	-26.4	-95.7	-128.0	14.1	-115.9
Other items net	-45.4	-88.1	-90.6	-56.7	-69.6	-70.0	-69.2	-69.5
Of which: Time deposits	...	22.0	-30.6	-1.5	-0.4	-10.0	-2.4	0.0
Monetary Survey								
Broad money	1,275.3	1,540.5	1,644.6	1,710.2	1,734.7	1,914.6	1,862.6	2,217.3
Currency	427.7	485.2	471.9	482.9	501.6	516.3	543.2	603.1
Deposits	847.7	1,055.2	1,172.7	1,227.3	1,233.0	1,398.3	1,319.4	1,614.2
Of which: Residents' FX deposits	396.8	474.4	543.6	552.3	547.1	612.7	538.6	640.8
Net foreign assets	538.3	534.4	496.0	515.1	456.2	597.4	353.5	312.5
Net domestic assets	737.0	1,006.1	1,148.6	1,195.1	1,278.5	1,317.2	1,509.1	1,904.9
Domestic credit	1,062.5	1,447.0	1,556.2	1,624.1	1,749.3	1,724.7	2,022.5	2,418.3
Private sector	909.4	1,368.0	1,448.4	1,530.5	1,680.4	1,729.4	1,867.9	2,377.3
Government (net)	153.0	79.0	107.8	93.6	68.9	-4.7	154.7	41.0
Other items net	-325.5	-440.9	-407.6	-429.1	-470.8	-407.6	-513.4	-513.4
Memorandum Items:								
Annual percentage change								
Reserve money	7.7	8.8	...	...	...	12.0	22.4	10.0
Broad money	27.9	20.8	...	...	...	24.3	20.9	19.0
Private sector credit 2/	36.7	50.4	...	...	...	26.4	36.5	27.3
Velocity	3.8	3.4	...	...	...	3.0	3.1	2.8
Money multiplier	2.250	2.499	2.602	2.569	2.640	2.772	2.469	2.671
Exchange rate (LVL/US$)	0.613	0.638	0.641	0.605	0.606	0.638	0.594	0.594
Net foreign assets (in millions of US$)	878.2	837.5	773.8	851.4	752.7	936.4	595.1	526.0
Bank of Latvia	884.3	1,194.4	1,171.8	1,200.3	1,291.0	1,334.4	1,311.8	1,621.8
Stock of swaps (in millions of US$)	184.1	206.8	178.9	167.7	216.9	...	244.7	...
Of which: Short-term swaps	100.5	27.9	0.0	0.0	72.1	...	148.6	...
Commercial banks	-6.0	-356.8	-398.0	-348.8	-538.2	-398.0	-716.7	-1,095.7
Change in NIR (in millions of US$, cumulative)	-13.0	310.1	-22.6	5.9	96.6	140.0	117.4	310.0
Domestic interest rates (end of period)								
Deposit rate (three to six months)	4.9	5.8	4.3	4.2	3.9	...	4.2	...
Lending rate (three to six months)	11.3	12.2	9.9	10.9	9.4	...	7.6	...
Money market rate (one month)	5.1	6.3	4.3	3.9	3.5	...	3.5	...

Sources: Bank of Latvia and IMF staff estimates.

1/ Assuming an Eurobond issue in the amount of euro 300 million in 2003.
2/ Private sector credit growth in 2001 would have been 40 percent excluding a loan from one bank to its leasing affiliate in the context of a restructuring operation.

Table 5. Latvia: Medium-Term Macroeconomic Framework, 2000-07

	2000 1/	2001 1/	2002	2003	2004	2005	2006	2007
			Est.	Projections				
	(In percent of GDP)							
Foreign savings 2/ 3/	6.9	9.6	7.8	7.3	6.8	6.0	5.6	5.3
Gross national saving	20.1	21.0	21.7	22.3	23.4	25.2	25.8	26.7
Nongovernment	19.4	19.5	20.5	21.1	21.1	21.1	21.1	21.1
Government 4/	0.7	1.5	1.2	1.2	2.3	4.1	4.7	5.6
Gross investment	27.0	30.6	29.5	29.6	30.1	31.2	31.4	32.0
Nongovernment capital formation 3/ 5/	23.0	26.9	25.7	25.2	24.9	25.2	25.4	25.7
Government fixed capital formation 6/	4.0	3.7	3.9	4.3	5.2	6.0	6.0	6.3
Memorandum item:								
Nongovernment savings-investment balance	-3.7	-7.4	-5.2	-4.6	-3.8	-4.1	-4.3	-4.6
Government savings-investment balance	-3.2	-2.2	-2.7	-3.2	-2.9	-1.9	-1.3	-0.7
Revenues	37.3	35.3	36.1	35.9	37.0	38.4	38.8	39.7
Expenditures and net lending	40.6	37.4	38.8	39.0	40.0	40.3	40.1	40.4
Real GDP growth rate	6.8	7.9	6.1	5.5	6.0	6.0	6.0	6.0
Inflation (annual average rate)	2.6	2.5	1.9	3.0	3.0	3.0	3.0	3.0

Sources: Latvian authorities and Fund staff estimates.

1/ Reflects the recent revision in national accounts data, which is due to the rebasing of real GDP at 2000 average prices and minor changes in the components of GDP from the expenditure side (mainly inventories).
2/ External current account deficit.
3/ 2001figures reflect LASCO's investment in ships which amounts to 1.5 percent of GDP.
4/ Government revenues do not include privatization receipts.
5/ Including change in inventories.
6/ Including net lending.

LATVIA: FUND RELATIONS
(As of February 28, 2003)

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	136.30	107.49
Reserve position in Fund	0.06	0.04

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Holdings	0.07	N.A.

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent of Quota**
Systemic Transformation	9.53	7.52

V. **Latest Financial Arrangements:**

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR million)**	**Amount Drawn (SDR million)**
Stand-by	04/20/01	12/19/02	33.0	0.00
Stand-by	12/10/99	4/9/01	33.0	0.00
Stand-by	10/10/97	4/9/99	33.0	0.00

VI. **Projected Obligations to Fund**
Under the Repurchase Expectations Assumptions (SDR million)

	Forthcoming				
	2003	2004	2005	2006	2007
Principal	5.72	3.81	0.0	0.0	0.0
Charges/interest	0.14	0.05	0.0	0.0	0.0
Total	5.86	3.86	0.0	0.0	0.0

VII. **Safeguards Assessment:**

Under the Fund's safeguards assessment policy, the Bank of Latvia (BoL) was subject to an assessment with respect to the SBA, which was approved on April 20, 2001 and expired on December 19, 2002. The safeguards assessment was completed on October 25, 2001. The assessment concluded that there were no vulnerabilities that could pose a risk to IMF resources and that an on-site assessment was not necessary. However, the assessment identified certain weaknesses and made appropriate recommendations. As outlined in a letter from the Governor of the Bank of Latvia to the Fund's Treasurer dated June 17, 2002, the BoL has largely implemented these recommendations.

VIII. **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. Latvia's exchange system is free of restrictions on the making of payments and transfers for current international transactions.

IX. **Article IV Consultation:**

Latvia is on the 12-month consultation cycle. The Executive Board concluded the 2001 Article IV Consultation on January 18, 2002. Directors noted that Latvia's economic performance in 2001 had been among the best of the EU accession candidate countries, but expressed concern about the magnitude and persistence of the external current account deficit. They emphasized that Latvia's medium-term growth prospects were strong, provided that the authorities continue to pursue disciplined macroeconomic policies, further improve public sector efficiency, and sustain the momentum of structural reforms. The exchange rate peg to the SDR remained appropriate, but Directors cautioned that it needed to be underpinned by continued sound fiscal and monetary policies. Directors supported the authorities' intention to move toward a balanced budget over the medium-term, while they expressed reservations about the expansionary fiscal policy in the 2002 budget, which could exacerbate pressure on the external current account. Directors recognized the spending needs associated with EU and NATO accession and supported the authorities' intention to lower the tax burden if this does not threaten fiscal consolidation. To make room for these important steps, Directors saw as crucial the improved prioritization and containment of public expenditure, enhanced tax administration, and more determined public sector reforms, including at the municipal level.

X. **FSAP Participation and ROSCs:**

A joint World Bank-International Monetary Fund mission conducted an assessment of Latvia's financial sector as part of the Financial Sector Assessment Program (FSAP) between February 14-28, 2001. An FSAP update was conducted between October 22-26, 2001, as part of the 2001 Article IV consultation. The Financial Sector Stability Assessment (FSSA) report (SM/02/1) was discussed at the Board on January 18, 2002, together with the 2001 Article IV staff report (SM/01/366).

ROSC Modules

Standard/Code assessed	Issue date	Document number
Code of Good Practices on Fiscal Transparency	March 29, 2001	SM/01/98
Code of Good Practices on Transparency in Monetary and Financial Policies	January 2, 2002	SM/02/01
Basel Core Principles for Effective Banking Supervision	January 2, 2002	SM/02/01
CPSS Core Principles for Systemically Important	January 2, 2002	SM/02/01

Payment Systems		
IOSCO Objectives and Principles of Securities Regulation	January 2, 2002	SM/02/01
IAIS Core Principles	January 2, 2002	SM/02/01
OECD Corporate Governance Principles	January 2, 2002	SM/02/01

XI. **Technical Assistance:**

TECHNICAL ASSISTANCE FROM THE FUND, 1999–2002

DEPT	Project	Action	Timing	Counterpart
MAE	Banking Supervision	Mission	October 1999	Bank of Latvia
STA	Balance of Payments	Long-term Expert	October 1999 to October 2000	Bank of Latvia/Central Statistical Bureau
MAE	Banking Supervision	Short-term Expert	April 2000	Bank of Latvia
MAE	Banking Supervision	Short-term Expert	June 2000	Bank of Latvia
FAD	Expenditure Policy	Mission	June 2000	Ministry of Finance
FAD	Tax Policy	Mission	July 2002	Ministry of Finance

XII. **Resident Representative:**

The fourth resident representative of the Fund in Latvia was Mr. Knöbl, who took up his post in October 1999. After the expiration of Mr. Knöbl's term in January 2003, the office is kept open with local staff.

XIII. **Fourth Amendment:**

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

LATVIA: IMF-WORLD BANK RELATIONS
(as of February 28, 2003)

Partnership in Latvia's Development Strategy

The main political, economic and social objective of Latvia in the coming years is successful integration into the European Union. Rapid growth of the economy in the past few years has allowed the country to start its convergence towards the income level of the EU countries. However, in the medium- to long-term Latvia will need to work on preserving its external competitiveness and improving the efficiency of the public sector.

The Bank has been operating in Latvia since 1992. It has supported the country in the form of lending, policy dialogue and analytical advisory services, mainly focusing on addressing social issues and public sector reform.

World Bank Group Strategy

The latest Country Assistance Strategy (CAS) for Latvia, dated April 2, 2002, was prepared in close cooperation with the government and civil society. During the CAS period, the Bank is planning to take a lead in key areas not explicitly covered by the EU *Acquis Communautaire.* The CAS for the next three years focuses on assisting all segments of the population to benefit from Latvia's admirable economic growth performance, by helping to:

(a) create a policy environment that encourages new enterprise entry and job creation;
(b) support crucial public sector reforms to make the government more efficient;
(c) achieve more balanced and sustainable development outside Riga, thus promoting poverty reduction in those areas; and
(d) make available more effective and better quality social sector programs and services throughout the country.

According to the framework for World Bank Group support to EU accession countries and the Bank's general graduation policy, the Bank could potentially continue lending to Latvia after EU accession takes place if there is demand for loans. The Bank will support Latvia in the EU accession process, helping to implement reforms and investment needed for EU accession, and will provide advice in areas outside the EU *Acquis Communautaire.* The Bank will take a selective approach based on the government's requests.

To date, the Bank has approved in Latvia projects in the amount of US$379.8 million. Of this amount, US$315.5 million has been disbursed and US$48.2 million has been repaid. The current amount of outstanding obligations is US$262.6 million.

IFC has supported 3 projects in Latvia and its total portfolio is about US$35 million. MIGA has no outstanding guarantees in Latvia. FIAS prepared a study on administrative barriers to investment in Latvia in 1999. In 2002, FIAS experts returned to carry out a new study, which is expected to be finalized in the first half of 2003.

The Bank is planning to continue close cooperation with the EU, and will continue its activities in Latvia as outlined in the latest CAS. Close collaboration will be maintained with the IMF to ensure sustainability of reforms and macroeconomic stability.

World Bank-Fund Collaboration in Specific Areas

The IMF and the World Bank will maintain a collaborative relationship in promoting macro stability through support of structural reforms. The Bank's input has been important in preparing the IMF's Stand-by Arrangements (SBA). The latest SBA expired on December 19, 2002. Latvia is expected to repay its outstanding obligations to the Fund by the end of 2004.

The government's reform program under the Bank's PSAL II was designed within a framework for macroeconomic stability consistent with the IMF SBA. Specifically, the PSAL II Policy Reforms Program Matrix has indicated "maintenance of an appropriate macroeconomic framework" as one of the benchmarks for PSAL III for the fall of 2003. The PSAL II program focuses on continued reforms in the following areas:

- maintaining a macroeconomic framework conducive to robust growth;
- strengthening the credibility of the public sector;
- strengthening the public sector institutional capacity; and
- rationalizing the interaction between the public and the private sectors.

Other areas of the World Bank-supported reforms in collaboration with the Fund include:

Public Expenditure Management

The Bank has carried out two Public Expenditure Reviews (PER) in Latvia (1994 and 2002). The latest PER focused on providing advice regarding the legislative and institutional changes required to move towards a medium-term expenditure framework. The study stressed the importance of clearly defining the policy priorities and developing a sustainable system of medium-term fiscal planning. The IMF has monitored closely Latvia's performance in containing the fiscal deficit, stressing its importance in the light of the high current account deficit. The cooperation in the area of public expenditure management will become even more important, as Latvia faces increased needs for public investment in order to support EU and NATO accession.

Financial sector reforms

The World Bank and the Fund have worked closely together to support financial sector reforms in Latvia. The Bank's key recent activities in this area have included the Macro-

Financial Vulnerability Study in 1998 and the joint Financial Sector Assessment (FSAP) in 2001. During the preparation of the Macro-Financial Vulnerability Study, the Bank examined the potential vulnerabilities of the economy and the financial system. The key areas of focus of the study were discussed and coordinated with the IMF. During the preparation of the FSAP report, the joint Bank-Fund team worked on examining key financial sector issues in the country. Follow-up on this report has taken place mainly through the IMF. In addition, the Bank's CAS envisages a follow-up on the FSAP report and continued policy dialogue on financial sector supervision.

Pensions

The Bank continues to work with the government on the pension reform, which is being successfully implemented. All the three pension system pillars are now in operation. Contributions to the second, fully funded tier started in July 2001, and starting from January 1, 2003, private asset management is allowed, which will foster the development of the Latvian financial and capital markets. The government's reform program is geared towards completing the pension reform agenda by 2005 and achieving an equitable and financially sound system.

Public sector reforms

The Bank has played a substantial role in promoting the country's public sector reforms. The assistance has been provided through the following key instruments: IDF grants, TA projects, and the PSAL. The major areas of support include: development of a public sector reform strategy; containing the proliferation of agencies; strengthening procurement and state and internal audits, as well as functional audits; and improving the link between policies and the budget, by introducing performance budgeting and strategic planning.

Latvia's current PSAL operations with the theme of "good governance" support a range of activities aimed at improving public and judicial sector performance. Among them are public sector pay reform, implementation of agency reform, and the introduction of a medium-term financial framework. These activities have been financed by the Japanese PHRD funds. The Bank is also providing assistance to strengthen implementation of the new Administrative Procedures Law and Law on Information Openness through the IDF facility.

Anti-corruption work

Latvia has one of the most extensive anti-corruption programs in the region. With the assistance of the Bank, the government established a Corruption Prevention Council (CPC) comprising top level officials, which developed the Corruption Prevention Program (CPP) consisting of activities in the three themes of prevention, enforcement and education. The government and the Bank have worked on a range of activities including conducting public surveys, organizing conferences, reviewing anti-corruption legislation

and its implementation, and working on a set of public sector reforms aimed at creating more transparent and efficient public institutions.

The Bank's report "Anticorruption in Transition" (2000) ranked Latvia as a country with one of the lowest levels of administrative corruption but also as a country with relatively high level of 'state capture'. The report's findings changed the direction of the country's anti-corruption policy, with increased focus on high-level corruption in the political decision-making process. The new policy is based on two thrusts: (i) increasing transparency and accountability of political parties' finances, and (ii) creating the independent Corruption Prevention Bureau (KNAB). The two activities are also supported by the PSAL operation. In response to the Prime Minister's request, the Bank is preparing an IDF project to support the recently created KNAB.

Energy sector

The PSAL program covers a number of structural reforms to liberalize the energy sector, including the restructuring of Latvenergo, the establishment of an independent Transmission System Operator (TSO), the formation of an electricity market, and the introduction of third-party access in the gas sector. The Fund has supported the Bank's efforts in these areas.

Regulatory framework

The creation of competitive markets in energy and telecommunications require a regulatory framework for public utilities both serving the public interest and creating a market environment. Therefore, the Bank's PSAL and the Fund's SBA have supported the Public Utilities Commission in the adoption of access rules and transparent pricing methodologies in the energy and telecommunications sectors—preconditions for actual opening of the markets.

Privatization

In the PSAL program, the Bank has supported the divestiture of large state-owned companies—Latvenergo, Latvijas Gaze, Lattelekom, Ventspils Nafta and LASCO—to the private sector in order to promote open markets and increase efficiency. The privatization of Latvijas Gaze and LASCO was completed in 2002. However, the privatization process of Latvenergo has been halted due to amendments in energy legislation. The recently expired Fund program supported the privatization program outlined in the PSAL, including the sales of remaining state shares in Ventspils Nafta and Lattelekom. Apart from these two companies, the Fund also included reference to the divestiture of Krajbanka and Lattelekom in the MEFP, although both privatizations have experienced delays.

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 many additional economic and financial aggregates are readily available on the websites of the Bank of Latvia (BoL) and Latvian government institutions and agencies. The authorities are reporting data for the Fund's *International Financial Statistics, Government Finance Statistics Yearbook*, the *Direction of Trade Statistics*, and the *Balance of Payments Statistics Yearbook*. Latvia has subscribed to the Special Data Dissemination Standard (SDDS) and meets SDDS specifications for the coverage, periodicity, and timeliness of the data, and for the dissemination of advance release calendars, and its metadata are posted on the Fund's Dissemination Standards Bulletin Board (DSBB, http://dsbb.imf.org). There is increased cooperation on data issues between the Central Statistical Bureau (CSB), the BoL, the Ministry of Finance, and the customs authorities.

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

National accounts

3. The CSB compiles and publishes quarterly national accounts statistics using 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 obtained primarily through a comprehensive survey of businesses and individuals, and are supplemented by data from labor force surveys and from administrative sources. The CSB believes that the basic data understate economic activity, particularly in the private sector, and there is an ongoing effort to increase coverage. Official national accounts data include an adjustment for under-recording, which the CSB currently estimates as 16 percent of total GDP. Additional data for the expenditure-based accounts are obtained from household budget surveys and other surveys from the State Treasury and ministries.

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 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 CSB also publishes export and import unit value and volume indices.

Government finance statistics

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

Monetary statistics

6. Monetary data are comprehensive, timely, and comply with international standards. Specifically, data on the balance sheets of the BoL, commercial banks, and other financial institutions, as well as the banking survey, are compiled with a very short time lag, i.e., within two weeks of the end of the reporting period. Fund staff is also weekly provided with 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. The BoL assumed responsibility for compiling the balance of payments statistics from the CSB in early 2000, and since 2001 has published monthly statistics based on an international transactions reporting system (ITRS). This source is to be supplemented with the results of three quarterly surveys that were launched in 2000: non-financial enterprises, foreign direct investment and related income flows, and transportation services. An annual survey of other services will be launched beginning with data for 2002.

8. The trade account is affected by recording problems and compilation of financial account transactions is hampered by inadequate sources. Merchandise trade data, based largely on customs data, underestimate imports and exports of about 140 Custom-bonded warehouses and three free trade zones. There is a need to improve procedures to ensure that goods passing through customs warehouses are properly valued. Coverage of exports to Russia and CIS countries is incomplete; and re-exports of cars and shuttle trade items are particularly difficult to capture. Estimates of travel credits and debits have been improved through a revised survey. In general, surveys techniques need to be further improved. The BoL made methodological improvements in compiling statistics on private transfers and textile exports in 2002. The improvements in survey techniques related to private transfers better capture income that sailors and other Latvians repatriate to Latvia. Regarding textile exports, the authorities found that many companies declared only the value added part of their processed textile exports, although they reported the full value added of imported inputs. While these methodological improvements are welcome, no attempt has been made to

revise earlier data. The resulting break in the data series hampers their usefulness for analysis. Debt data from Latvia's International Investment Position (IIP) show a more rapid buildup of debt than is indicated by the BOP statistics, and efforts are needed to explain and address this and other divergences between IIP and BOP data. These will be among the issues to be addressed in a forthcoming Data ROSC mission from the Fund in September 2003.

9. The authorities have taken stock of the Resident Advisor's recommendations and adopted in October 2001 an action plan to improve balance of payments statistics coverage for merchandise trade and travel data. However, they have not reported any improvement in their compilation techniques for financial transaction items nor identified whether the survey on foreign bank accounts of enterprises programmed for 2001 has been implemented.

Data dissemination standards

10. Latvia has subscribed to the Fund's SDDS since November 1996 and has been posting metadata on the DSBB since December 1997. Latvia has disseminated data on the reserves template since April 2000.

Survey of Reporting of Main Statistical Indicators
(As of March 31, 2003)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance 1/	Overall Government Balance	GDP/ GNP	Public External Debt and Debt Scheduling
Date of latest observation	28-Mar	28-Feb	28-Feb	28-Feb	28-Feb	28-Feb	28-Feb	Jan-03	Q4, 2002	28-Feb	Q4, 2002	28-Feb
Date received	31-Mar	17-Mar	17-Mar	17-Mar	17-Mar	17-Mar	10-Mar	17-Mar	31-Mar	17-Mar	20-Mar	17-Mar
Frequency of data	D	M	M	M	M	M	M	M	Q	M	Q	M
Frequency of reporting	D	M	M	M	M	M	M	M	Q	M	Q	M
Source of data	C	A	A	A	A	A, C	A, N	A, N	A, N	A	A, N	A, N
Mode of reporting	E	E	E	E	E	E	E	E	E	E	E	E
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/ Beginning in 2001, monthly Balance of Payments data are published within 30 business days after the end of the month. These data are regarded as preliminary estimates based on a smaller set of data sources.

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.

LATVIA: EXTERNAL SUSTAINABILITY SIMULATIONS

Latvia's persistently large external current account deficit has been the staff's major concern during much of the period since independence; it averaged about 7 percent of GDP (excluding interest payments) during the last three years. While larger current account deficits can be expected for an open economy and a country in transition like Latvia, the financing of such deficits is key to assessing the sustainability of the external position. In the case of Latvia, much of the deficit has been financed through sustained inflows of FDI (see Box 3), which has helped keep external debt indicators at moderate levels.

As of end-September 2002, Latvia's total gross external debt stood at about US$ 6.4 billion, or 79 percent of GDP. About three-fifths of this debt (48 percent of GDP) is related to short-term liabilities, representing to a large extent nonresident deposits attracted by Latvian banks. These deposits are largely redeposited in foreign banks or placed in other liquid foreign assets in OECD countries closely matching the currencies of the deposits, although some domestic leakage has recently been observed (see Box 6). Taking these corresponding assets into consideration, Latvia's net external debt is equivalent to just about one-fifth of GDP. In light of these features, it is reasonable to exclude nonresident deposits from short-term debt when assessing vulnerability, in line with the Board paper on *Debt- and Reserve-Related Indicators of External Vulnerability* (SM/00/65); doing so results in a ratio of short-term debt to reserves exceeding the benchmark level of 1.0.

External Debt Indicators

	2002 Q3
Gross external debt (in millions of U.S. dollars)	6,376
(in percent of GDP)	78.5
of which:	
Public sector external debt (in millions of U.S. dollars)	924
(in percent of GDP)	11.4
Short-term external debt (in millions of U.S. dollars) 1/	3,880
(in percent of GDP)	47.8
of which:	
Nonresident deposits	2,726
(in percent of GDP)	33.6
Net external debt (in millions of U.S. dollars)	1,795
(in percent of GDP)	22.1
Gross official reserves (in millions of U.S. dollars)	1,309
(ratio to short-term debt)	0.34
(ratio to short-term debt less non-resident deposits)	1.13
(ratio to reserve money)	1.21
Bond market indicators	
Foreign currency long-term debt rating 2/ 3/	BBB+
Spread of benchmark bond (basis points) 4/	77

Sources: Latvian Authorities, Datastream, Standard & Poor's.

1/ Remaining maturity basis.
2/ Standard & Poor's. In August, Latvia was upgraded from BBB to BBB+.
3/ In November, Moody's raised Latvia's rating by three grades, from Baa2 to A2.
4/ End-of-period spread of Eurobond maturing in 2004.

Public and publicly guaranteed external debt accounts for only 11 percent of GDP, one of the lowest such percentages of current EU member and accession countries. Much of this debt represents the two Eurobonds Latvia has issued since 1999, essentially in excess of its immediate financing needs so as to establish an international market presence and benchmark for possible issues by private debtors.

The simulations under the external sustainability framework indicate that Latvia's external debt is sustainable over the medium term. The baseline scenario—consistent with the medium-term macroeconomic framework (Table 5)—envisages a moderate built-up of net external debt by about 7 percentage points, to 29 percent of GDP by 2007; and of gross debt by about 14 percentage points, to 89 percent of GDP. This scenario is based on prudent assumptions regarding the inflow of FDI—which is projected to decline in terms of GDP—and the implicit interest rate underlying Latvia's external debt—higher by about one quarter than the level observed during the past few years. One of the interesting features of applying the external sustainability framework to the Latvian case was that it revealed the low implicit interest rate on Latvia's external debt. This low rate is due to the fact that four-fifths of non-resident deposits are demand deposits, for which banks provide little or no remuneration.

The stress tests illustrate a much sharper debt accumulation than under the baseline, but the levels continue to appear manageable.[1] For example, under the first stress test, while net external debt would more than double, it would remain at 52 percent of GDP; gross external debt would rise by 30 percentage points, to 105 percent of GDP. A significant drop in the real GDP growth rate to 0.5 percent in 2003 and 2004 (third stress test) or a substantial fall in FDI inflows to 0.5 percent of GDP in both years (seventh stress test)[2] would have noticeable but more moderate effects than under the worst-case (first) scenario.

These conclusions notwithstanding, vigilance is needed to carefully monitor external debt developments. Much of Latvia's vulnerability is related to the ability of the financial sector to deal with a sudden withdrawal of their non-resident deposits, which account for the bulk of Latvia's external debt. As mentioned above and analyzed in Box 6, as long as banks are largely matching their foreign liabilities with liquid, high-quality foreign assets, this does not pose any immediate risk.

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[1] A mechanical application of the template, based on historic averages and standard deviations, would have caused less striking developments. This is why staff deviated from the template and subjected the economy to somewhat sharper and more relevant shocks.

[2] From 2005 onward, the GDP growth rate and FDI, respectively, are assumed to revert to the baseline scenario.

External Sustainability Framework, 1999-2007

(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002 1/	2003	2004	2005	2006	2007
				Projections					
1 External gross-debt	57.5	65.7	72.8	75.3	78.4	81.3	85.3	88.4	89.1
External net-debt	11.5	14.1	19.9	21.9	22.6	24.1	25.4	26.6	28.9
2 Change in external gross debt	6.6	8.3	7.1	2.5	3.1	2.9	4.0	3.2	0.7
3 Identified external debt-creating flows (4+8+11)	1.6	0.4	3.1	-1.9	-3.4	-3.0	-2.5	-3.0	-3.3
4 Current account deficit, excluding interest payments	8.3	5.2	7.7	5.2	4.6	3.8	3.0	2.5	2.2
5 Deficit in balance of goods and services	10.4	8.6	11.2	11.3	11.2	11.1	11.0	10.6	9.9
6 Exports	43.8	45.6	44.4	46.5	46.8	47.3	48.7	50.0	51.6
7 Imports	54.2	54.2	55.6	57.8	58.0	58.4	59.2	60.6	61.5
8 Net non-debt creating capital inflows (negative) 2/	-4.0	-2.3	-2.8	-2.8	-2.4	-2.0	-1.7	-1.4	-1.2
9 Net foreign direct investment, equity	2.7	2.9	2.6	3.5	3.2	2.8	2.5	2.3	2.1
10 Net portfolio investment,equity	1.3	-0.7	0.2	-0.6	-0.8	-0.8	-0.8	-0.9	-0.9
11 Automatic debt dynamics 3/	-2.8	-2.5	-1.8	-4.2	-5.6	-4.8	-3.8	-4.1	-4.3
12 Contribution from nominal interest rate	1.5	1.6	1.9	2.7	2.8	2.9	3.0	3.1	3.2
13 Contribution from real GDP growth	-1.3	-2.6	-4.9	-4.0	-3.7	-4.2	-4.5	-4.7	-4.9
14 Contribution from price and exchange rate changes 4/	-3.0	-0.5	1.3	-2.9	-4.7	-3.5	-2.4	-2.5	-2.6
14 Residual, incl. change in gross foreign assets and exchange-rate valuation effects(2-3) 5/	5.0	7.9	3.9	4.4	6.5	5.9	6.5	6.2	4.0
Gross external debt-to-exports ratio (in percent)	131.1	144.1	164.0	162.1	167.6	171.9	175.2	176.8	172.9
Net external debt-to-exports ratio (in percent)	26.2	30.8	45.0	47.1	48.3	50.9	52.2	53.2	56.1
Gross external financing need (in billions of US dollars) 6/	3.5	3.9	4.8	5.4	6.5	7.6	8.5	9.6	10.8
in percent of GDP	52.6	55.0	62.4	64.8	68.3	72.2	73.8	77.0	79.2
Key Macroeconomic and External Assumptions									
Real GDP growth (in percent)	2.8	6.8	7.9	6.1	5.5	6.0	6.0	6.0	6.0
GDP deflator in US dollars (change in percent)	6.2	0.9	-1.9	4.1	6.7	4.7	3.0	3.0	3.0
Nominal external interest rate (in percent)	3.2	3.1	3.1	4.0	4.2	4.1	4.0	4.0	3.9
Growth of exports (GNFS in US dollar terms, in percent)	-8.2	12.3	4.0	14.8	13.4	12.2	12.3	12.3	12.6
Growth of imports (GNFS in US dollar terms, in percent)	-8.7	7.8	9.6	14.1	13.1	11.6	11.6	11.0	10.7
				II. Stress Tests for External Gross Debt					
1. GDP growth, interest rate, deflator, non-interest curr.acc., and non-debt inflows are at historical average in 2003-2007				75.3	82.6	89.1	95.8	102.0	105.7
2. Nominal interest rate is at historical average plus 4 percentage points in 2003 and 2004				75.3	80.3	85.2	89.0	92.1	92.6
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004				75.3	81.9	88.7	92.3	95.2	95.6
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004				75.3	88.2	100.3	103.4	105.7	105.6
5. Non-interest current-account deficit is at historical average plus two standard deviations in 2003 and 2004				75.3	84.2	93.2	96.6	99.3	99.5
6. One time 15 percent nominal depreciation in 2003				75.3	93.6	95.5	98.8	101.4	101.5
7. FDI drops to 0.5 percent of GDP in 2003 and 2004 with 30 percent offsetting decline in imports				75.3	81.2	85.7	89.7	93.0	93.7
				III. Stress Tests for External Net Debt					
1. GDP growth, interest rate, deflator, non-interest curr. acc., and non-debt inflows are at historical average in 2003-2007				21.9	29.2	35.7	42.4	48.6	52.3
2. Nominal interest rate is at historical average plus three percentage points in 2003 and 2004				21.9	26.9	31.8	35.6	38.6	39.2
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004				21.9	28.4	35.3	38.9	41.8	42.2
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004				21.9	34.8	46.9	50.0	52.3	52.2
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004				21.9	30.8	39.8	43.2	45.9	46.1
6. One time 15 percent nominal depreciation in 2003				21.9	40.2	42.1	45.4	48.0	48.1
7. FDI drops to 0.5 percent of GDP in 2003 and 2004 with 30 percent offsetting decline in imports				21.9	27.8	32.3	36.3	39.6	40.3

Historical Statistics for Key Variables (past 3 years) 7/	Historical Average	Standard Deviation
Current account deficit, excluding interest payments	7.1	1.6
Net non-debt creating capital inflows	3.0	0.9
Nominal interest rate (in percent)	3.1	0.1
Real GDP growth (in percent)	5.9	2.7
GDP deflator in US dollars (change in percent)	1.7	4.1

1/ End-2002 debt data were not available when this analysis was prepared.

2/ One third of total projected FDI is assumed to be debt creating (loans from parent companies).

3/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

4/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

5/ This term includes exchange-rate valuation effects, which for 2000-02 explain 1 - 3 percentage points of the debt increase. The large debt increase in these years does also reflect methodological changes.

6/ Defined as non-interest current account deficit, plus interest and amortization on medium- and long-term debt, plus short-term debt at end of previous period.

7/ Data consistency problems, including methodological changes, prevent use of a longer historic sample. It should be noted, nonetheless, that earlier years did include negative growth and financial instability.

LATVIA: PUBLIC DEBT SUSTAINABILITY SIMULATIONS

This annex presents the staff's baseline scenario for Latvia's public sector debt for the period through 2007 and compares this to alternative scenarios based on shocks to various underlying variables. The shocks are expressed as temporary deviations from the baseline, using shocks relative to historical averages of the variable under consideration, without considering dynamic feedback effects. The historical averages are based on the period 1996-2001, as the period before 1996 was marked by significant structural changes in the Latvian economy. The baseline scenario reflects what the staff believes are rather cautious assumptions about average interest rates, especially for the period 2003-04.

On average during 1996-98, Latvia's primary fiscal position (excluding interest payments) was in surplus. Together with real growth averaging about 5½ percent, the ratio of debt to GDP declined sharply, to 10½ percent at the end of 1998. As a result of the impact of the Russian crisis—felt especially in 1999—and the subsequent slow pace of fiscal consolidation, moderate primary deficits of 1½ to 3 percent of GDP have emerged; however, strong growth in 2000-02 and significant financing from privatization revenues has held the debt/GDP ratio to 15 percent. Under these circumstances, public debt has not emerged as a significant concern. To the contrary, the authorities have issued debt instruments in excess of immediate financing needs so as to establish a benchmark in international capital markets (with two Eurobond issues) and to broaden the maturities of their domestic debt instruments (recently issuing 10-year bonds); this in turn has helped to diversify risks associated with their public debt.

Under the baseline scenario, public debt would remain well below 20 percent of GDP and under 50 percent of revenues over the forecast period. Even as the recent weakening in Latvia's fiscal projection is expected to improve only slowly, the relatively low initial debt stock and the strong medium-term growth assumptions underlying the baseline scenario would limit the increases in the debt/GDP ratio until fiscal consolidation efforts begin to pay off in 2005-06.

The stress tests focus on additional risks to public debt sustainability. The results suggest resiliency: when the shocks are removed, the debt/GDP ratio resumes a declining trend. A larger primary deficit (stress test 4) that is sustained for only two years initially raises the debt/GDP ratio by several percentage points, to as much as 23½ percent, after which the ratio resumes a declining trend. Nonetheless, more severe shocks, or shocks sustained over a longer period, could lead to qualitatively different outcomes.

Public Sector Debt Sustainability Framework, 1996–2007

(In percent of GDP, unless otherwise indicated)

	Actual							Projections				
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
					I. Baseline Medium-Term Projections							
1 Public sector debt 1/	14.4	12.0	10.5	13.0	13.1	15.0	14.6	16.6	18.0	18.4	18.3	17.5
o/w foreign-currency denominated	8.3	6.7	6.5	9.3	8.0	9.5	8.9	11.4	13.3	14.1	14.2	13.7
2 Change in public sector debt	-1.6	-2.5	-1.5	2.5	0.2	1.8	-0.4	2.0	1.4	0.4	-0.1	-0.9
3 Identified debt-creating flows (4+7+12)	-0.7	-3.2	-1.8	2.6	2.0	0.8	0.2	2.1	1.4	0.4	-0.1	-0.8
4 Primary deficit	0.5	-1.3	-0.3	3.1	2.2	1.3	2.1	1.6	1.4	0.5	0.1	-0.6
5 Revenue and grants	37.4	41.3	42.6	40.0	37.3	35.1	36.1	36.2	37.3	38.6	38.8	38.6
6 Primary (noninterest) expenditure	37.8	40.0	42.3	43.1	39.4	36.4	38.3	37.8	38.7	39.1	38.9	38.0
7 Automatic debt dynamics 2/	-1.1	-0.5	-0.4	0.0	0.2	0.0	-1.0	0.0	-0.1	-0.3	-0.4	-0.4
8 Contribution from interest rate/growth differential 3/	-1.4	-1.0	-0.1	-0.2	-0.2	-0.3	-0.4	0.0	-0.1	-0.3	-0.4	-0.4
9 Of which contribution from real interest rate	-0.9	0.1	0.4	0.1	0.6	0.7	0.4	0.8	0.8	0.7	0.6	0.6
10 Of which contribution from real GDP growth	-0.5	-1.0	-0.5	-0.3	-0.8	-0.9	-0.8	-0.7	-0.9	-1.0	-1.0	-1.0
11 Contribution from exchange rate depreciation 4/	0.3	0.5	-0.3	0.2	0.4	0.3	-0.5	0.0	0.0	0.0	0.0	0.0
12 Other identified debt-creating flows	-0.1	-1.4	-1.2	-0.5	-0.4	-0.6	-1.0	0.5	0.2	0.2	0.2	0.2
13 Privatization receipts (negative)	-0.1	-1.4	-1.2	-0.5	-0.4	-0.6	-1.0	-0.1	-0.3	-0.3	-0.3	-0.2
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.5	0.5	0.5	0.5	0.4
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	-0.9	0.7	0.4	-0.1	-1.9	1.1	-0.6	0.0	0.0	0.0	0.0	0.0
Public sector debt in percent of revenues 1/	38.6	29.0	24.6	32.4	35.2	42.6	40.3	45.9	48.3	47.7	47.2	45.2
Gross financing 5/	6.4	6.3	4.9	7.0	7.1	4.5	4.2	5.6	6.1	3.7	3.2	1.9
in billions of U.S. dollars	0.3	0.4	0.3	0.5	0.5	0.4	0.4	0.5	0.6	0.4	0.4	0.2
Key Macroeconomic and Fiscal Assumptions												
Real GDP growth (in percent)	3.7	8.4	4.8	2.8	6.8	7.9	6.1	5.5	6.0	6.0	6.0	6.0
Average nominal interest rate on public debt (in percent) 6/	10.1	7.6	9.4	8.8	9.7	7.0	6.1	8.9	8.3	7.2	6.9	6.7
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-6.5	1.0	4.0	1.4	5.5	5.6	3.2	5.9	5.3	4.2	3.9	3.7
Nominal appreciation (increase in US dollar value of local currency, in percent)	-3.4	-5.8	3.7	-2.4	-4.9	-3.9	6.3	0.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	16.6	6.6	5.5	7.4	4.1	1.4	2.9	3.0	3.0	3.0	3.0	3.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-2.3	14.9	9.9	3.0	-2.1	0.8	10.2	4.2	8.6	7.1	5.5	3.6
							II. Stress Tests					
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007								15.8	16.3	16.7	17.2	17.7
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004								17.2	19.5	19.9	19.7	18.9
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004								17.3	19.7	20.1	20.0	19.0
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004								19.1	23.3	23.5	23.3	22.4
5. Combination of 2-4 using one standard deviation shocks								17.9	21.1	20.1	18.7	16.5
6. One time 30 percent real depreciation in 2003 7/								21.5	22.9	23.1	22.9	22.0
7. 10 percent of GDP increase in other debt-creating flows in 2003								26.6	27.9	28.1	27.8	26.8
8. Impact on debt-to-GDP ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04								19.1	24.1	24.4	24.2	23.2
8a. Impact on debt-to-revenue ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04								57.3	72.5	63.9	63.0	60.6

Historical Statistics for Key Variables (1996-2001)	Historical Average	Standard Deviation
Primary deficit	0.9	1.6
Real GDP growth (in percent)	5.7	2.3
Nominal interest rate (in percent) 6/	8.8	1.2
Real interest rate (in percent)	1.8	4.5
Inflation rate (GDP deflator, in percent)	6.9	5.2
Revenue to GDP ratio	38.9	2.8

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the denominator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

MEDIUM-TERM GROWTH IN LATVIA

This annex aims to explain Latvia's growth experience to date and to identify the factors that could enable it to maintain such growth over the medium term, with a view to further reducing its income gap with advanced economies. Latvia's recent economic performance has been among the best of transition economies and EU accession candidates. Real output has been growing at an average of 5¾ percent annually between 1995 and 2001, despite the impact of the Russian crisis in 1998, resulting in an increase in living standards—as measured by per capita GDP—by more than 50 percent. The authorities' overall sound macroeconomic and structural policies have created an environment conducive to growth, driven by the private sector. These policies, as well as the prospect of EU and NATO accession, have contributed positively to the growth momentum and helped attract large FDI inflows (see Box 3). Nevertheless, Latvia's per capita GDP (PPP based) remains at about one-third of the EU average.

To shed light on the sources of the recent growth experience, a standard growth accounting framework is employed, which decomposes output growth into contributions from labor input, capital accumulation, and total factor productivity (TFP) growth.[1] The analysis reveals that the rapid output growth in Latvia during 1995-2001 is mainly due to TFP growth (contributing 3.8 percentage points to GDP growth), and to a lesser extent, capital accumulation (contributing 2.0 percentage points to GDP growth). By contrast, partially reflecting the decline in population, employment has had a slightly negative contribution during the period.

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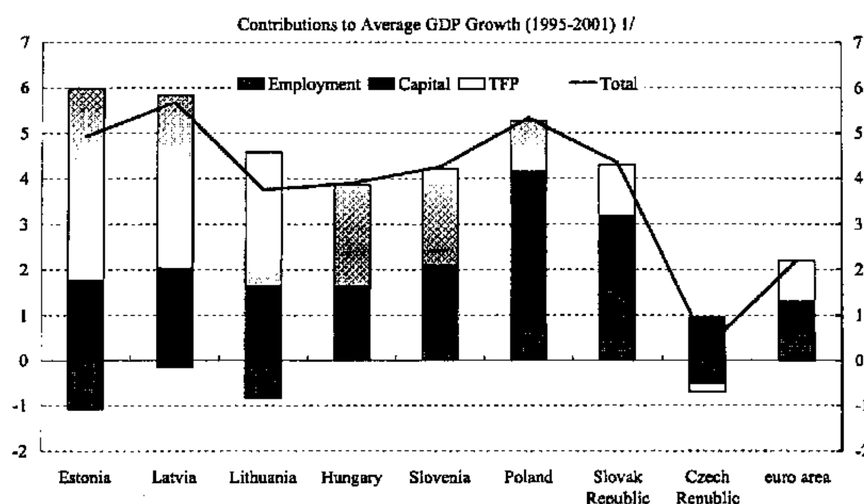
[1] Growth accounting is widely used in analyzing the sources of growth. When applied to transition economies such as Latvia, the quantitative results are marred by such problems as the short time span, labor shedding, and difficulties in estimating the initial capital stock. However, the qualitative implications, such as the importance of productivity growth and the international patterns of growth, are likely to be robust. For further discussion, see Peter Doyle, Louis Kuijs, and Gurong Jiang, *Real Convergence to EU Income Levels: Central Europe from 1990 to the Long Term*, IMF Working Paper 01/146. For calculations for the EU member states, see C. Denis, K. McMorrow and W. Röger, 2002, "Production Function Approach to Calculating Potential Growth and Output Gaps—Estimates for the EU Member States and the US," *European Commission Economic Papers* No. 176.

	1995-2001	2002-2007
Average GDP growth	5.7	5.9
Contribution from:		
Employment	-0.1	-0.3
Capital	2.0	2.4
TFP	3.8	3.7

This pattern is similar to that observed in other transition countries, such as Estonia, Lithuania, Hungary, and Slovenia, where TFP growth has played a dominant role relative to capital accumulation and employment.[2] It differs from the pattern in countries with a stronger industrial base, such as the Czech Republic and the Slovak Republic.



1/ Baltics: 1995-2001; Hungary, Poland, Slovak Republic, Slovenia: 1995-2000; Czech Republic: 1995-1999; euro area: 1996-2000
Source: IMF staff estimates; Doyle et al (2001); and Denis et al (2002).

In the next few years, TFP growth and capital accumulation must play similar roles as in the recent past for Latvian to maintain a trend growth rate of 5½ to 6 percent and for its income level to converge to those of the advanced economies. This is due to Latvia's demographic trends, as the labor force is expected to continue to decline.[3]

The scope exists for such rapid productivity growth, based on the current development stage of Latvia, the particular features of its economy, and past experiences with productivity growth in other countries, especially those that managed to substantially close their income

[2] See the accompanying staff background paper on "Competitiveness in the Baltics in the Run-Up to EU Accession"; and Doyle et al. (2001).

[3] According to the Central Statistical Bureau of Latvia and the World Development Indicators from the World Bank.

gap with advanced economies. For example, TFP growth in western European countries after World War II was estimated between 3 to 3½ percent, allowing for GDP growth rates of 5 to 6 percent over an extended period of time to narrow the income gap with the United States.[4]

While in the past the rapid growth in productivity can be attributed to efficiency gains resulting from Latvia's transition to a market economy, helped by strong FDI inflows, in the next few years productivity growth should reflect the further convergence of technology levels to those of the advanced economies, facilitated by greater openness resulting from EU accession and the deepening of structural reforms. After a decade of successful transition and rapid FDI inflows, the established market economy infrastructure and the large stock of FDI, coupled with high levels of human capital, are ready to unleash further productivity gains.

Human capital accumulation is conducive to rapid productivity growth. Latvia has an advanced education system, and the level of human capital, as indicated by the average number of years of schooling (12 years), is high. In the same vein, much of that part of the current labor force that possesses outdated skills from the Soviet era—which underlies much of Latvia's structural unemployment —will retire from the labor force in the coming years. The Latvian labor force can thus be expected to increasingly embrace new technologies and contribute to efficiency gains. Benhabib and Spiegel (1994)[5] find that countries with a higher level of education tend to close the technological gap faster than others, and provide a method for projecting TFP growth based on the income gap with the United States and the level of human capital in a given country. Applying their approach to Latvia suggests that there is scope for annual TFP growth of 4½ percent during the convergence process, which would be more than enough to enable Latvia to maintain its trend growth rate. Similar calculations for central European EU accession countries show TFP growth rates of up to 3 percent and for Estonia of about 3½ percent.[6]

The significant inflows of FDI have contributed to Latvia's relatively high investment rate and, through technology transfer and other effects, have laid the foundation for future TFP growth. The openness of the Latvian economy and the extensive financial relations with the rest of the world have allowed Latvia to take full advantage of technological progress. It can be expected that investment needs in the years to come will remain significant, partially triggered by the need to comply with EU norms and standards and in response to the competitive pressures in the EU.

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[4] See Nicholas Craft, *East Asia Growth Before and After the Crisis,* IMF Working Paper WP/98/137.

[5] Jess Benhabib and Mark Spiegel (1994), "Role of Human Capital in Economic Development: Evidence from Aggregate Cross-Country Data," Journal of Monetary Economics, Vol 34, pp. 143-173.

[6] See Doyle et al. (2001); and Appendix I in SM/02/186.

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

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

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

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

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

Statement by the IMF Staff Representative
April 23, 2003

Since issuance of the staff report, the following information has become available on macroeconomic developments, fiscal and monetary performance, and external debt. This information does not alter the thrust of the staff appraisal.

1. **Economic activity continues to be strong.** Industrial production grew by 10 percent in February, while retail trade turnover rose by 14 percent. Import growth, at 19.8 percent year-on-year, outpaced export growth, at 16.6 percent, during the first two months of 2003, with exports to the EU expanding by 20.3 percent. End-of-period inflation was 2.2 percent in March, mainly reflecting rising prices for clothing and fuel.

2. **The Treasury reports a general government fiscal surplus of LVL 14 million for the first quarter of 2003.** While the first quarter outcome is usually strong, this is the first time since 1998 that a surplus has been recorded. The surplus could reflect the delayed adoption of the 2003 budget law, which limited spending during the first two months of the year to 1/12 of last year's budget authorizations. Notwithstanding the rate reductions of the social and the corporate income taxes, tax revenues grew by more than 8 percent year-on-year, with excise tax and VAT collections performing particularly well. Based on recent statements by government officials, it appears unlikely that the planned mid-year supplementary budget would lead to a significant tightening.

3. **The outstanding stock of short-term foreign exchange swaps fell sharply to $16.6 million at end-March, as the Bank of Latvia shifted the provision of liquidity to repo operations.** While reserve money and broad money developed in line with annual projections during the first quarter of 2003, credit to the private sector remained buoyant, growing by 38 percent year-on-year, significantly higher than projected for 2003 in SM/03/121.

4. **Based on newly released international investment position data, strong inflows of non-resident deposits during the fourth quarter increased Latvia's gross external debt to 83 percent of GDP at end-2002.** This is higher than the estimate provided in the staff report. Nevertheless, as most of these nonresident deposits continued to be placed abroad, end-2002 net external debt was raised only slightly, to 23½ percent of GDP, and the ratio of reserves to short-term debt (excluding non-resident deposits) remained above the benchmark level of 1. The full-year debt data do not alter the conclusions of the external sustainability exercise.

5. **The spread on Latvia's Eurobond maturing in 2004 fell to a record-low of 23.7 basis points as of mid-April.**

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 03/55
FOR IMMEDIATE RELEASE
April 28, 2003

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

IMF Concludes 2003 Article IV Consultation with the Republic of Latvia

On April 23, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Latvia.[1]

Background

Latvia has enjoyed continued strong economic performance since the last Article IV consultation in January 2002. Real GDP growth was 7.9 percent in 2001 and 6.1 percent in 2002; growth has been led by investment and, more recently, consumption. Real per capita GDP now stands some 50 percent above its 1995 level. Inflation remains low and was under 1½ percent in 2002. The current account deficit rose to nearly 10 percent of GDP in 2001, partly reflecting stagnant external demand and one-time factors, while a deficit of below 8 percent of GDP was recorded in 2002. This apparent improvement, however, was due to improved coverage of certain exports and private transfers, masking a deterioration in the underlying external position. Nevertheless, Latvian exporters have demonstrated resiliency in the face of the slowdown in western Europe, quickly reorienting toward other export markets. Inflows of Foreign Direct Investment were strong in 2002, covering about three-fifths of the current account deficit and helping to keep external debt levels moderate. Financial market sentiment towards Latvia remains favorable, as evidenced by relatively low yield spreads on Latvia's Eurobonds.

This performance owes much to past macroeconomic policy but fiscal control lapsed significantly in late 2002. While the general government fiscal deficit declined by 1 percentage

[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.

point to 2.2 percent of GDP in 2001 and was kept to 0.7 percent of GDP during the first nine months of 2002, the fiscal position loosened abruptly in the last quarter of the year and the annual deficit rose to 2.7 percent of GDP. This mainly reflected a surge in spending late in the year, while tax and non-tax receipts continued to be buoyant. This spending surge led to reversal of the expenditure tightening that had been accomplished since 1999.

Supported by appropriate monetary policies, the exchange rate peg of the lats to the SDR has contributed to price stability and a stable macroeconomic framework. The growth of credit to the private sector remained high in 2002, but household borrowing taking on increased importance relative to enterprise borrowing; along with the strong wage growth, this contributed to higher rates of consumption. Latvia has continued to improve its financial sector infrastructure under the Financial and Capital Markets Commission, established in July 2001, and is actively aligning its legal and regulatory frameworks for anti-money laundering (AML) and combating the financing of terrorism (CFT) to international standards.

Together with its largely successful macroeconomic policies, political, institutional, and structural reforms underpinned the invitations Latvia received in late 2002 to join the European Union and North Atlantic Treaty Organization. EU membership is scheduled for May 2004.

In July 2002, the IMF Executive Board completed the first and second reviews under Latvia's 20-month Stand-By Arrangement. The Stand-By Arrangement expired in December 2002.

Executive Board Assessment

Executive Directors noted that Latvia's growth and inflation performance in 2002 was among the best of the EU accession countries, and that the economy has demonstrated resiliency in the face of relatively slow growth among its major trading partners. However, Directors expressed concern about the magnitude and persistence of unemployment and the external current account deficit, recognizing this deficit both as a sign of Latvia's transition and as its key vulnerability.

Directors noted that Latvia has completed an impressive decade of transition during its first 10 years of IMF membership, embracing sound fiscal and monetary policies at an early stage and setting the stage for the pursuit of structural reforms and for a remarkable growth and inflation performance. Real per capita GDP has risen more than 50 percent since 1995 and inflation has remained at or below 3 percent since 1998. Together with political and institutional reforms, the transition to a market economy has helped Latvia garner an invitation for EU membership. The IMF has supported Latvia's transition through a series of Stand-By Arrangements, which have been treated as precautionary since 1995, with the last one expiring on December 19, 2002.

Looking ahead, Directors observed that Latvia is poised for continued strong growth in 2003 and over the medium term, provided the authorities maintain prudent macroeconomic policies and forcefully implement the remaining structural reform agenda. The authorities will need to be watchful of the persistent current account deficit. Latvia's economy appears to be competitive, and further diversification of exports and deeper trade integration with the EU will help

contribute to strong economic growth over the medium term. With strong policy resolve, Latvia should be in a position to generate the productivity growth necessary to gradually close the income gap with the EU.

Directors agreed that the exchange rate peg to the Special Drawing Rights and the current value of the lats remain appropriate. The peg should remain the anchor of Latvia's economic strategy during the period leading to EU entry. Directors considered Latvia well positioned to join ERM II after EU accession as a precursor to the adoption of the euro. They underlined the importance of a good public understanding of the implications of the shift in the exchange rate regime. Directors recognized that the monetary policy conduct of the Bank of Latvia in support of the exchange rate peg has been broadly appropriate, but some cautioned against further cuts in the interest rate. Directors were also concerned with the occasional resort to the use of short-term foreign exchange swaps in amounts deemed excessive.

Directors underscored the importance of a prudent fiscal policy, given Latvia's large current account deficit, buoyant domestic demand, and expenditure commitments associated with EU and NATO membership. They regretted the resort to an expansionary supplementary budget and the loss of expenditure discipline toward the end of 2002, which had reversed the strong fiscal performance throughout much of the year. These developments stand in contrast with the more positive fiscal developments in the neighboring Baltic countries, which also face expenditure pressures associated with EU and NATO accession.

Against this background, Directors welcomed the authorities' intention to move toward a balanced budget over the medium term, and underscored the importance of early decisive steps in this direction. They noted the adoption of general government fiscal deficit of about 3 percent of GDP in the 2003 budget law, and regretted that this signaled further fiscal relaxation in the context of strong economic growth. Directors therefore called upon the authorities to quickly resume the path of fiscal consolidation, including by redoubling their efforts to durably reduce non-priority spending, improving medium-term budget planning, and enhancing the efficiency of spending. They also urged the authorities to exercise restraint in further raising wages following the sharp increase in the government wage bill in 2002, and they suggested that the introduction of the new merit-based pay scale in 2004 be combined with efforts to improve the efficiency of the civil service. Enhanced efforts to monitor expenditure commitments and advance payments are also required.

Directors noted that the reductions of the social and corporate income tax rates that took effect in January 2003 provide an unwarranted fiscal stimulus at a time when Latvia is enjoying buoyant growth. They urged that further tax rate reductions be delayed until Latvia's fiscal performance has improved. Most Directors suggested that at that time, reducing payroll taxes would probably warrant higher priority than reducing corporate taxes--already among the lowest of EU member and accession countries. The authorities should also move aggressively to improve tax collections and curtail tax exemptions.

Noting that the 2002 amendments to the Law on Local Government Budgets had done little to enhance control over subnational fiscal positions, Directors urged the authorities to monitor developments and take steps to enhance local government discipline. Directors felt that

according local governments some scope to influence their tax revenues would, by providing flexibility in setting property and personal income tax rates, complement, and perhaps facilitate, steps to tighten control over deficits.

While noting that the banking system is well-supervised and financially sound, Directors welcomed the authorities' initiatives to strengthen financial sector surveillance. The authorities have brought their regulatory and supervisory framework largely in line with international standards. They have also made progress in monitoring the continued large inflows of non-resident deposits and the rapid growth of credit, particularly foreign-currency credit, such as through their new financial sector stability reports. Directors urged the authorities to remain vigilant to possible risks and emerging financial sector vulnerabilities in these areas, and to be ready to take action as necessary. Directors welcomed the authorities' steps to strengthen the framework for AML and CFT, in order to bring Latvia into full compliance with international AML/CFT standards.

Directors stressed that progress against corruption and state capture will be critical for allowing Latvia to improve its business climate and achieve its full growth potential. They welcomed the authorities' recent steps to reduce corruption, including through the adoption of a national anti-corruption strategy and the opening of an anti-corruption bureau. They also encouraged the authorities to build on the recent divestment of the state gas and shipping companies and to complete the process of large-scale privatization.

Directors commended the continued evolution of the Action Plan to Improve the Business Environment, which has helped to remove unnecessary administrative barriers and other obstacles to business. They emphasized the need to maintain Latvia's flexible labor market institutions and policies while addressing the underlying causes of the high, albeit declining, unemployment rate. In this context, Directors stressed that wage growth needs to be contained to improvements in productivity in order to safeguard Latvia's external competitiveness.

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. The Staff Report for the 2003 Article IV Consultation with Latvia is also available.

Republic of Latvia: Selected Economic Indicators

	1997	1998	1999	2000	2001	2002
	Changes in percent					
Real Economy						
Real GDP	8.4	4.8	2.8	6.8	7.9	6.1
Unemployment rate (ILO, end of period)	14.4	13.7	14.5	14.6	12.8	11.6
Consumer price index (end of period)	7.0	2.8	3.2	1.8	3.2	1.4
	In percent of GDP					
Public Finance						
General government balance	0.3	-0.8	-3.9	-3.2	-2.2	-2.7
Total government debt 1/	12.0	10.5	13.0	13.1	15.0	14.6
External government debt 1/	6.7	6.4	9.2	8.2	9.5	8.9
	End-period; changes in percent					
Money and credit						
Reserve money	31.2	6.7	11.6	7.7	8.8	22.4
Broad money	38.6	6.0	8.0	27.9	20.8	20.9
Domestic credit (non-government)	76.2	58.6	15.3	36.7	50.4	36.5
	In percent of GDP unless stated otherwise					
Balance of payments						
Trade balance	-15.1	-18.6	-15.4	-14.8	-17.6	-17.2
Current account balance	-6.1	-10.6	-9.7	-6.9	-9.6	-7.8
International reserves (in months of imports)	2.5	2.9	2.9	2.6	3.0	2.9
Exchange rate						
Exchange rate regime	Peg to the SDR					
Exchange rate (lats per US$; period average)	0.581	0.590	0.585	0.607	0.628	0.618
Real effective exchange rate (2000 = 100) 2/	80.0	91.4	98.8	98.9	97.0	91.8

Sources: Latvian authorities and IMF staff estimates.
1/ Excludes government-guaranteed debt.
2/ CPI-based, end-of-period.

Statement by Benny Andersen, Alternate Executive Director for the Republic of Latvia and Inguna Kupča, Assistant to Executive Director
April 23, 2003

On behalf of our Latvian authorities, we would like to thank Mr. Mueller and his team for their cooperation and dedication during the discussions in Riga and for presenting a set of well-balanced documents. Our authorities are in broad agreement with the staff's analyses and the key economic challenges Latvia is facing.

With the last precautionary Stand-By Arrangement expiring at the end of 2002, this is the first stand-alone consultation with Latvia. Our authorities appreciate this new level of cooperation, and they would like to use this opportunity to emphasize the constructive dialogue and fruitful cooperation, which consistently have characterized their relations with the Fund. The framework of Fund-supported programs, together with regular Fund surveillance and well-targeted technical assistance, has been very useful in guiding policies through the challenges of reform and transformation. Our authorities also would like to extend their gratitude to the Fiscal Affairs Department and the Legal Department for the recent technical assistance missions in the tax policy area and they emphasize the usefulness of the recommendations made by staff. In a similar vein, they look forward to the data ROSC planned for September 2003. Moreover, they would like to thank the resident representative Mr. Knöbl for his outstanding job facilitating the cooperation with the Fund throughout his term that expired in January 2003.

Following elections in October 2002, a new majority coalition government was formed on November 7 headed by the former governor of the central bank, Mr. Repše. The government's first priority is to conclude Latvia's accession process in the EU and NATO. The NATO accession protocol was signed by Latvian officials on March 26, and on April 16 in Athens Latvian officials signed the European Union Accession Treaty that will allow the country to become a full member of the EU on May 1, 2004. The EU membership referendum is scheduled for September 20, 2003. Working towards these two membership goals has largely facilitated the authorities' focus on macroeconomic stability. In this process, Latvia has demonstrated a sustained track record of general fiscal discipline, price stability, and exchange rate stability, contributing to high and sustainable growth rates in recent years. This culture of stability-oriented macroeconomic policies combined with determined structural reforms makes Latvia well placed to deal with the significant challenges looking ahead, including the preparation of EMU accession upon meeting the Maastricht criteria. In that regard, Latvia is well prepared with low and stable inflation, a recent successful launching of a 10–year domestic bond with yields well within the Maastricht-set convergence criteria, fiscal deficits below the 3 percent limit in recent years and a general government debt level at 15 percent of GDP end-2002.

Recent economic developments and prospects

Over the last couple of years, the growth of the Latvian economy has been the highest amongst the ten EU accession countries, facilitating a gradual convergence of per capita income toward the EU levels. In 2002, GDP grew by 6.1 percent as high domestic demand and strong exports helped to shield the country from the sluggish growth across the globe. The trade sector developed vigorously and other sectors including construction, manufacturing and financial services also reported better-than-expected performance. Those developments fully offset some slowdown in the transit sector due to an uncertain situation in the world oil markets and a sharp reduction of oil transportation via the Ventspils pipeline. For 2003, the authorities expect growth around 5 ½ percent. Even stronger growth is anticipated in the medium term as Latvia reaps the benefits of a decade of sound macroeconomic policies and far-reaching structural reforms, and the authorities expect that the forthcoming accession to the EU would foster further inflow of foreign direct investments. According to the consensus forecasts, Latvia will have the highest GDP growth amongst the EU accession countries for both 2003 and 2004.

Despite the economic slowdown in major trade partners, export performance improved during 2002. Latvia saw a strong increase in exports of woods and metals to the EU, expanding trade with CIS countries, including Russia, a significant increase of exports to the neighboring Baltic countries, and the current account deficit narrowed to 7.8 percent of GDP compared to 9.6 percent in 2001. Latvia's current account structure continues to reflect the country's investment needs with foreign direct investments (FDI) being a significant source of financing, thereby keeping the external debt at a low level. In 2002, net FDI inflows reached 4.6 percent of GDP, thus financing about 60 percent of the current account deficit. Our authorities realize that FDI flows can be volatile and they agree that maintaining steady FDI inflows is a key challenge.

Inflation has remained sluggish in Latvia. In 2002, annual inflation was 1.9 percent, and it has accelerated slightly since the beginning of 2003, mainly due to a rise in the price of fuel. In March, annual inflation was 2.2 percent. Low and stable inflation has been backing a persistent trend of declining interest rates. Higher banking sector efficiency and competition has also been a factor in trimming interest rates. A continued tight monetary policy stance of the central bank should help keeping the inflation at an annual average below 3 percent in 2003.

Fiscal policy

In response to staff's concern about erosion of fiscal discipline late 2002 and a budget deficit target for 2003 of 3 percent of GDP, a little more than 1 percent higher than recommended by staff, our authorities would like to emphasize their continued commitment to a prudent fiscal policy stance in line with the requirements of the EU. To achieve medium term budget balance remains of key importance for the authorities, and with EU membership, this is to be achieved consistent with the Stability and Growth Pact. They think this commitment is consistent with a somewhat higher budget deficit for 2003 than suggested by staff.

The general government deficit in 2002 amounted to 2.5 percent of GDP (or 2.7 percent as calculated by staff), well exceeding the target of 1.8 percent of GDP. The budget overrun was due, in particular, to a high deficit of the City of Riga and one-time commitments made by the previous government, including compensation to farmers related to the drought last summer. Thus, up to the fall of 2002, the government maintained a tight fiscal policy stance, keeping the budget deficit well below the projected margins, but a supplementary budget adopted in the last quarter of the year increased the budget expenditures significantly. The authorities concur with staff on the need to strengthen local governments' financial discipline. While the Parliament has already adopted legislative measures to enhance the financial control of municipalities by the amendments to the Laws "On Budget and Financial Management" and "On Local Governments' Budgets" in late 2002, they might not have been as forceful as hoped for and the government is looking for possible avenues to address the need in line with staff's recommendations.

The budget for 2003 approved on February 28 foresees a slight increase in the deficit to about 3 percent of GDP. Extra spending is related to NATO and EU accession, as well as to the government's other priorities, including a strong and independent judiciary system, prevention of corruption and crime, and health and education sector reforms. Furthermore, the government plans to strengthen revenue performance through improving tax administration and reducing tax evasions, including through customs enforcement and fight with fraud connected with reimbursement of the VAT. Measures already taken have resulted in a welcomed increase in tax revenues with excise tax and VAT collections performing particularly well as mentioned in the Buff statement by staff. Regarding the need for further fiscal consolidation, staff has come up with a number of specific recommendations, most of which being in line with the government's priorities. To reduce non-priority expenditures in preparation of the 2004 budget, the government is determined to better control spending and they will scrutinize comprehensively the budgets of various ministries in order to enhance the efficiency. Moreover, the government envisages to streamline the so far few remaining tax exemptions. While staff urges the authorities to move cautiously with respect to tax reductions, it should be emphasized that lower taxation is a key priority for the government and in line with their emphasis on a business-friendly environment and the need to maintain a dynamic economy in order to advance further real convergence to the EU. Furthermore, although the Latvian Government plans to pass a supplementary budget this summer, it is less likely to achieve a fiscal tightening in 2003.

Exchange rate and monetary policy

Since 1994, the Bank of Latvia has pegged the lat to the SDR. The structure of the SDR basket largely corresponds to the currency composition of Latvian foreign trade and debt. The peg has proven successful in its main objectives: facilitating low inflation, supporting business confidence, and enhancing stability in financial markets. As the current exchange rate strategy suits the needs of the Latvian economy well, the Bank of Latvia intends to keep it unchanged until the entry in the EU. Latvia's good progress in nominal and real convergence provides a sound basis for joining the ERM II soon after entry into the EU. With decisions to be taken in accordance with the agreed common procedures, the authorities

are targeting ERM II membership no later than 2005 with an adoption of the euro after a minimum of two years under ERM II upon meeting the Maastricht criteria. The legislative framework, including central bank independence and the central bank's monetary instruments are considered to be in broad compliance with the EU requirements.

Staff has expressed some concerns regarding the 50 basis points cut in the official interest rates and the increased use of short-term currency swaps in the previous fall. The Bank of Latvia takes note of the concerns that Latvia's cyclical position needs to be taken into consideration when adjusting interest rates. However, with a fixed exchange rate regime and free capital movements the central bank cannot protractedly sustain considerably higher interest rates compared to those prevailing in the region and the countries of its currency peg.

Financial sector policies and combating money laundering

Financial intermediation has continued to expand and deepen within an environment of price stability and buoyant demand. This includes lending, which has increased by an average of over 30 percent during the last five years, although from a low base. Against this backdrop, the authorities are pleased to note the recognition of the staff and others that the Latvian authorities have made remarkable progress in strengthening their supervisory framework, including that the December 2002 EU Peer Report identified no major weaknesses in Latvia's financial system, thereby reinforcing the findings of the 2001 FSAP. Provisioning is considered by the authorities to be adequate and only 2 percent of loans are classified as sub-standard, banks are well capitalized and the asset quality remains high. Privatization in the banking sector is nearly completed – the government share in the Savings Bank will be sold during 2003, thus keeping only one state-owned bank. Two thirds of the banking sector are now controlled by foreign capital, mostly Nordic and German banks. Moreover, major progress has been achieved in the field of harmonization of the Latvian financial sector legislation with that of the EU, and the latest amendments to the EU banking and insurance directives have been reflected in Latvian legislation. The authorities agree that vigilance remains important and they will continue to monitor developments closely. Moreover, the Latvian AML/CFT framework has been strengthened through various steps since the last Article IV consultation bringing it into compliance with international standards.

Structural reforms

The EU accession process has worked as a significant catalyst for the structural reform agenda. Now the privatization process has almost been completed as described in the staff report. An ambitious work was launched by the Latvian government in 1999, notably the *Action Plan to Improve the Business Environment* aiming at simplifying tax administration, streamlining administrative procedures of customs clearance, and providing transparency and better protection of investors' interests. This plan has been revised frequently and the new *Action Plan* approved in October 2002 envisages measures to improve tax policy and administration, combat corruption, improve central and local government procurement procedures, and foster the confidence in the rule of law. Not least, the effective fight against corruption is of key importance under the government's reform agenda. To this end, the Anti-

Corruption Bureau is now made fully operational. Health care reform is also of paramount importance with a newly established Ministry of Health. The main objective of the health reform is the introduction of an efficient and transparent health care financing and administrative framework. The reform anticipates elimination of existing shortages, including by increasing the access to high-quality health services, fostering the technological and professional development of the health care sector, and securing a proper wage level for health sector employees. Finally, a flexible labor market with a skilled labor force and competitive wages is considered crucial for the Latvian economy, and this emphasis is reflected in the National Employment Plan.