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Republic of Latvia: 2004 Article IV Consultation—Staff Report; 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 2004 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 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on April 30, 2004, 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 July 15, 2004. 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 Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its August 4, 2004 discussion of the staff report that concluded the Article IV consultation.

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

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

Selected Issues Paper

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

REPUBLIC OF LATVIA

Staff Report for the 2004 Article IV Consultation

Prepared by Staff Representatives for the 2004 Consultation with the Republic of Latvia

Approved by Susan Schadler and Matthew Fisher

July 15, 2004

- The consultation discussions were held in Riga during April 19–30, 2004, on the eve of Latvia's accession to the EU. Staff representatives met with Prime Minister Emsis, Finance Minister Spurdzinš, Bank of Latvia Governor Rimsevic, other senior officials, parliamentarians, and representatives of the business, financial, academic, and diplomatic communities.

- The mission comprised Messrs. Samiei (head), Luna, Xiao (EUR), and Worrell (MFD). Ms. Zunda of the resident representative office assisted the mission. Mr. Solheim, Executive Director for Latvia, and Ms. Zubkova from the Executive Director's office participated in some of the meetings. Messrs. Samiei and Luna visited Frankfurt and Brussels to discuss ERM2 entry issues with ECB and EU officials. The authorities released the mission's concluding statement and agreed to the publication of the staff report.

- A new government led by Mr. Emsis of the Green and Farmer Union Party took office in March 2004. The government, supported by a four-party minority coalition, has expressed its commitment to European integration and combating corruption.

- In concluding the 2003 Article IV consultation discussions, Executive Directors focused their recommendations on fiscal discipline and the fight against corruption. In particular, they regretted the end-2002 fiscal loosening and underscored the importance of taking decisive steps toward a medium-term structural balanced budget. To this end, they urged that further tax rate reductions be delayed until fiscal performance had improved. In addition, Directors stressed that progress against corruption would be critical to improving Latvia's business climate.

- Latvia has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains no restrictions on the making of payments and transfers for current international transactions, except for those imposed in compliance with applicable UN Security Council resolutions. All such restrictions have been notified to the Fund pursuant to Decision 144(52/51).

- Latvia subscribes to the Special Data Dissemination Standard. Coverage, periodicity, and timeliness of the data are adequate for surveillance.

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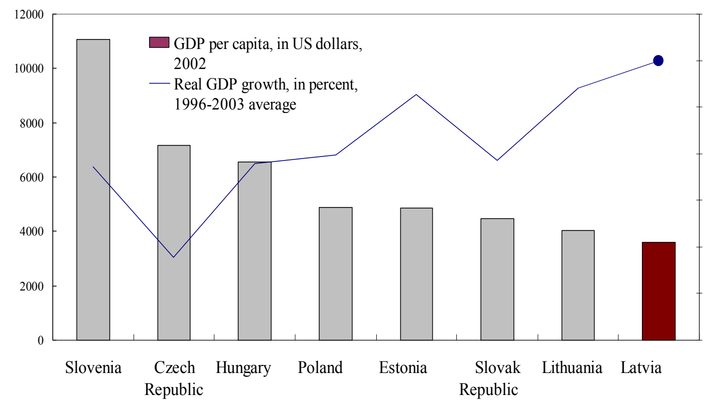
I. BACKGROUND

A. A Glance at the Past

1. **Latvia's transition, culminating in EU accession in May 2004, has been a success story, but achieving real convergence with European standards of living remains a long-term objective.** With an average annual rate of about 6 percent since 1996, GDP growth has been the highest among the new EU member countries (see chart). The narrow band around the SDR-lats exchange rate peg—introduced in 1994—together with responsible fiscal and monetary policies have fostered macroeconomic stability, while structural reforms have nurtured the development of a thriving private sector. Despite a very fractured political setup (eleven governments since independence) and institutional weaknesses, Latvia's strong economic growth and reform efforts garnered invitations to join the EU and the NATO. These developments also helped attract large inflows of foreign direct investments (FDI), which, in turn, contributed to the financing of Latvia's large current account deficit. However, per capita income is still below that of other acceding countries and stands at only one-third of the EU-15 average in PPP terms, suggesting that it may take several decades for Latvia to catch up with its richer neighbors.

GDP per capita and Real GDP Growth



Sources: Country authorities and *International Financial Statisitcs*, IMF.

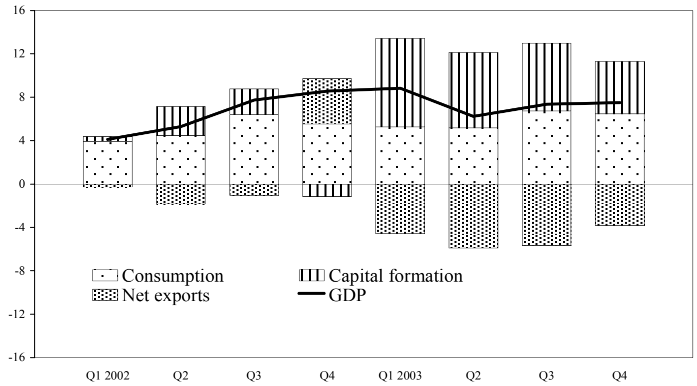
2. **The consistency between the Fund's recommendations and the authorities' views has been high.** Following 7 Standby arrangements—with the last one expiring in December 2002—Latvia has been cited as an example of highly effective prolonged assistance by the Fund.[1] Consultations have been constructive, and the quality of the policy dialogue with the Fund has been high. The authorities have, in particular, appreciated the Fund's contribution to capacity building in the early transition years and its role in managing the banking crisis of 1995. The Fund's advice has been followed in most instances, in particular in the development of a stable exchange rate regime and an effective banking supervisory framework, which led to the creation of the Financial and Capital Market Commission (FCMC) in 2000. Fiscal policy has also mostly been in line with the Fund's recommendations, although recently, in the context of repeated political changes, the authorities on occasion have favored a looser stance than recommended by staff.

[1] IMF IEO, "Evaluation of Prolonged Use of IMF Resources: IMF Staff Response," 2002.

B. Recent Developments

3. **Strong economic activity is maintaining its momentum.** Led by robust domestic demand, real growth reached 7½ percent in 2003 and 8¾ percent (year-on-year) in the first quarter of 2004. Despite sluggish activity in its European trading partners, Latvia's exports boomed in 2003. Leading indicators such as industrial production, retail trade, and investment spending suggest that strong growth has continued into the second quarter of 2004.

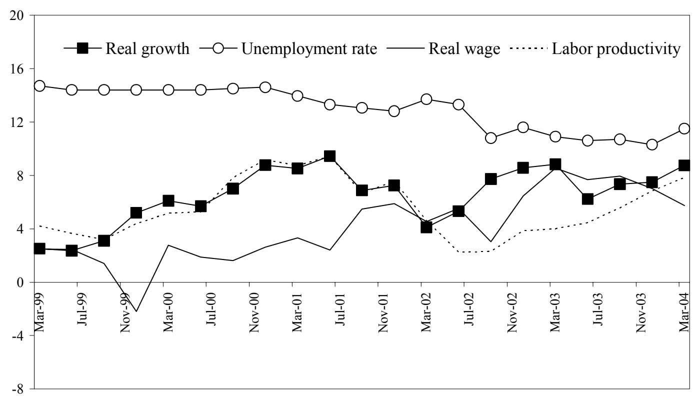
Contributions to GDP Growth, 2002-03



Sources: Latvia authorities and Fund staff estimates.

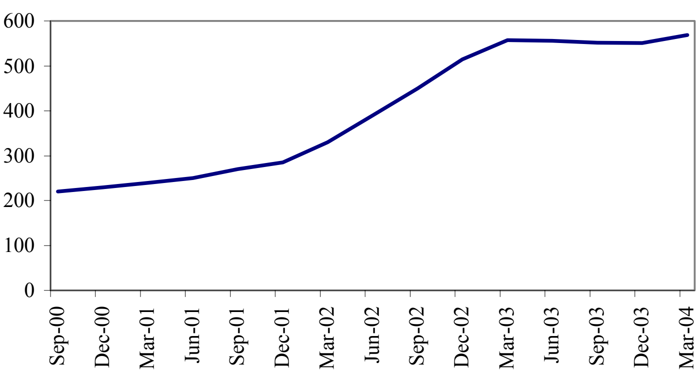
4. **Overheating is potentially a serious concern in the run-up to euro adoption (see Section II), although at present the evidence is not fully conclusive.** Credit continues to grow rapidly—over 40 percent annually at end-May 2004—mainly driven by mortgage and consumption loans. Consumption grew faster than GDP in real terms in 2003, but with rapid import growth and a weakening current account deficit, it contributed little to domestic resource constraints. Above-trend growth in 2003 may have created a positive output gap, but capacity utilization in manufacturing has remained unchanged at 74 percent over the past twelve months. Inflation surged to 6.2 percent at end-May 2004, from 3.6 percent at end-2003, but so far it has largely reflected exogenous one-off factors—estimated to have contributed about 4 percentage points to inflation (Box 1 and Selected Issues papers). Although unemployment is significantly

Labor Market and Productivity Growth,1999-2004
(In percent)



Sources: Latvia authorities and Fund staff estimates.

Average Price per Square Meter of Typical Apartment in Riga
(In US dollars)



Source: www.latio.lv.

lower than two years ago, it has recently increased somewhat—albeit largely owing to an increase in labor force participation; accordingly real wage growth, which exceeded growth in labor productivity in much of 2002 and 2003, has slowed down in 2004 (see chart). House prices have increased rapidly, with apartment prices in Riga more than doubling in the past

Box 1. Recent Developments in Inflation

Inflation in Latvia has been on the rise in recent months, surging to 6.2 percent at end-May from an average of about 3 percent in previous years. This box suggests that the acceleration of inflation is largely accounted for by one-off events and the depreciation of the Lats vis-à-vis the euro, rather than the rapid credit growth. Furthermore, similar price movements have recently been observed in other new EU member countries.

One-off events have affected recent inflation

Selected commodity group	Inflation (May 2003 - May 2004)	Contribution to total inflation
Total	**6.2**	**6.2**
Of which:		
Food	5.9	1.7
Housing, utilities and fuels	8.7	1.2
Health care	17.0	0.7
Transport	9.4	1.0

- World food prices have risen 20 percent from a year earlier. In addition, for new EU members, exports from other EU countries will no longer qualify for subsidies, and there is evidence of price speculations in food markets in the run up to accession.
- Changes in regulated rent and utility prices accounted for slightly more than one percentage point in the overall inflation.
- To meet EU requirements certain taxes were introduced, including excise taxes on fuel, and VAT on pharmaceutical products.
- The surge in world oil prices in the first half of 2004 caused fuel prices to rise.
- The depreciation against the euro contributed to inflation over the past year. This is supported by the fact that annual inflation in the other Baltic countries, which maintain currency board arrangements vis-à-vis the euro, is lower, despite facing similar shocks otherwise.

For now credit growth does not appear to be contributing to higher inflation

- The aforementioned exogenous factors likely contributed about 4 percentage points to inflation in May (see table), which leaves little room for credit growth in explaining recent inflation.
- Credit growth, while increasing vulnerability, is largely the result of catching up and reflects the response to rising demand for credit in the economy. The ratio of credit to the private sector to GDP, and the ratios of household debt to GDP and to disposable income, are all significantly below European comparators and the equilibrium levels suggested by Latvia's per capital income, the degree of financial liberalization and the level of legal/regulatory/corporate culture (see Cottarelli, Carlo, Giovanni Dell'Ariccia and Ivanna Vladkova-Hollar, "Early birds, late risers, and sleeping beauties: bank credit growth to the private sector in Central and eastern Europe and the Balkans," IMF Working Paper/03/213).

The main risk to the inflation outlook is that price increases could become persistent if strong demand continues to drive output above potential and causes credit growth to feed into inflation.

three years, but they seem to have stabilized recently and, adjusted for per capita income, are not high by international standards. In addition, the surge in housing construction could herald price weakening.

5. **The rapid credit growth has increased risks, but at present it appears consistent with Latvia's stage of development.** Credit growth, by increasing private sector's—and in particular households'—indebtedness, has made the economy more vulnerable to exogenous shocks. Furthermore, while it does not appear to have been responsible for the recent rise in inflation, credit growth has likely accommodated the increase in the current account deficit. Nevertheless, credit growth is largely a reflection of strong economic activity (rather than irresponsible monetary policy or inappropriate lending practices) and appears justified by the very low starting point and developmental/ institutional factors (see Box 1).[2] In addition, the increase in credit has been funded by sustainable sources—deposit growth, bond flotation on the euro market, and internal funding arrangements by foreign banks with subsidiaries in Latvia.

6. **In addition, there are no signs of deterioration in overall credit quality.** The banking system's financial soundness indicators remain favorable (see table below).[3]

7. **Although the external current account deficit widened further in 2003 (to 8.6 percent of GDP), competitiveness does not appear to be a problem (Box 2 and Selected Issues papers).** At end-2003, the real effective exchange rate was below the early-1999 levels. Latvia's export penetration ratio has grown steadily since 1999, despite unfavorable market conditions for its main export (wood and wood products), and has surpassed the level reached before the Russia crisis in 1998. Furthermore, export growth over the last 5 years has been accompanied by increasing profit margins. Latvia's competitiveness ranking by the World Economic Forum has also improved.

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[2] The ratio of household debt to GDP is about 20 percent, compared with the European average of 57 percent and a level above 100 percent for most industrial countries (Austrian National Bank, *Financial Stability Report 6*, Nov. 6, 2003).

[3] The decline in commercial banks' reserves-to-deposits ratio and liquidity ratio in 2003 reflects the reduction in reserve requirements.

Latvia: Selected Financial Indicators, 2000–04

(In percent unless otherwise indicated)

	2000 IV	2001 IV	2002 IV	2003 IV	2004 I
Net foreign assets of the BoL, in millions of U.S. dollars	882.0	1194.4	1311.8	1538.5	1501.5
Net foreign assets of commercial banks, in millions of U.S. dollars	-6.0	-378.3	-716.7	-1383.7	-1562.1
Commercial banks total reserves/total deposits	16.3	14.5	13.6	6.7	6.3
Commercial banks excess reserves/total reserves	7.5	4.8	2.0	3.2	1.2
Loans/deposits	58.3	70.3	69.2	80.4	82.9
Loans/total assets	40.3	47.3	48.1	52.5	54.5
Credit to nongovernment/GDP 1/	19.6	26.5	32.3	38.8	...
Liquidity test 2/	44.2	32.0	32.9	20.8	20.6
Capital adequacy -- risk-weighted average 3/	14.0	14.2	13.1	11.7	12.5
Nonperforming loans/total loans	4.6	2.8	2	1.4	1.5
Loan-loss provisioning/gross loans	3.0	1.7	1.5	1.2	1.3
Return on equity 4/	19.0	19.0	16.4	16.7	20
Net foreign asset position 5/	579.5	464.4	667.8	593.7	657
Nominal interest rate spread 6/	7.5	6.4	4.6	5.6	... 8/
Stock market index, level 7/	139.2	200.4	161.1	228.4	275.7
Stock market capitalization/GDP 1/	7.5	8.5	7.3	9.3	...

Sources: Bank of Latvia and Financial and Capital Market Commission (FCMC).

1/ GDP is calculated using annualized quarterly data.
2/ Liquidity test is defined as: (cash + claims on the central bank + claims on other credit institutions + fixed-income government bonds – liabilities to the central bank – liabilities to other credit institutions) / deposits.
3/ End-December values based on audited financial statements; otherwise, as reported by banks.
4/ Return on equity is defined as the ratio of profits to the value of bank-issued equity.
5/ Net foreign asset position vis-à-vis foreign credit institutions, in LVL millions.
6/ Commercial bank lending-deposit spreads for 3-month average of 3–6 months' maturities.
7/ Dow Jones Riga stock exchange index, end-of-period data.
8/ As of January 2004, the Bank of Latvia has introduced new interest rate reports with respect to domestic deposits and loans, interest rate spreads for 3–6 months' maturities not available.

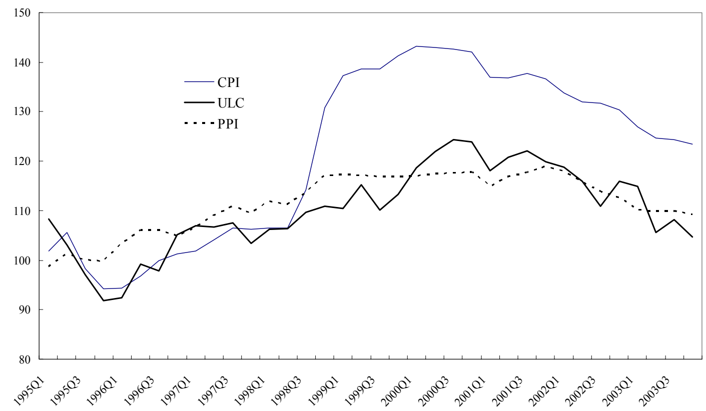
8. **Despite a significant reduction in net FDI, external debt has increased only moderately and poses no immediate concern.** Net FDI coverage of the current account deficit, at 34 percent in 2003 was well below the average observed in the last three years—nearly 60 percent. But this reflected two specific factors. First, Lattelekom's capital was reduced and in part returned to Teliasonera—the Finnish partner company. Second, a significant part of the loans extended by parent companies to Latvian enterprises matured in 2003 and were repaid rather than rolled over. Net FDI is expected to increase in 2004 and

Box 2. Equilibrium Exchange Rate and External Competitiveness

For Latvia, the imminent ERM2 accession requires abandoning the current SDR peg and fixing a new euro peg. Such a peg could serve as the basis for the eventual adoption of the euro. Assessing how close the current exchange rate is to its equilibrium level is a daunting task in an economy undergoing rapid growth and structural change. Some competitiveness indicators can nonetheless guide the analysis.

Latvia's large external current account deficit may suggest an underlying exchange rate misalignment. However, as argued in IMF Country Report No. 03/331, structural factors, such as an increase in expected income and investment explain most of the deficit during the last decade. Indeed at end-2003, the Unit Labor Cost (ULC-based) Real Effective Exchange Rate (REER), the CPI-based REER and the PPI-based REER were all at or below early 1999 levels. In addition, the market-to-PPP exchange rate ratio—well below unity—is about 10 percent lower than for Lithuania after adjusting for per capita income.

Latvia: REER (CPI, ULC and PPI)

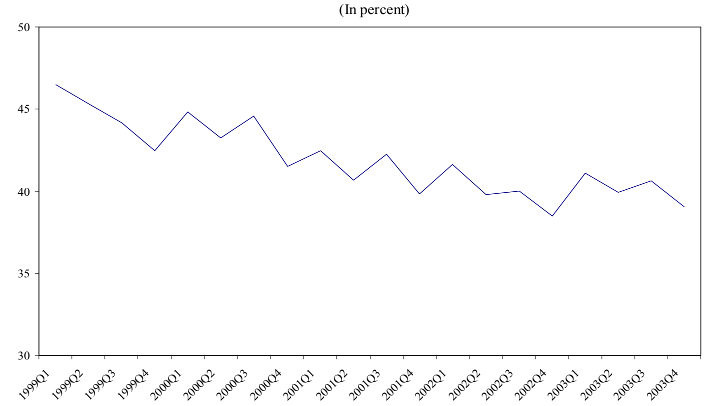


Sources: Latvia authorities and Fund staff estimates.

A comprehensive study of the competitiveness in the Baltic states (Special Issues Paper: The Baltics: Competitiveness on the Eve of EU Accession) concluded that the equilibrium exchange rate in Latvia appreciated significantly in the early years of transition prompted by strong productivity growth and large capital inflows. The REER has followed similar dynamics and, since 1999, has remained quite stable. Based on a broad range of indicators, the analysis suggests no clear evidence of exchange rate misalignment in Latvia.

An exchange rate overvaluation could also manifest itself in weak export performance. Latvia's export penetration, however, has grown steadily since 1999. Market shares in EU and world markets have grown about 25 percent since 1999 and exports to the EU now accounts for nearly 85 percent including the new accession countries. Furthermore, export growth and the successful penetration of international markets have been accompanied by increasing profit margins over the last 5 years. Despite the limitations of the indicator employed—the ratio of wage costs to value added—the figure is at least indicative of a trend.

Latvia: Share of Wage Costs in Manufacturing Value Added, 1999-2003
(In percent)



Sources: Latvia authorities; and Fund staff estimates.

The BoL has been involved in foreign currency interventions and swaps with commercial banks to provide them with needed liquidity. This could suggest that the parity is maintained artificially. The null hypothesis that total interventions **do not** Granger cause the lats-SDR exchange rate cannot be rejected for all considered lag structures. This suggests that the parity is likely sustained by fundamentals and the *potential* ability of the BoL to intervene (with net international reserves equivalent to about 100 percent of reserve money) rather than by actual interventions.

beyond. Gross external debt is about 80 percent of GDP, but more than half of this is due to non-resident deposits (see Table 6). These deposits are in large part dollar denominated and officially come from the USA, even though, according to the BoL, they include funds repatriated by Latvian citizens and funds that originate in CIS countries. The latter are mostly for import-export operations or for safe keeping—as in the case of deposits from Ukraine and Russia. Non-resident deposits are largely redeposited in foreign banks or placed in other liquid foreign assets in OECD countries, closely matching the currencies of the deposits.[4] In light of these features and in line with the Board paper on *Debt-and-Reserve-Related Indicators of External Vulnerability* (www.imf.org), the notion of net external debt appears to be a more appropriate measure to assess Latvia's external vulnerability. Net debt is only 25 percent of GDP.

9. **Fiscal performance has improved appreciably, and public debt remains very low (13½ percent of GDP in 2003).** The general government budget deficit, at 1.6 percent of GDP in 2003,[5] narrowed by nearly 1 percentage point from 2002. This outcome reflected lower-than-budgeted expenditures, unexpectedly high tax revenues, and lower net lending. Subsidies, transfers, and capital spending were lower than budgeted, and, owing to the recently established restraining mechanisms on advance payments, a repeat of the end-2002 spending spree did not materialize. On the revenue side, the collection of personal income tax, social tax, VAT, and excise tax was especially good due to buoyant growth, as well as to the implementation of several tax administration measures. The strong revenue performance has continued in 2004, resulting in a small surplus as of May, despite interruptions to VAT and excise collection following EU accession.

10. **Further steps have been taken to fight corruption; while AML/CFT enforcement has remained weak.** The Corruption Prevention and Combating Bureau (KNAB) established a National Program for Preventing and Combating Corruption and began investigating cases of corruption involving high officials in 2003. In May, Parliament elected a new director for the bureau after a prolonged process complicated by political interference. Recent amendments to the AML/CFT legislation put the Latvian law in line with the international standards and procedures required by the EU. Enforcement, however, remains weak and Latvia was recently put on the list of countries—compiled by the U.S. Treasury—deeply involved in money laundering.

11. **Latvia's statistical system has been evaluated with a Report on Observance of Standards and Codes (ROSC)—Data Module, published on July 1, 2004.** The ROSC

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[4] Despite the redepositing, commercial banks have negative net foreign assets, reflecting long-term financing of domestic branches and subsidiaries of foreign banks and more recently the floating of euro-denominated bonds by commercial banks.

[5] The figure was revised down from the initial estimate of 1.8 percent following the upward revision in GDP figure (see paragraph 10).

indicates a well-functioning statistical system with good interagency coordination, a commitment to quality, and generally strong data series. However, in some areas the ROSC team recommended improvements, in particular concerning the compilation of the CPI, government financial statistics, and some monetary statistics. The Central Statistical Bureau recently revised the calculation of fixed asset depreciation and imputed rent in national accounts in compliance with ESA 95, resulting in higher nominal GDP.

II. Report on the Discussions

12. **Discussions focused on two main areas: the authorities' ERM2 accession strategy and the potential risks of overheating and the associated role of fiscal policy.** The authorities are moving ahead with their plans to enter ERM2 in January 2005. Staff agreed with the authorities that a more rapid path would not be necessary or desirable, given the adjustments needed in the interim. They described the measures they were undertaking to make the transition smooth. The discussion centered on the feasibility of the authorities' strategy and the vulnerabilities that may endanger the success of Latvia's participation in ERM2. On overheating, the authorities generally argued that the risks were limited. Staff stressed the need to forestall the potential risks of overheating and to address the large external deficit. It urged a stronger emphasis on strengthening the flexibility of fiscal policy in dealing with shocks—in view of the increasingly limited role of monetary policy—and adopting a tighter fiscal stance. While the BoL favored an immediate fiscal tightening, the MoF regarded it as not feasible. The authorities and the mission also jointly performed stress tests—in the context of an updated analysis of FSAP-related issues—to assess potential financial sector vulnerabilities stemming from rapid credit growth and other developments.

A. Macroeconomic Outlook

13. **The outlook remains favorable, with real GDP expected to grow 6½ percent in 2004, driven by strong domestic demand and ongoing recovery in Europe.** The authorities' projection is more optimistic—closer to 7 percent—assuming a more favorable external environment. Over the medium term, staff projects that real GDP will maintain the trend growth of 6 percent, led by productivity growth and investments. This outlook requires prudent macroeconomic policy and sustained FDI facilitated by deepening structural

Medium-Term Macroeconomic Framework, 2004-08

	2004	2005	2006	2007	2008
Real GDP growth rate	6.5	6.0	6.0	6.0	6.0
Inflation rate (end-year)	5.0	3.5	3.0	3.0	3.0
	(as percent of GDP)				
Current account balance	-9.3	-8.2	-7.4	-7.1	-6.8
Fiscal balance	-1.5	-1.3	-1.1	-0.9	-0.7
Private saving	18.7	19.7	20.2	20.4	20.4
Private investment	26.5	26.6	26.6	26.6	26.5
Private savings-investment balance	-7.8	-6.9	-6.3	-6.2	-6.2

Sources: Latvian authorities and Fund staff estimates.

reforms.[6] Regarding recent price developments, the BoL and the Ministry of Economy attributed the pickup in inflation to EU accession and expected it to come down by year's end; the BoL's latest projection for end-2004 is 4.5 percent, compared with staff's projection of 5 percent. The current account deficit is expected to widen to 9¼ percent of GDP in 2004, a view shared by the authorities, and to remain quite large in the next few years, reflecting large one-off effects triggered by EU accession and the adoption of EU standards on environmental protection.[7] However, the ongoing economic recovery in the euro area could boost Latvian exports more than currently expected and in part curb the trend. In view of the large current account deficit and the various risks to inflation, staff stressed the need for a prudent fiscal path. In the scenario projected by staff, the current account will improve gradually beyond 2004. The trend reflects the assumptions of continued fiscal consolidation and some improvements in private saving (as the effect of one-off imports wears out and as catch-up continues and the propensity to consume gradually declines).

14. **While inflation was broadly consistent with the Maastricht criterion at end-2003, there are some upside risks in the period ahead.** In the absence of fiscal adjustments, high inflation could become persistent, because of the spillover effects of one-off factors (in particular oil prices) and/or if continuing rapid credit growth causes capacity constraints and starts to feed into inflation. In addition, the authorities recognized that the risks of overheating would increase in the run-up to euro adoption. In particular, the economy could face a demand boom as capital inflows increase and as interest rates converge to European levels. The risks are intensified by Latvia's geographic position, which makes it an ideal base for Russian firms trying to enter the EU market and for EU companies targeting the CIS markets. Other upside risks to inflation over the medium term include those that arise from the Balassa-Samuelson (BS) effect and further tariff harmonization required by EU accession. The BoL argues in a recent study that the BS effect is probably small in Latvia. Staff noted the difficulties in measuring this effect with any precision in a transition economy and that estimated effects in many other countries were generally positive. The harmonization of tariffs will put additional upward pressure through higher administered prices. The direct impact on CPI inflation should peak in 2004 at about one percentage point and then subside gradually with the last adjustment scheduled for end-2007.

15. **Assuming gradual fiscal consolidation and efforts to tackle other potential vulnerabilities, medium-term fiscal and external sustainability would be maintained.** With real GDP expected to grow by about 6 percent per annum as the catch-up process

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[6] See Annex III of "Republic of Latvia: 2003 Article IV Consultation—Staff Report" (IMF Country Report No. 03/113) for a detailed discussion on Latvia's medium term growth outlook.

[7] The Latvian shipping company, LASCO, will have to modernize its fleet, and the state energy company, Latvenergo, will have to introduce more efficient turbines.

continues, external debt would remain sustainable in the staff's scenario, despite the large current account deficit. Assuming a conservative path for FDI, gross external debt could reach almost 100 percent of GDP by 2008 (Table 6). However, net external debt would increase to 40 percent of GDP and in most of the stress test scenarios envisaged would remain under 60 percent of GDP. The risks emanating from the short term nature of non-resident deposits (which constitute over 50 percent of gross external debt) or from their possible dubious origins are relatively limited (see Box 6 on dollarization and the "Uruguay effect" in the Staff Report for the 2003 Article IV Consultation—IMF Country Report No. 03/113). Leakages from these deposits to the domestic market are small and effected only by two banks, which are not systemically important. Assessing public debt sustainability, however, is made difficult by the absence of an official medium-term budgetary framework (see ¶25). Given the low level of public debt, it is unlikely that a looser fiscal deficit path than envisaged by staff could in itself cause fiscal sustainability problems. But such a path, together with continuing rapid credit growth, could jeopardize external sustainability and make the economy more vulnerable to external shocks. It could also generate financing problems—although FDI could well be higher than projected by staff. Staff also noted that the import cover of foreign reserves had declined to 2.5 months and was expected to decrease further this year. The authorities pointed out that this was due to the impressive import growth rate driven by one-off capital goods purchases; in real terms reserves had continued to grow. Also, the new

Latvia: Indicators of External Debt and Vulnerability, 1999-2003

	1999	2000	2001	2002	2003	
					Q2	Q4
Gross external debt (in millions of U.S. dollars)	3,821	4,714	5,570	6,972	7,754	9,142
(in percent of GDP)	52.9	61.0	67.7	75.6	76.4	82.6
of which:						
Public sector external debt (in millions of U.S. dollars)	708	706	859	919	980	999
(in percent of GDP)	9.8	9.1	10.4	10.0	9.7	9.0
Short-term external debt (in millions of U.S. dollars) 1/	2,344	2,818	3,341	4,483	4,812	5,883
(in percent of GDP)	32.5	36.5	40.6	48.6	47.4	52.9
of which:						
Nonresident deposits	1,240	1,824	2,267	3,257	3,649	4,632
(in percent of GDP)	17.2	23.6	27.6	35.3	36.0	41.7
Gross official reserves (in millions of U.S. dollars)	944	919	1,218	1,327	1,368	1,535
(ratio to short-term debt)	0.40	0.33	0.36	0.30	0.28	0.26
(ratio to short-term debt less non-resident deposits)	0.86	0.93	1.13	1.08	1.18	1.23
(ratio to reserve money)	104.6	99.4	134.7	120.0	110.8	106.0
Bond market indicators						
Foreign currency long-term debt rating 2/	BBB	BBB	BBB	BBB+	BBB+	BBB+
Spread of benchmark bond (percentage points) 3/	1.66	1.12	1.09	0.79	0.56	0.33

Sources: Latvian Authorities, Datastream, Standard & Poor's.
1/ Remaining maturity basis.
2/ S&P. In August, Latvia was upgraded to BBB+.
3/ End-of-period spread of Eurobond maturing in 2004. Starting 2003, end-of-period spread of Eurobond maturing in 2008.

Eurobond issue and the expected increase in capital inflows should increase reserves further. Reserves remain over 120 percent of short-term external debt, excluding non-resident deposits, and 100 percent of reserve money.

B. ERM2 Entry and Monetary Policy

16. **The authorities plan to enter ERM2 in January 2005 and introduce the euro in January 2008—following the EU assessment in mid-2007.** The BoL and various commercial banks noted that this schedule should allow all stakeholders sufficient time to prepare. The authorities did not consider that speeding up the process by repegging the lats to the euro before entering ERM2 would be desirable, since a January repegging had already been incorporated in private agents' plans. In addition, the switch from the SDR to the euro would require adjustments in the financial system (see below). For these reasons, staff supported the proposed entry path, which is slower than Latvia's Baltic neighbors. The authorities intend to adopt the lats-euro market exchange rate immediately prior to entry as the ERM2 parity and to continue to use a narrow band (plus/minus1 percent) during the ERM2 period. They noted that using a different parity, after the lats-SDR peg had been successfully maintained for 10 years, could diminish the BOL's credibility. Moreover, there were no signs of a misalignment—notwithstanding the large current account deficit. Staff agreed with this assessment, but felt that as a precaution against any risk of misalignment, the parity choice should be revisited again prior to ERM2 entry.

17. **The authorities described the supporting measures they would take to guarantee a successful ERM2 entry.** Regarding the special reserve management procedures involved in the repegging, the BoL noted that, to reequilibrate its portfolio, it had contacted the Bank for International Settlements (BIS) and other counterparts to conclude a series of forward contracts and swaps to hedge about 60 percent of its reserves. The currency composition of reserves is being adjusted to reflect the reduction in risk of euro fluctuations, and the corresponding increase in risk of other currencies. The process should be completed before the end of the year. Staff stressed that similar adjustments would have to be undertaken by commercial banks, enterprises, and, especially, individuals to avoid serious currency mismatches. In particular, given the widespread financial dollarization, the adjustment may involve the refinancing of mortgages and long-term loans, amendments to outstanding contracts, and the preparation of new templates for future contracts. The authorities pointed to their extensive information campaign directed at commercial banks and the public.

18. **The mission stressed the need to further improve monetary management in preparing to join the EMU.** In particular, to familiarize commercial banks with standard instruments, open market operations should be developed further and substitute the widespread use of foreign exchange rate swaps. The BoL noted that commercial banks found swaps to be the cheapest way to manage liquidity and that there was no problem with confidence in BoL policies or currency stability. The mission agreed with this interpretation, but pointed out that existing liquidity provision procedures available to euro-area countries

were mainly based on open market operations. For this reason, the ERM2 period should be used to train banks and streamline the procedures for open market operations.

C. Financial Sector

19. **The financial system's stability was the object of an updated analysis of FSAP-related issues.** The banking system is well capitalized, profitable, and liquid, but the authorities agreed that the rapid credit growth, the high proportion of nonresident deposits, and the volatility of the dollar-euro exchange rate were a major concern. The BoL and FCMC prepared, with staff assistance, specific stress tests. These revealed that the banking system was highly resilient to the first-round effects of possible shocks, including severe deterioration of overall credit quality or of the mortgage portfolio, and large changes in interest rates or the exchange rate. Nevertheless, to minimize financial institutions' risk exposure and to reduce vulnerabilities generated by rapid credit growth—for example possible balance sheet problems for borrowers-the mission supported the authorities' cautious initiatives to tighten prudential guidelines, in particular in relation to mortgage loans. The authorities agreed that such measures should be applied judiciously because they had the potential to distort the financial market, create perverse incentives, and their effect on overall credit growth would likely be limited.

Box 3. Banking System Strengths and Vulnerabilities, and Prudential Responses

There has been no deterioration of credit quality, and banks are resilient to a decline in credit quality:

- NPLs are 1.4 percent of total loans;
- If a collapse of real estate values forced banks to write off 30 percent of their exposure, no bank would be at risk of bankruptcy unless there are significant second round effects.

Exposure to exchange rate, liquidity, interest rate and real sector risks are contained, and no bank is at risk of insolvency under stress test scenarios. In particular:

- Banks are subject to a maximum on their total NOP exposure, equivalent to 20 percent of capital;
- Liquid asset holding by banks exceeds their foreign currency deposits;
- Interest rate risk is limited by the fact that marketable securities comprise almost 40 percent of bank assets, and most loans are priced in relation to a variable reference rate;
- Real sector risks are diversified, because, apart from households, bank lending is not concentrated in any one economic sector.

Intensified surveillance of banks is advisable, but the use of prudential controls as a credit rationing measure is likely to have limited effects.

- The FCMC should encourage banks to maintain conservative risk guidelines, including tightening loan-to-value guidelines, and should carefully monitor systems and guidelines for asset valuation, documentation and certification;
- Banks should be encouraged, as far as possible, to match the currency of the denomination of loans to the currency of the borrower's earnings.

D. Fiscal Policy

20. **The authorities' 2004 budget envisages a deficit of 2.2 percent of GDP, 1 percentage point lower than the original 2003 budget**—but higher than the actual 2003 outcome. The budget makes an effort to cut discretionary expenditure (in real terms) to allow for EU and NATO related spending. Higher-than-expected GDP resulted in significant overperformance in 2003 and continues to do so in 2004. Revenues in May did not appear to suffer as much as expected from EU accession, although some risks remain, because of procedural changes associated with the introduction of new EU borders.

21. **Given the potential risks of overheating for inflation and the current account, and the strong revenue performance so far in 2004, staff urged the authorities to explore the possibility of restraining expenditure below budget in 2004** and, at a minimum, use any additional revenues to lower the deficit. Staff projects that revenues for the year as a whole could be higher than originally budgeted by ½ percent of GDP, given the larger-than-projected tax base, and recent performance. While the authorities are receptive to this outlook, they are reluctant to revise revenue projections before the fall of 2004, when the impact of EU accession will become clearer.

22. **A supplementary budget will be prepared in the fall.** The amendments will incorporate increased spending for the second biannual adjustment of pensions to inflation and for cofinancing of EU funds. Staff urged the authorities to find savings elsewhere to make room for these changes—for example by reducing expenditure on goods and services in the main budget. The BoL expressed its open support for an immediate fiscal tightening, noting the limited power of monetary policy in controlling inflationary pressure, and the delay between taking fiscal measures and their effect on inflation. Some members of the cabinet, however, voiced their outspoken opposition to this proposal.

23. **For 2005, the authorities are considering a tentative fiscal deficit target of about 2 percent of GDP.** In the absence of detailed information during the mission on the authorities' expenditure and revenue projections, a full discussion of the budget was postponed. Staff argued that, given the favorable macroeconomic environment and the need to pre-empt increased risk of excess demand, a budget deficit target of around 1¼ percent of GDP would be both desirable and feasible. The authorities pointed out that their deficit target took account of the large cofinancing need, the lag in receiving EU funds, and the need for infrastructural spending to sustain growth. The mission acknowledged the importance of these factors, but urged the authorities to make efforts to free resources by limiting discretionary spending. Staff also stressed that the planning of cofinancing related to the disbursement of EU funds and the budget formulation process should be coordinated in a multiyear context. In the absence of such a framework, for example, the bulk of an advance payment by the EU of LVL 100 million for the period 2004–06, was included in the 2004 budget.

24. **In the medium term, a balanced budget remains the authorities' objective, but their plans do not appear to support it.** The authorities agreed with the mission that fiscal consolidation was crucial to curb the large current account deficit and to ensure a fiscal balance consistent with successful membership in the euro area. However, they noted that too rapid an adjustment could hamper the objective of catching up. The absence of a medium-term budgetary framework makes it difficult to assess the authorities' plans. However, based on the mission discussions and the authorities' Convergence Programme finalized after the mission, they appear to be willing to maintain a deficit of about 2 percent for the next few years. The mission urged the authorities to speed up fiscal consolidation, given the large current account deficit and the risks of overheating. According to staff's projections, assuming trend GDP growth, the deficit could be lowered by about 0.2 percentage points annually, without hampering EU-related and social expenditure. This would require expenditures on wages, goods and services, and transfers to grow below nominal GDP.

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

	2002	2003	2004	2005	2006
Grants	0.5	1.3	2.6	3.7	4.0
Budget support	...	...	0.4	0.3	0.2
Pre-accession instruments	0.5	1.3	1.0	0.8	0.5
Post-accession instruments	...	...	1.2	2.7	3.3
of which : Agriculture	...	...	0.4	1.1	1.4
Contributions to the EU budget	...	...	0.7	1.0	1.0
Memo : Net cash flow with the EU	0.5	1.3	1.9	2.7	2.9
EU-related expenditure 1/	0.3	1.8	3.8	4.4	4.6
Spending of pre-accession grants	0.2	1.4	1.1	0.9	0.5
Co-financing for pre-accession grants	0.1	0.4	0.4	0.3	0.2
Spending of post-accession grants	...	...	1.6	2.7	3.3
Advance payments for agriculture	...	...	0.4	...	...
Co-financing for post-accession grants	...	...	0.3	0.5	0.6
Memoranda :					
General government revenue and grants	33.0	33.4	33.9	34.8	35.0
General government expenditures and net lending	35.4	35.0	35.3	36.1	36.1
o/w: EU-related and contributions to EU budget	0.3	1.8	4.5	5.4	5.6
General government fiscal deficit	-2.4	-1.6	-1.5	-1.3	-1.1
Discretionary spending (LVL millions)	1342	1430	1466	1523	1648
Discretionary spending 2/	23.6	22.6	20.9	19.9	19.7
Discretionary spending (percent real growth) 2/	...	3.1	-1.5	0.9	5.2

Source: 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.

25. **The authorities agreed that developing a medium-term budget framework would greatly enhance fiscal policy.** Such a framework is crucial for strengthening the budgeting of resources, including EU funds. However, they argued that Latvia lacked the capacity and preparedness to implement a multiyear budget. The strategic planning process piloted by the Ministry of Agriculture, which aims to link budgetary resources to policy objectives, has been successful; however, it has had little impact on actual budget formulation because other line ministries are lagging behind. Nevertheless, this approach will be extended progressively to other line ministries. By 2006 all line ministries are expected to develop strategic plans, which will be used to formulate a multiyear budget.

E. Structural and Other Issues

26. **Strengthening the flexibility of the Latvian economy is key to a successful integration with the European community.** Reforms are under way in four key areas.

Corruption and money laundering

- After its successful enforcement efforts, KNAB will now focus on prevention and education. The mission commended the bureau for the impressive results, but noted that enforcement should remain strong. In view of the proposed transfer of supervisory function from the PM office to Parliament, staff reiterated the need to maintain the bureau's independence from political pressure.

- The authorities noted that the recent inclusion of Latvia in the list—compiled by the U.S. Treasury—of countries deeply involved in money laundering was the result of indirect inference, based mainly on aggregate indicators rather than explicit evidence. The list, for example, also includes the United States and Germany. The mission agreed that after the latest legislative amendments more time was needed to see the results of ongoing investigations.

Business environment and privatization

- Improvements in the business environment are noticeable. The World Economic Forum on Competitiveness has lately assigned Latvia a very high ranking, just after Estonia. As recommended by the Fund and the World Bank, business surveys are now conducted and the results published on a regular basis on the website: www.lda.gov.lv. Staff commended the authorities for their constructive dialogue with the Foreign Investors' Council and the practice of elaborating annual action plans. However, it noted that further improvements are necessary to attract foreign investments. In particular, amendments to the law on insolvency are needed to better guarantee creditors' rights; and public procurement procedures, especially at the regional and municipal level, should be streamlined and made more transparent.

- New public utility and telecommunication tariffs were established in 2003, aimed at promoting competition. The separation of the production, transmission, and distribution functions was completed from an accounting perspective for the large energy providers. However, the authorities felt that the privatization of the remaining public concerns should follow an appropriate restructuring. More recently, the Prime Minister has publicly stated that Lattelekom should not be privatized.

- Latvia has adopted EU's trade policy and agreements. While acknowledging that several glitches on the eastern border had obstructed imports and exports for several days, the authorities noted that these had been rapidly corrected.

Public sector reforms

- The public administration is being reformed after the needed legislation took force at the beginning of 2003. Under this law, by 2006 all state agencies will have to operate as nonprofit institutions.

- The authorities stated that although the civil servant pay reform initiated in 2002 had stalled for lack of resources, it would be pursued next year.

Data issues

- The authorities found the data ROSC very useful, and confirmed their intention to implement all the remaining recommendations.

III. Staff Appraisal

27. **Following the successes of the past decade, Latvia is in a strong position to maintain high growth and benefit from the opportunities offered by EU accession and the forthcoming euro adoption.** Overall, prospects are favorable. Given the success with the hard peg during the last ten years, Latvia is generally well-placed for ERM2 entry and euro adoption. EU accession should over time create positive synergies, thus supporting structural reforms and fiscal consolidation, and reduce risk premium and interest rates, thus fostering financial integration. Risks, however, need to be recognized. The current account deficit (albeit in good part financed by FDI) is large and feeds into external debt; a credit-fed boom could create an overheating episode or a weakening of bank balance sheets; and a recent spurt in inflation could become entrenched. The burden of preempting any of these risks will fall mainly on fiscal policy and bank supervision. Over the longer term, real convergence will require attention to maintaining a flexible labor market, an appropriate level of competitiveness and structural conditions aimed at boosting Latvia's growth potential.

28. **The immediate challenge is to secure a smooth ERM2 entry.** The authorities' overall strategy for repegging and ERM2 accession appears appropriate. The announced entry path, which is slower than Latvia's Baltic neighbors, is justified. The exchange rate does not

appear to be misaligned and the market lats-euro exchange rate at the time of entry will likely be the appropriate entry rate. It would be wise, however, to reassess the risks of misalignment prior to entry.

29. **Fiscal policy will increasingly be the principal tool of demand management and will need to curb any emerging excesses in demand growth or the current account deficit.** Further tightening in 2004–05 would reduce the risks of overheating and increase the flexibility of fiscal policy over the course of the business cycle. It is paramount that the supplementary budget in the fall not include new spending, and that savings in discretionary spending be found to accommodate the necessary adjustments caused by the inflation indexation of pensions and increased cofinancing needs. In addition, any revenues in excess of the budgeted amount should be used to lower the deficit. For 2005, these considerations suggest that a deficit target of around 1¼ percent of GDP would be optimal. Such a target, together with the need to make room for recent tax rate reductions raise the urgency for discretionary spending cuts. Over the medium term, favorable revenues developments should be used to tackle the risks of excess demand and improve Latvia's external position.

30. **In order to enhance the quality of fiscal policy and the credibility of medium-term objectives, the development of a medium-term budgetary framework should be accelerated.** Such a framework would help plan expenditure out of EU funds and facilitate the medium-term stabilizing role of fiscal policy. In the absence of such a framework, the authorities' medium-term plans cannot be satisfactorily assessed.

31. **Strengthening fiscal policy and fiscal flexibility is also needed in order to tackle increased risks resulting from rapid credit growth.** While credit growth is largely a reflection of Latvia's developmental needs and does not appear to have contributed to the recent rise in inflation, it has increased vulnerabilities to shocks. A more flexible fiscal policy would enable the authorities to address such shocks in a more effective and speedy manner.

32. **While the financial system is sound, tighter prudential guidelines could also help reduce risks that rapid credit growth will lead to worsening portfolio quality.** The banking system appears resilient to the impact of a wide range of shocks. However, because continued rapid credit growth carries the danger of deterioration in loan quality as well as potential balance sheet problems for borrowers, the authorities could judiciously tighten prudential guidelines, while bearing in mind their likely limited impact on overall credit growth. Furthermore, while leakages from non-resident deposits to the domestic credit market are at present very small, given the large magnitude of these deposits, careful monitoring is called for. In particular, the rather strict rules on open positions may not be sufficient to forestall the risks associated with a sudden withdrawal of these deposits; and the FCMC should make sure that banks maintain matching and high-quality liquid assets.

33. **Progress against corruption and the fight against AML need to be accelerated.** KNAB's enforcement efforts have been successful. However, the announced shift of emphasis toward prevention should not translate into lax enforcement. It is also crucial that

KNAB remain independent from political pressure. Recent amendments to the AML legislation should bear fruit soon after the ongoing investigations are completed.

34. **The quality and timeliness of statistics are adequate for surveillance purposes and the statistical system is functioning well.** The authorities should proceed with implementing the recommendations of the data ROSC, in particular concerning the compilation of the CPI, government financial statistics, and some monetary statistics.

35. 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 1. Latvia: Selected Economic Indicators, 2000–04

	2000	2001	2002	2003	2004 proj.
Output, prices, and employment	(Annual percent change, unless otherwise stated)				
Real GDP	6.9	8.0	6.4	7.5	6.5
Real industrial production	3.3	8.5	5.8	7.2	...
Consumer price index (average)	2.6	2.5	1.9	2.9	5.5
(End-of-period)	1.8	3.2	1.4	3.6	5.0
Unemployment rate (in percent)					
Registered unemployment 1/	8.4	8.8	7.8	8.9	...
ILO definition	14.4	13.1	12.4	10.6	...
Real wage	3.3	3.9	6.4	8.2	...
Consolidated government	(In percent of GDP)				
Revenue	34.6	32.8	33.0	33.4	33.9
Expenditure and net lending	37.6	34.9	35.4	35.0	35.3
Fiscal balance	-3.0	-2.0	-2.4	-1.6	-1.5
Gross government debt 2/	12.2	13.8	13.3	13.4	...
Money and credit	(Annual percent change, unless otherwise stated)				
Broad money (millions of lats)	1,275.3	1,540.5	1,862.6	2,256.5	2,736.4
Broad money (M2X)	27.9	20.8	20.9	21.1	21.3
Lats broad money	25.8	21.3	24.2	23.5	22.5
Credit to nongovernment	36.7	50.4	36.5	37.3	29.0
FX deposits (U.S. dollar millions)	647.3	743.6	906.7	1,147.8	...
FX deposits (percent of M2X)	31.1	30.8	28.9	27.5	...
Broad money to FX reserves ratio	235.3	202.1	239.0	272.8	...
Interest rates (annualized)					
BoL basic rate	3.5	3.0	3.0	3.0	...
Money market (one month)	3.3	5.5	2.9	3.3	...
Balance of payments	(In millions of USD, unless otherwise stated)				
Gross official reserves	919	1,218	1,327	1,535	1,562
(In months of prospective imports of GNFS)	2.6	3.1	2.6	2.5	2.2
Current account balance	-493	-732	-602	-956	-1,225
(In percent of GDP)	-6.4	-8.9	-6.5	-8.6	-9.3
Trade balance	-1,058	-1,351	-1,444	-1,998	-2,490
Exports GNFS	3,271	3,404	3,828	4,698	5,572
Imports GNFS	-3,886	-4,259	-4,728	-6,112	-7,389
Gross external debt (in percent of GDP)	61.0	67.7	75.7	75.7	77.0
Net External debt (in percent of GDP)	13.1	18.5	21.6	22.6	25.6
Exchange rates					
Lats per U.S. dollar	0.613	0.638	0.594	0.541	...
(yoy percent change, + means depreciation)	5.1	4.1	-6.9	-8.9	...
REER (end-of period; CPI based)	98.9	96.9	91.4	87.3	...
(yoy percent change, + means appreciation)	0.2	-2.0	-5.6	-4.5	...

Sources: Latvian authorities; and staff estimates.

1/ Figures for 2002 and 2003 are based on a new definition of economically active population (aged from 15 years to the retirement age instead of aged 15 years and over). The authorites have not revised the data for earlier years.
2/ Excluding government guaranteed debt.

Table 2. Latvia: Balance of Payments, 2000–08

	2000	2001	2002	2003	2004	2005	2006	2007	2008
				Prelim			Projections		
				(In millions of U.S. dollars)					
Current Account	-493	-732	-602	-956	-1225	-1185	-1170	-1215	-1286
excluding official transfers	-529	-756	-635	-1026	-1438	-1574	-1631	-1677	-1747
Goods	-1058	-1351	-1444	-1998	-2490	-2698	-2868	-3072	-3332
Exports	2058	2216	2576	3171	3755	4378	4992	5638	6361
Imports	-3116	-3567	-4020	-5169	-6246	-7075	-7860	-8710	-9693
Services	443	496	590	583	674	778	913	1081	1260
Transportation	559	561	584	595	696	763	857	972	1092
Travel	-117	-105	-68	-106	-129	-123	-115	-104	-90
Other	1	40	74	95	107	138	170	213	258
Income	24	45	-7	-59	-86	-144	-173	-210	-228
Current transfers	98	78	260	517	678	878	959	986	1014
Official	36	24	33	70	213	390	462	462	462
Private 1/	62	54	227	447	465	489	497	524	552
Capital and Financial Account	548	999	716	951	1257	1269	1329	1334	1398
Capital Account	29	44	18	34	37	39	42	46	50
Financial Account	519	956	698	917	1220	1229	1287	1289	1348
Direct Investment	400	170	374	328	365	363	356	359	353
Portfolio investment 2/	-319	133	-216	-219	16	-259	-285	-314	-361
Other Investment	437	653	541	808	838	1125	1216	1243	1356
Trade Credits, Loans and Other	274	358	-239	415	...	...	...	...	...
Deposits	163	295	780	393	...	...	...	...	...
Errors and omissions	-27	47	-62	97	0	0	0	0	0
Overall Balance, Net reserve assets	28	314	12	79	32	84	159	119	112
Memorandum items:				(In percent of GDP, unless otherwise indicated)					
Current account balance	-6.4	-8.9	-6.5	-8.6	-9.3	-8.2	-7.4	-7.1	-6.8
Trade balance	-13.7	-16.4	-15.7	-18.1	-18.8	-18.7	-18.2	-17.9	-17.7
Merchandise exports	26.6	26.9	28.0	28.7	28.4	30.3	31.7	32.8	33.9
Merchandise imports	-40.3	-43.4	-43.7	-46.7	-47.3	-49.0	-49.9	-50.6	-51.6
Services, income & transfers balance	7.3	7.5	9.1	9.4	9.6	10.5	10.8	10.8	10.9
Gross official reserves (millions of US$)	919	1,218	1,327	1,535	1,562	1,646	1,805	1,924	2,038
in months of GNFS imports	2.6	3.1	2.6	2.5	2.2	2.1	2.1	2.0	1.9
Value growth of merchandise exports (percent) 3/	9.0	7.6	16.2	23.1	18.4	16.6	14.0	12.9	12.8
Value growth of merchandise imports (percent)	6.9	14.4	12.7	28.6	20.8	13.3	11.1	10.8	11.3
Terms of Trade, GNFS (percent)	-3.0	0.0	-1.5	-2.4	-0.3	2.8	2.1	0.9	0.6
Net FDI / Current Account, percent 4/	81	23	62	34	30	31	30	30	27
Net FDI / GDP	5.2	2.1	4.1	3.0	2.8	2.5	2.3	2.1	1.9
Gross external debt	61.0	67.7	75.7	82.6	82.8	87.9	91.8	95.6	98.4
Net external debt	13.1	18.5	21.6	25.1	27.7	31.2	34.2	37.6	40.6

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 400 million and related 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.

Table 3. Latvia: Consolidated General Government, 2001–05
(In millions of lats, unless stated otherwise)

	2001	2002	2003			2004		2005
				Supp				
	Act.	Act.	Budget	Budget	Act.	Budget	Proj	Proj.
Revenue 1/	1697	1876	2025	2086	2109	2329	2371	2658
Tax revenue	1450	1582	1654	1722	1783	1864	1901	2078
Direct taxes	865	960	969	987	1023	1080	1102	1203
Corporate income tax	98	110	105	93	94	86	87	95
Personal income tax	285	321	334	348	367	393	401	437
Social taxes 2/	481	529	530	545	562	601	614	670
Indirect taxes	573	622	667	717	742	764	779	854
Taxes on goods & services	527	576	624	664	690	717	731	802
VAT	351	383	415	446	459	481	490	535
Excises	161	178	194	202	212	225	229	251
Customs duty	15	15	15	17	19	11	11	16
Property taxes	47	47	43	52	52	47	48	53
Other (incl. taxes in transit)	12	0	18	19	18	20	20	20
Non-tax revenue	247	294	371	364	326	465	470	580
of which : EU grants	31	28	84	69	51	200	200	285
Expenditure	1804	2031	2200	2276	2239	2494	2494	2759
of which: EU related	...	19	101	...	...	287	312	415
Current expenditure	1623	1815	1959	2037	2018	2226	2226	2421
Wages & salaries	425	495	536	543	562	587	587	629
of which: soc sec contributions	85	103	104	106	106	114	114	122
Goods & services	315	334	370	433	403	453	453	481
Contributions to the EU budget	...	...	...	...	...	50	50	78
Interest	40	44	67	68	64	71	71	70
Subsidies & transfers	839	941	986	993	989	1065	1065	1164
Transfers to households	590	628	661	667	647	696	696	760
Other	248	313	325	325	341	369	369	404
Other expenditure 3/	3	0	0	0	0	0	0	0
Capital expenditure	182	215	241	239	222	268	268	338
Financial balance 4/	-108	-154	-175	-190	-131	-166	-123	-101
Net lending (+)	-3	-15	3	-15	-26	-29	-21	-2
Fiscal balance 4/	-105	-139	-178	-175	-104	-137	-103	-99
Financing	105	139	178	175	104	137	103	99
Privatization receipts	32	37	3	3	10	...	...	...
Domestic	-35	111	-26	-26	162	...	...	...
Banks	-81	84	-107	-107	192	...	...	...
BOL	-99	97	-124	-124	60	...	...	...
Commercial banks	18	-14	16	16	132	...	...	...
Other domestic	46	27	81	78	-30	...	...	...
Foreign	108	-9	201	201	-68	...	...	...
Memorandum items: 4/				(in percent of GDP)				
Revenue, *of which* :	32.8	33.0	35.9	37.0	33.4	37.8	33.9	34.8
Tax revenue	28.1	27.8	29.3	30.5	28.2	30.2	27.1	27.2
EU grants	0.6	0.5	1.5	1.2	0.8	3.2	2.9	3.7
Expenditure, *of which:*	34.9	35.7	39.0	40.3	35.4	40.4	35.6	36.1
Wages & salaries (net of social taxes)	6.6	6.9	7.7	7.8	7.2	7.7	6.8	6.6
Transfers to households	11.4	11.0	11.7	11.8	10.2	11.3	9.9	9.9
Capital expenditure	3.5	3.8	4.3	4.2	3.5	4.4	3.8	4.4
EU-related and contributions to EU budget	...	0.3	...	...	1.8	4.7	4.5	5.4
Non-EU related	...	35.3	...	...	37.2	35.8	31.2	30.7
Net lending	-0.1	-0.3	0.1	-0.3	-0.4	-0.5	-0.3	0.0
Fiscal balance 5/	-2.0	-2.4	-3.2	-3.1	-1.6	-2.2	-1.5	-1.3
Including spending via the LPA 6/	...	-2.7	...	...	...	...	...	...
Social Budget 7/				(in millions of lats)				
Revenues (social taxes)	481	529	530	545	562	601	614	670
Transfers to individuals	478	511	540	523	523	548	548	599
Pensions	439	464	490	473	469	490	490	535
Balance	3	18	-10	23	39	53	65	71
In percent of GDP	0.1	0.3	-0.2	0.4	0.6	0.9	0.9	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/ Figures for 2004 budget are based on the original GDP assumption.
5/ UMTS license receipts of LVL 8 million in 2002, treated as revenues in the authorities' presentation, here are treated as financing.
6/ Additional LPA spending directed by decrees that is *not* effected through the Treasury.
7/ Revenues include only first pillar social taxes; expenditures include only transfers to households.

Table 4. Latvia: Monetary Developments, 2000–04
(In millions of lats)

	2000	2001	2002	2003				2004			2004
	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec	Mar	Apr	May	Dec. Proj.
Bank of Latvia											
Reserve money	566.7	616.4	754.4	702.8	762.5	783.2	806.0	755.3	820.6	798.5	908.7
Currency	482.3	556.0	622.6	604.9	628.8	632.4	682.1	649.6	666.3	657.9	772.4
Reserves	84.4	60.4	131.8	97.9	133.7	150.8	123.8	105.7	154.3	140.6	136.3
Net foreign assets 1/	542.0	762.0	779.2	689.6	772.3	837.3	827.2	809.6	1,007.8	867.2	843.1
Net domestic assets 1/	24.7	-145.6	-24.8	13.2	-9.8	-54.1	-21.2	-54.4	-187.2	-68.7	65.6
Domestic credit	70.1	-57.4	44.7	73.5	59.3	11.4	44.4	5.9	-134.9	-2.2	129.2
Banks	42.5	18.8	30.7	60.8	102.3	73.6	59.3	49.4	63.5	5.9	127.2
Government (net)	27.5	-76.3	14.1	12.6	-43.0	-62.2	-15.0	-43.5	-198.4	-8.0	2.0
Other items net	-45.4	-88.1	-69.5	-60.2	-69.1	-65.5	-65.6	-60.3	-52.3	-66.5	-63.6
Of which: Time deposits	…	22.0	-2.4	-0.4	0.0	0.0	0.0	0.0	0.0	-7.0	0.0
Monetary Survey											
Broad money	1,275.3	1,540.5	1,862.6	1,912.0	2,003.7	2,065.2	2,256.5	2,346.3	2,418.0	2,472.5	2,736.4
Currency	427.7	485.2	543.2	531.0	551.2	560.3	601.1	578.4	587.6	585.4	687.4
Deposits	847.7	1,055.2	1,319.4	1,380.9	1,452.5	1,504.9	1,655.4	1,767.9	1,830.4	1,887.0	2,049.0
Of which: Residents' FX deposits	396.8	474.4	538.6	568.3	585.1	610.6	621.0	643.0	654.1	669.4	733.4
Net foreign assets	538.3	534.4	353.5	308.8	298.7	207.4	78.9	-38.6	171.6	46.9	-158.7
Net domestic assets	737.0	1,006.1	1,509.1	1,603.2	1,704.9	1,857.7	2,177.6	2,384.9	2,246.5	2,425.6	2,895.1
Domestic credit	1,062.5	1,447.0	2,022.5	2,131.8	2,290.8	2,465.4	2,815.1	3,013.5	2,886.6	3,107.3	3,576.8
Private sector	909.4	1,368.0	1,867.9	2,001.3	2,166.4	2,360.3	2,564.9	2,800.5	2,919.4	3,001.5	3,309.7
Government (net)	153.0	79.0	154.7	130.5	124.4	105.1	250.2	213.0	-32.7	105.8	267.1
Other items net	-325.5	-440.9	-513.4	-528.6	-585.8	-607.6	-637.5	-628.6	-640.2	-681.7	-681.7
Memorandum Items:											
Annual percentage change											
Reserve money	7.7	8.8	22.4	11.2	14.5	19.2	6.8	7.5	16.2	9.5	12.7
Broad money	27.9	20.8	20.9	16.3	17.2	19.1	21.1	22.7	24.5	25.5	21.3
Private sector credit 2/	36.7	50.4	36.5	38.2	41.5	40.5	37.3	39.9	42.6	42.6	29.0
Velocity	3.8	3.4	3.1	3.0	3.1	3.1	3.1				2.9
Money multiplier	2.250	2.499	2.469	2.721	2.628	2.637	2.800	3.107	2.947	3.096	3.011
Exchange rate (LVL/US$)	0.613	0.638	0.594	0.587	0.569	0.565	0.541	0.543	0.553	0.544	0.530
Net foreign assets (in millions of US$)	878.2	837.5	595.1	526.0	525.0	367.1	145.8	-71.1	310.2	86.1	-299.5
Bank of Latvia	884.3	1,194.4	1,311.8	1,174.7	1,357.3	1,481.9	1,529.0	1,491.0	1,822.5	1,594.1	1,590.7
Stock of swaps (in millions of US$)	184.1	206.8	244.7	70.2	168.9	273.8	128.8	53.8	54.1	23.0	...
Of which: Short-term swaps	100.5	27.9	148.6	16.6	138.8	265.7	128.8	53.8	54.1	23.0	...
Commercial banks	-6.0	-356.8	-716.7	-648.7	-832.3	-1,114.7	-1,383.2	-1,562.1	-1,512.3	-1,508.0	-1,890.2
Change in NIR (in millions of US$, cumulative)	-13.0	310.1	117.4	-137.1	45.5	170.1	217.2	-37.9	293.5	65.1	61.7

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, 2001–08

	2001 1/	2002	2003	2004	2005	2006	2007	2008
			Est.	Projections				
Foreign savings 2/ 3/	8.9	6.5	8.6	9.3	8.2	7.4	7.1	6.8
Gross national saving	18.0	20.3	20.2	20.8	22.8	24.0	25.0	25.2
Nongovernment	16.5	19.2	18.8	18.7	19.7	20.2	20.4	20.4
Government 4/	1.4	1.1	1.4	2.1	3.1	3.8	4.6	4.8
Gross investment	26.9	26.8	28.8	30.0	31.0	31.5	32.1	32.1
Nongovernment capital formation 3/ 5/	23.4	23.3	25.8	26.5	26.6	26.6	26.6	26.5
Government fixed capital formation 6/	3.5	3.5	3.1	3.5	4.4	4.9	5.5	5.5
Memorandum item:								
Nongovernment savings-investment balance	-6.9	-4.1	-7.0	-7.8	-6.9	-6.3	-6.2	-6.2
Government savings-investment balance	-2.0	-2.4	-1.6	-1.5	-1.3	-1.1	-0.9	-0.7
Revenues	32.8	33.0	33.4	33.9	34.8	35.0	35.1	35.2
Expenditures and net lending	34.9	35.4	35.0	35.3	36.1	36.1	35.9	35.9
Real GDP growth rate	8.0	6.4	7.5	6.5	6.0	6.0	6.0	6.0
Inflation (annual average rate)	2.5	1.9	2.9	5.5	3.5	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/ 2001 figures 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.

Table 6. Latvia: External Sustainability Framework, 1999–2008
(In percent of GDP, unless otherwise indicated)

		1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
						Projections					
1	External gross-debt	52.9	61.0	67.7	75.7	82.6	82.8	87.9	91.7	95.6	98.3
	External net-debt	11.5	14.1	18.5	21.6	25.1	27.7	31.2	34.2	37.6	40.5
2	Change in external gross debt	2.0	8.1	6.7	8.0	6.8	0.2	5.1	3.9	3.8	2.7
3	Identified external debt-creating flows (4+8+11)	1.3	0.4	2.6	-2.2	-8.6	-6.8	-2.0	-3.1	-3.6	-4.0
4	Current account deficit, excluding interest payments	7.7	4.9	6.9	4.4	6.5	7.3	6.2	5.3	4.9	4.6
5	Deficit in balance of goods and services	9.6	8.0	10.4	9.8	12.8	13.7	13.3	12.4	11.6	11.0
6	Exports	40.3	42.3	41.4	41.6	42.4	42.2	44.5	46.2	47.8	49.3
7	Imports	49.9	50.3	51.8	51.4	55.2	55.9	57.8	58.6	59.3	60.3
8	Net non-debt creating capital inflows (negative) 1/	-3.6	-2.1	-2.7	-2.7	-3.6	-3.8	-3.6	-3.5	-3.3	-3.2
9	Net foreign direct investment, equity	2.5	2.7	2.6	2.7	1.8	2.1	1.9	1.8	1.6	1.5
10	Net portfolio investment,equity	1.2	-0.6	0.1	0.0	1.9	1.7	1.7	1.7	1.7	1.7
11	Automatic debt dynamics 2/	-2.8	-2.3	-1.6	-3.9	-11.5	-10.3	-4.6	-4.9	-5.2	-5.5
12	Contribution from nominal interest rate	1.5	1.5	1.8	2.5	2.4	2.3	2.4	2.5	2.5	2.6
13	Contribution from real GDP growth	-1.3	-3.4	-4.6	-3.7	-4.6	-4.5	-4.5	-4.8	-5.0	-5.3
14	Contribution from price and exchange rate changes 3/	-3.0	-0.5	1.2	-2.7	-9.3	-8.1	-2.4	-2.6	-2.7	-2.8
14	Residual, incl. change in gross foreign assets and exchange-rate valuation effects(2-3) 4/	0.8	7.7	4.1	10.2	15.4	7.0	7.1	7.0	7.4	6.8
	Gross external debt-to-exports ratio (in percent)	131.1	144.1	163.6	182.1	194.6	196.3	197.3	198.4	200.1	199.6
	Net external debt-to-exports ratio (in percent)	28.5	33.2	44.7	52.0	59.2	65.7	70.2	73.9	78.6	82.3
	Gross external financing need (in billions of US dollars) 5/	3.5	3.9	4.8	5.4	6.7	8.1	9.0	10.1	11.3	12.4
	in percent of GDP	48.4	51.0	58.1	58.6	60.7	61.3	62.1	64.2	65.8	66.0
	Key Macroeconomic and External Assumptions										
	Real GDP growth (in percent)	2.8	6.8	7.9	6.1	7.4	6.5	6.0	6.0	6.0	6.0
	Exchange rate appreciation (US dollar value of local currency, change in percent)	0.8	-3.5	-3.5	1.6	8.3	7.7	0.0	0.0	0.0	0.0
	GDP deflator in US dollars (change in percent)	6.2	0.9	-1.9	4.1	14.0	10.9	3.0	3.0	3.0	3.0
	Nominal external interest rate (in percent)	3.2	3.1	3.1	4.0	3.8	3.3	3.2	3.1	3.0	3.0
	Growth of exports (GNFS in US dollar terms, in percent)	-8.2	12.3	4.1	12.5	22.7	18.6	15.3	13.4	12.8	12.6
	Growth of imports (GNFS in US dollar terms, in percent)	-8.7	7.8	9.6	11.0	29.3	20.9	12.9	10.7	10.5	10.9
						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 2003-2008				75.7	82.6	88.7	95.1	101.1	107.3	112.5
	2. Nominal interest rate is at historical average plus 4 percentage points in 2004 and 2005				75.7	82.6	85.7	93.8	97.3	100.9	103.3
	3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005				75.7	82.6	86.3	94.7	98.3	101.7	104.2
	4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2004 and 2005				75.7	82.6	95.1	106.8	109.6	112.5	114.3
	5. Non-interest current-account deficit is at historical average plus two standard deviations in 2004 and 2005				75.7	82.6	84.9	92.8	96.4	100.0	102.5
	6. One time 15 percent nominal depreciation in 2004				75.7	82.6	102.5	106.5	109.3	112.2	114.0
	7. FDI drops to 0.5 percent of GDP in 2004 and 2005 with 30 percent offsetting decline in imports				75.7	81.0	83.5	87.2	90.2	92.3	94.5
						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 2003-2008				21.6	28.5	34.6	41.0	47.0	53.2	58.4
	2. Nominal interest rate is at historical average plus three percentage points in 2004 and 2005				21.6	28.5	31.6	39.7	43.2	46.8	49.2
	3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005				21.6	28.5	32.2	40.6	44.2	47.6	50.0
	4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2004 and 2005				21.6	28.5	40.9	52.7	55.5	58.4	60.2
	5. Non-interest current account is at historical average minus two standard deviations in 2004 and 2005				21.6	28.5	30.8	38.7	42.3	45.9	48.4
	6. One time 15 percent nominal depreciation in 2004				21.6	28.5	48.4	52.4	55.2	58.1	59.9
	7. FDI drops to 0.5 percent of GDP in 2004 and 2005 with 30 percent offsetting decline in imports				21.6	26.9	29.4	33.1	36.1	38.2	40.4

Historical Statistics for Key Variables (past 3 years) 6/	Historical Average	Standard Deviation
Current account deficit, excluding interest payments	6.0	1.6
Net non-debt creating capital inflows	2.8	0.6
Nominal interest rate (in percent)	3.3	0.5
Real GDP growth (in percent)	5.9	2.2
GDP deflator in US dollars (change in percent)	1.7	3.5

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

2/ 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.

3/ 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).

4/ This term includes exchange-rate valuation effects, which in 2000 and 2001 may explain 1 - 2 percentage points of the debt increase. The large debt increase in these years does also reflect methodological changes.

5/ 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.

6/ 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.

Table 7. Latvia: Public Sector Debt Sustainability Framework, 1996–2008
(In percent of GDP, unless otherwise indicated)

	Actual								Projections				
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
I. Baseline Medium-Term Projections													
1 Public sector debt 1/	13.3	11.0	9.6	12.1	12.2	13.8	13.3	13.4	15.1	15.4	15.6	15.8	16.0
o/w foreign-currency denominated	7.7	6.1	5.9	8.6	7.4	8.8	8.2	10.2	11.7	12.4	12.7	12.7	12.5
2 Change in public sector debt	-1.3	-2.3	-1.3	2.4	0.1	1.6	-0.5	0.1	1.7	0.3	0.2	0.2	0.2
3 Identified debt-creating flows (4+7+12)	-0.5	-3.0	-1.6	2.6	1.8	0.6	-0.3	0.9	1.3	0.7	0.3	0.1	-0.2
4 Primary deficit	0.4	-1.1	-0.2	2.8	2.2	1.2	1.7	1.8	1.6	0.7	0.5	0.3	0.0
5 Revenue and grants	34.4	37.9	39.2	36.9	34.6	32.8	33.0	32.0	28.9	34.6	34.8	34.9	35.1
6 Primary (noninterest) expenditure	34.8	36.8	38.9	39.8	36.9	34.1	34.6	33.8	30.5	35.4	35.3	35.2	35.1
7 Automatic debt dynamics 2/	-0.8	-0.5	-0.3	0.2	-0.1	0.0	-1.1	-1.2	-0.6	-0.4	-0.4	-0.5	-0.5
8 Contribution from interest rate/growth differential 3/	-1.1	-0.9	0.0	0.0	-0.4	-0.4	-0.5	-0.3	-0.3	-0.4	-0.4	-0.5	-0.5
9 Of which contribution from real interest rate	-0.7	0.0	0.5	0.3	0.3	0.5	0.3	0.6	0.4	0.5	0.4	0.4	0.4
10 Of which contribution from real GDP growth	-0.5	-0.9	-0.5	-0.3	-0.8	-0.9	-0.8	-0.9	-0.8	-0.8	-0.8	-0.9	-0.9
11 Contribution from exchange rate depreciation 4/	0.3	0.4	-0.2	0.2	0.4	0.3	-0.6	-0.9	-0.2	0.0	0.0	0.0	0.0
12 Other identified debt-creating flows	-0.1	-1.3	-1.1	-0.5	-0.3	-0.6	-0.9	0.3	0.3	0.3	0.3	0.3	0.3
13 Privatization receipts (negative)	-0.1	-1.3	-1.1	-0.5	-0.3	-0.6	-0.9	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.5	0.4	0.4	0.4	0.4	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	0.0
16 Residual, including asset changes (2-3)	-0.8	0.7	0.3	-0.1	-1.7	1.0	-0.2	-0.8	0.4	-0.4	-0.1	0.1	0.3
Public sector debt in percent of revenues 1/	38.6	29.0	24.6	32.7	35.2	42.0	40.3	41.8	52.3	44.6	44.9	45.3	45.6
Gross financing 5/	5.9	5.8	4.5	6.4	6.5	4.3	3.6	5.0	5.4	3.2	3.0	2.2	1.9
in billions of U.S. dollars	0.3	0.4	0.3	0.5	0.5	0.4	0.3	0.6	0.7	0.5	0.5	0.4	0.4
Key Macroeconomic and Fiscal Assumptions													
Real GDP growth (in percent)	3.8	8.3	4.7	3.3	6.9	8.0	6.4	7.5	6.5	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	6.9	7.1	6.2	8.8	7.9	6.6	6.1	5.8	6.0
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-4.8	0.6	4.8	4.0	3.1	4.9	2.8	5.4	3.9	3.6	3.1	2.8	3.0
Nominal appreciation (increase in US dollar value of local currency, in percent)	-3.4	-5.8	3.7	-2.4	-4.9	-3.9	7.4	9.8	2.1	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	14.9	7.0	4.6	4.8	3.8	2.1	3.4	3.4	4.0	3.0	3.0	3.0	3.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-0.5	14.5	10.8	5.6	-0.9	-0.2	8.2	4.8	-3.8	22.9	5.8	5.7	5.7
II. Stress Tests													
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2004-2008								13.4	14.5	15.1	15.8	16.8	17.9
2. Real interest rate is at historical average plus two standard deviations in 2004 and 2005								13.4	15.8	16.9	17.0	17.2	17.3
3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005								13.4	15.7	16.7	16.9	17.1	17.2
4. Primary balance is at historical average minus two standard deviations in 2004 and 2005								13.4	17.3	20.6	20.6	20.7	20.7
5. Combination of 2-4 using one standard deviation shocks								13.4	16.4	19.0	17.7	16.4	15.2
6. One time 30 percent real depreciation in 2004 7/								13.4	20.5	20.7	20.8	20.8	20.8
7. 10 percent of GDP increase in other debt-creating flows in 2004								13.4	25.1	25.2	25.1	25.0	24.9
8. Impact on debt-to-GDP ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2004-05								13.4	14.2	19.2	19.3	19.4	19.5
8a. Impact on debt-to-revenue ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2004-05								41.8	47.4	64.4	55.5	55.5	55.5

Historical Statistics for Key Variables (1996-2003)	Historical Average	Standard Deviation
Primary deficit	1.1	1.3
Real GDP growth (in percent)	6.1	1.9
Nominal interest rate (in percent) 6/	8.1	1.4
Real interest rate (in percent)	2.6	3.4
Inflation rate (GDP deflator, in percent)	5.5	4.0
Revenue to GDP ratio	35.1	2.6

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; a = 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).

LATVIA: FUND RELATIONS

(As of April 30, 2004)

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	128.67	101.47
Reserve position in Fund	0.06	0.04

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

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent of Quota**
Systemic Transformation	1.91	1.50

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				
	2004	2005	2006	2007	2008
Principal	1.91	0.0	0.0	0.0	0.0
Charges/interest	0.02	0.0	0.0	0.0	0.0
Total	1.93	0.0	0.0	0.0	0.0

VII. **Exchange Arrangements:**

The currency of Latvia is the lats, which was introduced in March 1993 to replace the Latvian ruble. The exchange rate has been pegged to the SDR since February 1994. Latvia's exchange system is free of restrictions on the making of payments and transfers for current international transactions.

VIII. **Article IV Consultation:**

Latvia is on the 12-month consultation cycle.

The 2003 Article IV staff report was issued on April 7, 2003 (IMF Country Report No. 03/113). The last Article IV Board discussion took place on April 23, 2003. The Public Information Notice No. 03/55 was released on April 28, 2003.

IX. 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 (IMF Country Report No. 02/67) was discussed at the Board on January 18, 2002, together with the 2001 Article IV staff report (IMF Country Report No. 02/10).

ROSC Modules

Standard/Code assessed	Issue date	IMF Website
Code of Good Practices on Fiscal Transparency	March 29, 2001	www.imf.org
Code of Good Practices on Transparency in Monetary and Financial Policies	March 22, 2002	www.imf.org
Basel Core Principles for Effective Banking Supervision	March 22, 2002	www.imf.org
CPSS Core Principles for Systemically Important Payment Systems	March 22, 2002	www.imf.org
IOSCO Objectives and Principles of Securities Regulation	March 22, 2002	www.imf.org
IAIS Core Principles	March 22, 2002	www.imf.org
OECD Corporate Governance Principles	March 22, 2002	www.imf.org

X. 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
STA	Monetary and Financial Statistics	Mission	July 2003	Bank of Latvia
FAD	Budget Reforms	Mission	January 2004	Ministry of Finance

XI. **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.

XII. **Fourth Amendment:**

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

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 derived from 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 was 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 were among the issues addressed in a 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 May 2000.

Survey of Reporting of Main Statistical Indicators
(As of June 30, 2004)

	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	30-Jun	31-May	31-May	31-May	31-May	31-May	31-May	Apr-04	Q1, 2004	31-May	Q1, 2004	31-May
Date received	30-Jun	17-Jun	17-Jun	17-Jun	17-Jun	17-Jun	10-Jun	10-Jun	30-Jun	17-Jun	10-Jun	17-Jun
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.

Public Information Notice (PIN) No. 04/85
FOR IMMEDIATE RELEASE
August 6, 2004

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

IMF Concludes 2004 Article IV Consultation with the Republic of Latvia

On August 4, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Latvia.[1]

Background

Latvia's successful transition culminated in EU accession on May 1. Impressive economic performance—an average real GDP growth of 6 per cent per annum since 1998, the highest among accession countries—has been fostered by responsible fiscal and monetary policies and bold structural reforms. However, per capita income is still below that of the other acceding countries and stands at a little more than one third of the EU-15 average, suggesting that real convergence remains a long-term objective.

Since the last Article IV consultation discussions, economic activity has maintained its momentum, as GDP grew 7½ percent in 2003 and 8¾ percent year-on-year in the first quarter of 2004; however, inflation climbed to 6.1 percent at end-June from 3.6 percent at end-2003. Exogenous factors (in particular the hike in oil prices and tax rate increases resulting from EU tax harmonization) were largely responsible for this bout of inflation. Several elements suggest that overheating could be a potential concern in the run-up to euro adoption, but the evidence is at present mixed. In particular, while above-trend growth may have created a positive output gap, capacity utilization in manufacturing has remained unchanged over the past 12 months. In addition, unemployment, which is significantly lower than two years ago, has recently

[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.

increased somewhat (in large part owing to increased participation), and real wage growth has slowed in 2004. House price inflation also appears to have decelerated.

Latvia's external position has worsened: the current account deficit reached 8.6 percent of GDP in 2003, as consumption spilled over into imports, and foreign direct investment coverage of the deficit declined (to 34 percent from an average of about 60 percent in the last few years). However, the latter development is likely temporary, and, furthermore, competitiveness does not appear to have weakened. Latvia's export penetration continues to expand despite unfavorable market conditions for its main export and has been accompanied by increasing profit margins.

Credit continues to grow rapidly (about 40 percent per annum in the last three years), driven by mortgage and consumption loans, although it does not appear to have contributed to higher inflation. The credit growth is, however, increasing the vulnerability of the economy to external shocks that may feed into inflation or weaken household balance sheets.

Fiscal performance has improved appreciably, and public debt remains low. The general budget deficit, at 1.6 percent of GDP in 2003, narrowed by nearly 1 percentage point from 2002, reflecting lower-than-budgeted expenditures, unexpectedly high tax revenues, and lower net lending. Lower expenditures were helped by the adoption of restraining mechanisms on advance payments. On the revenue side, the collection of personal income tax, social tax, VAT, and excise tax was particularly good due to buoyant growth and the implementation of several tax administration measures. The strong revenue performance has continued in 2004, resulting in a small surplus as of May, despite interruptions to VAT and excise collections following EU accession.

The fight against corruption and state capture continues. The Corruption Prevention and Combating Bureau (KNAB) established a National Program for Combating and Preventing Corruption and began investigating cases of corruption involving high officials in 2003. The Parliament (Saeima) elected a new director for the bureau after a long process, complicated by political interference. The recently approved amendments to the law on AML/CFT put legislation in line with international standards, but enforcement needs to be strengthened.

Executive Board Assessment

Executive Directors welcomed Latvia's accession to the European Union and agreed that, following the successful transition of the past decade, Latvia is now in a strong position to reap the maximum benefits of EU membership and the prospect of euro adoption. Directors commended the authorities for the impressive growth performance in 2003, which continued to be among the best in the EU accession countries, and for the better-than-expected fiscal outcome—a result of both revenue and expenditure efforts.

Directors observed that the growth outlook remains favorable, driven by strong domestic demand and ongoing recovery in Europe. The widening external current account deficit and rapid credit growth—though consistent with Latvia's development needs—will, however, require a prudent fiscal path and vigilant bank supervision. Over the longer term, Directors stressed that, to achieve real convergence with European standards of living, Latvia will need to maintain macroeconomic stability and a flexible labor market, and pursue further structural reforms aimed at boosting the country's growth potential and safeguarding its competitiveness.

Directors agreed that Latvia's immediate challenge is to secure a smooth ERM2 entry. They supported the authorities' overall strategy for repegging the currency from the SDR to the euro, and pursuing an entry path that is slower than Latvia's Baltic neighbors. While the market exchange rate does not appear misaligned, Directors recommended that the authorities reassess the ERM2 parity choice prior to entry. They also suggested that the ERM2 period should be used to further improve monetary management and develop instruments for liquidity management based on open market operations.

Directors considered that the recent rise in inflation—though largely due to one-off factors—together with the rapid credit growth, could increase the vulnerability to external shocks. They underscored the increased role that fiscal policy should play as the principal tool of demand management, including by increasing the flexibility of fiscal policy over the course of the business cycle. To ward off potential overheating risks in a timely manner, Directors urged the authorities to use the opportunity of the favorable macroeconomic environment to aim for a tighter fiscal policy stance than currently envisaged, even though they recognized Latvia's significant infrastructure needs. In this context, they expressed concern that the supplementary budget for 2004 could result in an overall increase in expenditure, and urged the authorities to use revenues in excess of the original budget to lower the deficit. Efforts to broaden the tax base should also be sustained.

Looking ahead, Directors underscored the importance of moving toward fiscal balance over the medium term, consistent with EU membership. While Latvia's low level of public debt and fiscal deficit path do not pose direct fiscal sustainability problems, Directors saw a further strengthening of fiscal policy as key to addressing external sustainability concerns that could arise from continuing rapid credit growth. In this context, they urged the authorities to work toward developing a medium-term budgetary framework to improve the quality of fiscal policy and the credibility of medium-term objectives. Such a framework would also help plan expenditure out of EU funds and enhance the role of fiscal policy in stabilizing the economy.

Directors noted that Latvia's banking system is well-capitalized, profitable, and liquid, and appears resilient to a wide range of shocks. Nevertheless, the rapid expansion of credit, the potential volatility of nonresident deposits, and the possibility of increased short-term capital inflows following Latvia's integration into the EU all require close monitoring. Directors therefore welcomed the steps being taken to tighten liquidity, and strengthen bank supervision and prudential guidelines, although it was recognized that the impact of prudential tightening on overall credit growth may be limited. They stressed that particular attention should be given to preventing balance sheet problems for borrowers, and minimizing possible leakages to the domestic market from the sizeable nonresident deposits. In addition to strict rules on banks' open positions, it will be important to ensure that banks maintain matching and high-quality liquid assets.

Directors looked forward to continuing progress on promoting private sector activity, attracting foreign direct investment, and reducing the still high unemployment level. They welcomed the authorities' resolute commitment to improve the business environment, and encouraged them to sustain their efforts to enhance export diversification, raise labor productivity, and remove remaining administrative barriers and other obstacles to business. In particular, Directors highlighted the importance of amendments to the insolvency law to improve creditors' rights and making public procurement procedures more transparent. They encouraged the authorities to press ahead with the reorganization and eventual privatization of the remaining public concerns.

Directors commended the authorities' progress on fighting corruption, while underscoring the importance of ensuring that the Corruption Prevention and Combating Bureau remains independent from political pressure and maintains its strong enforcement efforts. They welcomed the recent amendments to the AML/CFT legislation in line with international standards, and urged the authorities to ensure its strict enforcement.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Republic of Latvia: Selected Economic Indicators

	1998	1999	2000	2001	2002	2003
	Changes in percent					
Real Economy						
Real GDP	4.7	3.3	6.9	8.0	6.4	7.5
Unemployment rate (ILO, end of period)	13.7	14.5	14.6	12.8	11.6	10.3
Consumer price index (end of period)	2.8	3.2	1.8	3.2	1.4	3.6
	In percent of GDP					
Public Finance						
General government balance	-0.8	-3.6	-3.0	-2.0	-2.4	-1.6
Total government debt 1/	9.6	12.1	12.2	13.8	13.3	13.4
External government debt 1/	5.9	8.6	7.4	8.8	8.2	10.2
	End-period; changes in percent					
Money and credit						
Reserve money	6.7	11.6	7.7	8.8	22.4	6.8
Broad money	6.0	8.0	27.9	20.8	20.9	21.1
Domestic credit (non-government)	58.6	15.3	36.7	50.4	36.5	37.3
	In percent of GDP unless stated otherwise					
Balance of payments						
Trade balance	-18.6	-15.4	-13.7	-16.4	-15.7	-18.1
Current account balance	-10.6	-9.7	-6.4	-8.9	-6.5	-8.6
International reserves (in months of imports)	2.9	2.9	2.6	3.1	2.6	2.3
Exchange rate						
Exchange rate regime	Peg to the SDR					
Exchange rate (lats per US$; period average)	0.590	0.585	0.607	0.628	0.618	0.571
Real effective exchange rate (2000 = 100) 2/	91.2	98.7	98.9	96.9	91.4	87.3

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

Statement by Jon A. Solheim, Executive Director for Republic of Latvia and Jelena Zubkova, Assistant to Executive Director
August 4, 2004

On behalf of our Latvian authorities, we would like to thank Mr. Samiei and his team for their well-balanced appraisal of Latvia's economic performance. Our authorities broadly agree with their analysis and recommendations, and they appreciate the constructive dialogue and advice of the staff. The fruitful cooperation with the Fund has been very useful in helping Latvia to make progress on its way of economic transformation and towards the EU entry.

The EU accession on May 1, 2004 marks an important milestone for Latvia, testifying the success of the authorities' efforts in transforming the economy over the last decade. The work towards this goal has facilitated and strengthened the authorities' focus on macroeconomic stability, placing major emphasis on fiscal discipline, price and exchange rate stability, and determined structural reforms. This should make Latvia well-placed to meet the challenges of the integration within the EU.

Economic Developments and Outlook

In recent years, Latvia has taken a leading position among the new EU member states in terms of average GDP growth. Supported by a strong domestic demand and a resilient merchandise export, real GDP grew by 7.5 percent in 2003, and reached 8.8 percent in the first quarter of this year. For 2004, the authorities project a GDP growth of about 7.0 percent, or some 0.5 percentage points higher than staff's projection. Domestic demand is expected to remain the driving force of the economic upturn. However, export performance is also anticipated to strengthen in line with global recovery and improved access to the EU market.

Inflation is expected to reach about 4.5 percent in 2004 (annual, average basis) and come down to around 3 percent in the next few years. The current account deficit is expected to remain at a relatively high level in the next few years due to the large one-off effects triggered by the EU accession and several large investment projects (e.g., improvement in the energy infrastructure by the *Latvenergo*, renewal of the fleet by the *Latvian Shipping Company* and others).

In the staff paper, concern is expressed regarding a possible overheating of the Latvian economy. However, as outlined by staff, the evidence is not conclusive. On the one hand, GDP growth is at present above the potential, the current account deficit is widening further, private consumption is expanding at a fast pace and in June inflation picked up to 6.1 percent (on an annual basis) . Moreover, the unemployment rate is falling, the real wage growth is increasing, and credit growth to the private sector remains buoyant.

On the other hand, a number of factors are mitigating these concerns. The pick-up of inflation is largely driven by supply side factors and temporary effects linked to the EU accession, including a rise in administered prices, tax adjustments, surge in world oil prices, adjustment of food prices and price speculations in the run-up to the EU accession. In addition, the decentralized wage-setting mechanism is likely to bring wage growth in line with or below productivity growth, and a stable lats/euro exchange rate will reduce external price impulses. Moreover, the unemployment rate remains at a high level. The weakening of the trade balance – the main factor behind the current account deficit – is still largely a result of strong investment growth. Capital and intermediate goods constitute about two-thirds of total merchandise imports. Export competitiveness remains strong, which is reflected in a growing foreign market penetration and increasing export profit margins. The banking sector remains healthy and well capitalized to sustain the ongoing high lending growth. The growth in real estate prices has slowed down and is currently broadly in line with the income growth (which is not substantially higher than the growth in consumer prices).

While our authorities share staff's concerns about the potential risks of overheating, they consider the development of major economic indicators as mixed and that the risks of overheating are relatively limited. They will, however, monitor developments closely, and take the appropriate measures if clear signs of overheating are emerging. Overall, our authorities' plans to enter ERM2 in January 2005, and to introduce the euro in January 2008, should ensure continued consistency and credibility of the authorities' macroeconomic and structural policies.

Fiscal Policy

The authorities are fully aware that fiscal policy will have to play a key role in ensuring that domestic demand does not add to inflationary pressures and lead to a deterioration in external balances. Over the past years, Latvia has achieved good performance in fiscal consolidation, reducing the 2003 general government budget deficit to 1.6 percent of GDP. This was a strengthening of 0.8 percentage points from the previous year and the lowest deficit during the last five years. Major improvements from the previous year were recorded in social security (showed a surplus) and local government budgets. In general, the budgetary outcome in 2003 was determined by both lower expenditures and higher tax revenues than expected. The strong revenue performance was largely attributed to the robust economic activity and the implementation of a number of tax administration measures. At the same time, strict expenditure controls combined with restraints on advance payments at the end of 2003 helped restrain budget expenditures.

For 2004, the Parliament adopted a budget with a 2.2 percent deficit of GDP. The authorities expect that the actual deficit in 2004 will be lower than budgeted. So far in 2004, revenues have been higher than projected, making room for channeling additional revenues to reduce the budget deficit. However, future revenue performance is somewhat uncertain due to procedural changes associated with the EU accession. Moreover, additional expenditures (the second biannual pension adjustment in line with the new inflation indexation procedure, and compensation increase for school teachers) scheduled for budget amendments this fall will reduce the net budget impact.

The authorities agree with staff's recommendations to move towards a medium-term budgetary framework. However, they acknowledge the potential problems to achieve substantial progress during the next few years due to the significant budget expenditures that will come from payments related to the NATO and the EU as well as required social reforms. In the next few years, these additional expenditures will restrict the government's capacity to decrease the budget deficit. Given the delicate balance between future expenditure commitments and securing a sustainable macroeconomic performance, the authorities will in the coming years aim at a budget deficit of about 2 percent of GDP. However, the long-term aim of the government's medium term budgetary framework is a gradual reduction of the budget deficit towards a balanced budget.

Monetary-Financial Policies and the Run-Up to the ERM II and the Euro

The authorities are pleased to note the recognition by staff of the credibility of the ERM II entry and the euro adoption strategy. The authorities aim at repegging the lats from the SDR to the euro and a subsequent entry in the ERM II at the beginning of 2005, in accordance with multilateral procedures and within the adopted framework. The adoption of the euro is tentatively scheduled for the beginning of 2008 and is dependent upon a successful convergence assessment and sufficient time to handle the necessary technical matters to guarantee a smooth entry into the EMU.

In order to reduce the macroeconomic risks associated with the rapid increase of private consumption, the Bank of Latvia (BoL) has tightened its policies in 2004 by raising its refinancing rate from 3.0 to 3.5 percent in March and the reserve requirements from 3 to 4 percent in July. In addition, the BoL has reduced the banking system liquidity by placing the bulk of government deposits in the central bank.

As stated in the staff report, the Latvian banking sector is healthy: banks remain well capitalized, profitable, with good credit quality and well-established modern risk management systems and techniques. Stress test results reveal that the banking system is likely to be resilient to major sources of vulnerability. Financial soundness indicators are positive and bank credit to the private sector relative to GDP remains low, or less than half of the average in the Euro area countries. However, notwithstanding the current low level of credit to the private sector, the rapid lending growth carries with it the risks of deteriorating credit quality in the future. The authorities will therefore closely monitor the situation. Recently, the Financial and Capital Market Commission (FCMC) has sent a letter to the banks to increase the banks' awareness of potential effects of the strong household lending expansion on borrowers' financial position and banks' asset quality. Moreover, the banks have been advised to pay special attention to the expected interest rate hikes during the second half of the year, and encouraged to warn their clients of potential exchange rate and interest rate risks. Likewise, the FCMC plans to tighten the guidelines for mortgage lending and ensure better monitoring of banks' loan portfolio quality. In June 2003, the Register of Debtors was introduced under the management of the BoL. It contains information on borrowers with late payments and serves as an additional tool to evaluate the creditworthiness of borrowers.

The authorities agree that Latvia's accession to the EU may result in increased capital inflows and intensify the credit growth. Against this backdrop, the possibilities for using a combination of monetary and prudential instruments are being explored to limit the risks of overheating. However, the authorities recognize that the mentioned measures may be insufficient and, therefore, the stance of fiscal policy remains of paramount importance.

Structural Reforms

The staff paper outlines several areas of structural reforms where progress needs to be accelerated, including the process of restructuring and privatizing the remaining public concerns, and fight against corruption and money laundering. The authorities affirm that necessary legal procedures are being elaborated to enable the shift from a mass to a case-by-case privatization with the objective to sell the assets that are not associated with the direct performance of state functions. The creation of a market system in the electricity sector is a priority of the government, and the opening of a Latvian electricity market is gradually taking place.

The fight against corruption is one of the key priorities of the authorities and the work on enforcement and prevention will continue. The recent AML/CFT law amendments came into force in February 2004, and they include more detailed specific requirements for customer identification, explaining the responsibilities of different supervisory authorities. The financial sector is steadily improving its internal control system of the AML/CFT regime and applying the best international practice of AML/CFT to everyday activities. However, our authorities are somewhat concerned by some of the staff's comments on Latvia's AML/CFT performance. Latvia has traditionally had a relatively competitive financial sector with a high share of non-resident deposits. It is, however, no reason to believe that these deposits are of a more dubious origin than similar deposits in other European countries with a high share of non-resident deposits.