Latvia
Focus on Country Development

Latvia has made considerable progress over the past decade in transforming its centrally planned economy into a market-oriented one. What role has its central bank played in this transition, and what steps is it taking to promote the country's continuing economic development?

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LAST YEAR, in contrast to those immediately preceding it, the world economy grew rapidly. This trend should continue, because numerous nations have now recovered from crises they faced, and GDP is expected to grow significantly in various regions. The economic boom will also improve the economies of the Baltic states, including Latvia, which has been striving to stabilize and boost growth since the mid-1990s.

The Bank of Latvia, the country's central bank, plays an important role in managing the country's economic processes. Indeed, central bank policy is crucial to the development of any newly independent country. In its early days, the Bank of Latvia, which was reestablished in 1990, was critically important in cementing Latvia's economic and political independence. Various tasks had to be accomplished simultaneously, including drafting legislation, privatizing state enterprises, attracting foreign investment, and implementing economic reforms. One of the central bank's key tasks in the early 1990s was to assist in stabilizing the economy and thereby lay the foundation for development.

Laying the foundation

The national currency, the lats, was introduced to create a reliable and effective financial system that would make the necessary reforms possible. Since its introduction, the lats has been fully convertible, and current account and capital account transactions have not been subject to any limitations. The Bank of Latvia has set price stability as its main objective and pursued a strict monetary policy despite the initial antagonism of various groups. Economic indicators for the years immediately following Latvia's emergence from the former Soviet Union provide evidence that it has chosen the proper model for economic development. Even the financial turmoil that Latvia subsequently experienced, especially during the Russian financial crisis that began in August 1998, did not inflict serious harm on the economy.

Price stability is a key element of macroeconomic stability, attracting foreign investors and strengthening local enterprises' competitiveness. The reduction in Latvia's inflation rate, as measured by the consumer price index, took place gradually—from 13.1 percent in 1996 to 7.0 percent in 1997 and 2.8 percent in 1998. This is a remarkable achievement, given that inflation was considerably higher in the early 1990s. In 1999, the inflation rate increased slightly to 3.2 percent. The stability of the lats is ensured also by its peg—since 1994, the lats has been pegged to the SDR basket of currencies, and its fluctuations against any particular currency in the basket depend solely on fluctuations in the world money market.

Latvia, a small country with approximately 2.5 million inhabitants, is located at a crossroads between East and West. After emerging from the former Soviet Union, Latvia needed to retain established economic links to its eastern neighbors as well as to develop trade with new partners in the West. Its shift to

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western markets was slow initially, but the European Union's share of Latvia's exports has now reached more than 57 percent. The biggest exporters to Latvia are Germany, the United Kingdom, Sweden, Lithuania, and Russia, and the biggest importers of Latvian goods and services are Germany, Russia, Finland, Lithuania, and Sweden. In 1999, as Latvia's surplus of imports over exports decreased, its trade deficit decreased by almost 12 percent, and the inflow of foreign currency exceeded the current account deficit. Consequently, the Bank of Latvia's foreign reserves increased and the country's balance of payments was positive.

Among the Central and Eastern European countries, Latvia is one of the leaders in per capita foreign direct investment. This year, its remaining state enterprises attracted significant investments under a privatization program. The inflow of investments should continue as enterprises consolidate their recovery from the Russian financial crisis and Latvia becomes increasingly engaged in European Union projects.

Recent developments

The Bank of Latvia has always emphasized the advantages of a balanced budget and supported a strict fiscal policy. In 1997 and 1998, balanced consolidated state budgets were achieved, which helped keep interest rates low. In 1999, fiscal conditions were complicated, and the year closed with a fiscal deficit in the consolidated state budget, although this was less than expected. The consolidated state budget for 2001 has been planned to avoid the running of a deficit and to continue the positive growth seen in recent years.

During the late 1990s, Latvia's GDP grew—by 3.3 percent in 1996, 8.6 percent in 1997, and 3.9 percent in 1998. The economy's development was particularly successful in 1997, when there was dynamic growth in all principal sectors. Productivity increases and macroeconomic stability—including reduced inflation, which stimulated the inflow of capital and facilitated the making of long-term loans to develop production—were particularly important in bringing this about, as was substantial foreign direct investment. Exports continued to rise during the late 1990s. During the first half of 1998, industrial production grew rapidly, but it decreased in the second half owing to the Russian crisis.

Latvia was unique among the Baltic states in that its GDP actually increased in 1999 (by 0.1 percent). Compared with 1998, output growth occurred mainly in industries producing for foreign markets. The rise in the Index of Physical Volume of Industrial Output at the end of 1999 indicates that production has recovered from the crisis: the decline in production has slowed down significantly in most industries.

The expansion of entrepreneurship in Latvia has stimulated its labor market. In 1999, the number of unemployed persons registered by the State Employment Service decreased from 10.2 percent of the economically active population in April to 9.1 percent in December. By consistently pursuing price stability, the central bank will foster a favorable environment for entrepreneurship and investment, boosting employment levels.

By the end of 1999, the Latvian stock market had regained vigor after the drop in the stock exchange index that began in the fall of 1998 and continued until December 1999. Its rebound was propelled by recovery in Eastern Europe after the Russian crisis and by positive developments in the domestic economy. Foreign investors' participation grew as the Riga Stock Exchange, like the other Baltic stock exchanges, joined NOREX, the Alliance of Nordic Exchanges, thereby stirring the interest of Scandinavian investors in shares of Latvian enterprises. In addition, the Latvian government successfully placed an issue of eurobonds in the international market.

Latvia's interbank market and securities interest rates fluctuated considerably during much of 1999 and decreased again during its last few months. As macroeconomic conditions stabilized after the Russian crisis, business risk decreased; competition among banks increased; securities and interbank market interest rates dropped; and interest rates for loans issued in lats decreased. Interest rates paid on deposits of domestic enterprises and private persons, however, remained stable.

Strengthening the banking system

A well-developed financial market has now been established in Latvia, with 23 banks offering their services. These banks have been privatized, and the government owns only one small bank and holds less than 5 percent of banks' fixed capital. After Latvia regained independence, new banks were founded in the early 1990s. Improvements in the supervision system fostered the development and strengthening of the banking sector. In the autumn of 1998, several banks experienced problems because they had underestimated the country and credit risks involved when they invested in the Russian securities market. Nevertheless, by this time, Latvia's banking sector as a whole was characterized by stability and incremental growth. In general, all the major indicators for the banking sector improved in 1999. Assets of the banking sector increased by 14.2 percent. The volume of bank loans to domestic enterprises and private persons rose by 15.3 percent. As the purchasing power of employed workers and trust in the banking system grew, the volume of deposits of domestic enterprises and private persons increased as well. The term structure of the credit portfolio continued to follow a positive trend. The proportion of medium- and long-term loans increased, while that of short-term loans decreased. These changes indicate a gradual transition, in banks' portfolios, from short-term trade loans to longer-term loans to finance investment in the production and services sectors.

Several banks well known in the international arena acquired qualifying holdings (a qualified holding exists when there is a direct or indirect holding of 10 percent or more of the capital or voting rights in a firm, or when it is possible for a holder of capital or voting rights in a firm to exercise significant influence over its management) in Latvian banks, thereby strengthening the Latvian banks' capital bases and promoting their growth and development.

Trust in banks was further strengthened by the law "On Natural Person Deposit Guarantees," which became effective on October 1, 1998. It provides for guaranteed compensation to be paid to depositors who are natural persons (that is, individuals, as opposed to corporations) from the deposit-guarantee fund of a bank that has declared bankruptcy. To make Latvia's banking environment conform to the European Union's requirements, the law "On the Prevention of Laundering the Proceeds Derived from Criminal Activity" was adopted and entered into force on June 1, 1998.

During its relatively short history, the Bank of Latvia has developed into a modern, independent central bank that successfully implements strict monetary and banking supervision policies. In 1998, by virtue of amendments to the law "On the Bank of Latvia," full compliance with European Union requirements was achieved. To regulate the amount of money in circulation, the Bank of Latvia has introduced various monetary policy instruments, the most recent being auctions of long-term currency-swap agreements, which will reduce long-term interest rates on loans made, and enhance the availability of long-term resources held, in lats.

By using the monetary policy instruments, the Bank of Latvia ensures stability of the national currency, encourages decreases in money market interest rates, and helps banks to maintain sufficient liquidity. Owing to the central bank's consistent monetary policy, the lats has become a stable and valuable currency that has earned the trust of the general public, local business circles, and Latvia's economic partners. The Bank of Latvia has always tried to promote trust in banks and the financial system and is fully aware of its public duty to develop a modern and reliable banking supervision system.

The central bank's supervision of credit institutions is organized in keeping with the principles for effective supervision of banks set by the Basel Committee on Banking Supervision. Its regulations governing banking activities comply with the European Union's requirements and, in some instances, even surpass them in strictness. Latvian banks' annual reports are prepared in accordance with international accounting standards and are audited by international auditing firms. The off-site and on-site inspections carried out by the Bank of Latvia are strict and more frequent than inspections in European Union countries. Supervision experts of the Bank of Latvia continuously hone their skills by learning from the best supervision practices in the developed countries. The minimum founding share capital of a bank has been set at five million euros. Foreign banks are in no way restricted from establishing their branches, subsidiaries, or representative offices in Latvia, and the requirements for doing so are the same for local and foreign banks.

A new development was the introduction of consolidated supervision on July 1, 1999. Consolidated supervision helps supervisors assess those risks posed by a bank's corporate links and evaluate its financial health. In the near future, the Bank of Latvia will implement the European Union's directive on capital adequacy of credit institutions, setting the capital requirements to reflect market risks. In general, the banking supervision system has been successfully modified to meet the European Union's requirements.

Conclusion

Integration with the European Union is a high priority for Latvian foreign and economic policies. In December 1999, Latvia was invited to open its European Union accession talks. That provides an additional stimulus for Latvia's development and obligates it to ensure compliance with the convergence criteria established by the Maastricht Treaty, achieve harmonization, and perfect and implement the necessary legislation. The Bank of Latvia considers compliance with the Maastricht convergence criteria an important task for the medium term. At present, many of the relevant indicators for Latvia are close to meeting the requirements. The results achieved in 1999 provide a solid basis for optimism in forecasting Latvia's economic development in 2000. Its growth rate is expected to accelerate, and its economic indicators are likely to improve considerably over 1999's. With improvements in industrial production and oil transit, Latvia's GDP may grow as much as 4 percent in 2000.

Latvia's strict fiscal policy will help reduce the budget deficit, which, along with the Bank of Latvia's conservative monetary policy, will help keep inflation low. Consumer prices are not expected to rise more than 4 percent this year. By the end of 2000, unemployment may well drop to 8 percent. Latvia's economic policies and the stability of the lats are sure to promote exports, and the country's current account deficit may drop to 9 percent of GDP in 2000.

The achievements of the Latvian economy are recognized by both local and foreign experts. For example, the international credit-rating agencies Moody's, Fitch IBCA, and Standard & Poor's have repeatedly rated Latvia's bonds as investment grade, providing another piece of evidence that Latvia's economy is strong and has good potential. F&D