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Republic of Latvia: 2006 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 2006 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 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 6, 2006, 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 September 13, 2006. 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 October 4, 2006 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 has 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 2006 Article IV Consultation

Prepared by Staff Representatives for the 2006 Consultation with the Republic of Latvia

Approved by Alessandro Leipold and G. Russell Kincaid

September 13, 2006

The 2006 Article IV consultation discussions were held in Riga during May 24–June 6, 2006. The team comprised Ms. van Elkan (head), and Messrs. Brunner, Gray (all EUR), and Prokopenko (MFD). Mr. Kravalis (Senior Advisor, OED) participated in key meetings, while Mr. Tirpak (Regional Representative office) joined for part of the mission. Mr. Saarenheimo (ED) and Mr. Rosenberg (Regional Representative) attended the final meeting. The mission met with Finance Minister Spurdziņš, Bank of Latvia (BoL) Governor Rimšēvičs, senior officials, academics, and representatives of financial institutions and the business community.

Latvia acceded to the European Union (EU) on May 1, 2004 and entered ERM2 on May 2, 2005. Parliamentary elections are scheduled for October 7, 2006. The four-party center-right coalition government that took office at end-2004 was reduced to a three-party minority coalition in April 2006—an interim arrangement that is widely seen as stable. Earlier this year, the Government indicated that it would review its timetable for euro adoption (initially targeted for the beginning of 2008) on the basis of Latvia's macroeconomic performance; with no official announcement forthcoming, market participants generally expect euro adoption in 2010 or later. Latvia currently meets all the quantitative Maastricht requirements, with the exception of the inflation criterion, where it exceeds the allowable limit by about 3½ percentage points as of mid-2006.

Latvia maintains security-related exchange restrictions pursuant to UN Security Council resolutions and EC Council regulations, which have been notified to the Fund under Decision No. 144-(52/51), adopted August 14, 1952.

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

The authorities released the mission's concluding statement (see link: http://www.imf.org/external/np/ms/2006/060606a.htm), and have expressed their intention to publish the staff report.

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Executive Summary

Background: Financial deepening, EU-funded spending, and real wage growth caused a surge in domestic demand that pushed the economy above capacity. GDP growth accelerated to 10¼ percent in 2005, and the current account deficit and inflation remained elevated. Foreign liabilities continued to build, while competitiveness weakened, banks' exposure to credit and market risks rose, and currency mismatches of households widened. High inflation will thwart plans to adopt the euro in 2008; while a new target date has not yet been set, market participants now expect euro adoption only in 2010 or later.

Outlook: Recent drivers of demand are expected to persist in the near term, and growth will remain very strong, while the current account deficit will widen further and inflation will remain in excess of the Maastricht limit. Thereafter, a gradual unwinding of imbalances through a moderation of growth is likely, but with a more disruptive scenario also possible were imbalances to remain unchecked.

Policy issues and discussions

An upfront policy tightening is needed to contain near-term overheating and secure a soft landing. A sizable front-loaded fiscal adjustment, combined with more subdued wage and credit growth, would help unwind the output gap, slow inflation, narrow the current account deficit, and stabilize external liabilities. The ensuing reduction in external and financial vulnerabilities would also increase the likelihood that a soft landing is realized.

Fiscal restraint is needed to counter the sizable demand stimulus already in play. Achieving the needed fiscal withdrawal requires: (i) saving revenue overperformance in full in 2006; (ii) sharply curtailing spending growth in 2007-08, including on projects in already overheated sectors; and (iii) postponing the reduction in the personal income tax rate.

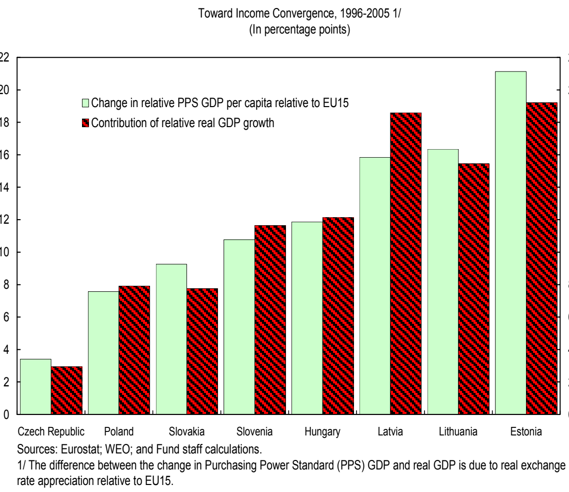
Moderating credit growth is essential to relieve overheating pressures. Monetary policy should continue to lean against the wind by tracking changes in the euro policy rate. However, policies that divert bank lending offshore or to less-regulated nonbanks, but without slowing overall credit, should be avoided. More effectively taxing real estate would restrain mortgage borrowing and ease pressures in the construction sector.

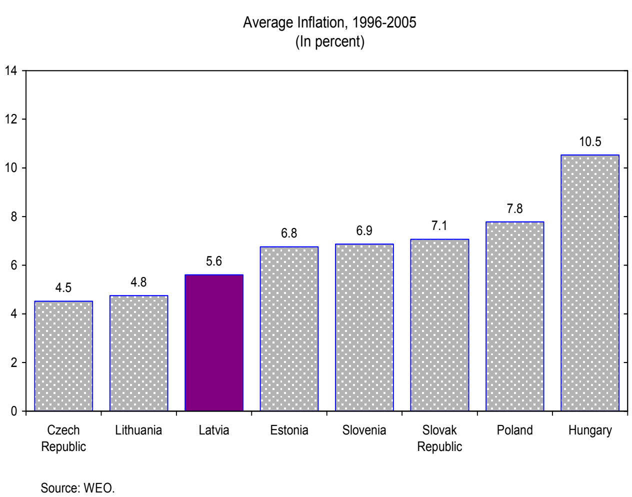
Risks from the credit boom and delayed euro adoption reinforce the need for a strong regulatory and supervisory framework for banks. Open positions in euros should be treated the same as any other foreign currency in setting prudential regulations, while Basel 2 introduction increases the imperative for close and effective cooperation with foreign supervisors. More accurate financial data is needed on the household sector and stress tests should simulate feedback channels between macroeconomic shocks and the banking sector.

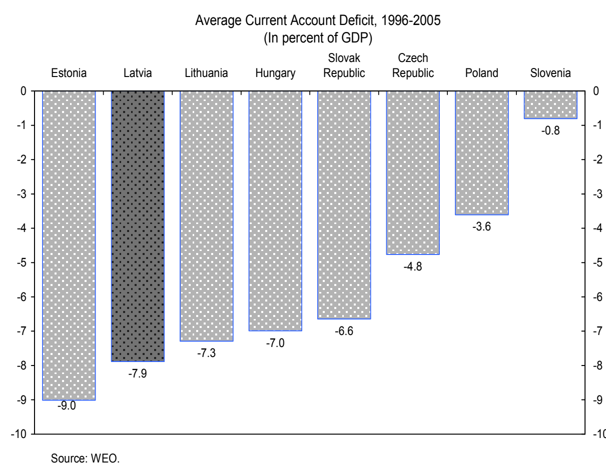
Safeguarding competitiveness while narrowing the wage gap requires scaling the technology ladder. Slowing domestic demand, improving productivity in the public sector and further increasing labor force participation will help ease emerging labor shortages. But to sustainably raise incomes while boosting exports, productivity gains underpinned by a move up the value-added chain are needed.

I. Overview

1. **The Latvian economy has made remarkable strides since the mid 1990s combining, for the most part, macroeconomic stability with rapid income convergence**. Substantial catchup opportunities, together with deft policymaking, helped underpin rapid economic growth and macroeconomic stability. Relative to the 15 original European Union members (EU15), Latvia's per capita income in purchasing power parity (PPP) terms climbed an impressive 16 percentage points, among the fastest of the eight new east European member states (EU8).[1] Inflation performance was also commendable until recently and, while current account deficits were larger than for most other EU8, they were broadly consistent with Latvia's low initial income and the economy's estimated growth potential.[2] Nonetheless, against this largely favorable background, substantial reliance on foreign savings over an extended period caused net foreign liabilities to approach 60 percent of GDP in 2005, a level that is unlikely to be sustainable over the medium term.







[1] At 43 percent of the EU15 average in 2005, however, per capita income in PPP terms remains the lowest in the EU.

[2] See Schadler and others (2006), "Growth in the Central and Eastern European Countries of the European Union: A Regional Review," forthcoming IMF Occasional Paper.

2. **Since 2004, the economy has been riding the wave of an integration-related boom that has undermined Latvia's record of macroeconomic stability and led to euro adoption being put on hold**. EU accession in mid-2004 and the prospect of imminent euro adoption ushered in a rapid acceleration in economic activity and associated overheating pressures. Deepening European integration brought lower nominal interest rates, large disbursements of EU grants, substantial foreign inflows to domestic banks, and extensive outward migration of labor. As a result, and notwithstanding Fund advice to address macroeconomic policy shortcomings (Box 1), GDP growth increased to record levels, a positive output gap emerged, inflation ratcheted up (including because of accession-related convergence of food prices), current account deficits widened, credit growth accelerated, and external debt increased (Figure 1, Table 1). Sustained inflation well in excess of the Maastricht criterion has delayed the timetable for euro adoption (initially planned for the beginning of 2008). In the absence of an official announcement of a revised planned entry date, market participants generally expect euro adoption in 2010 or later.

Box 1. Response to Fund Advice

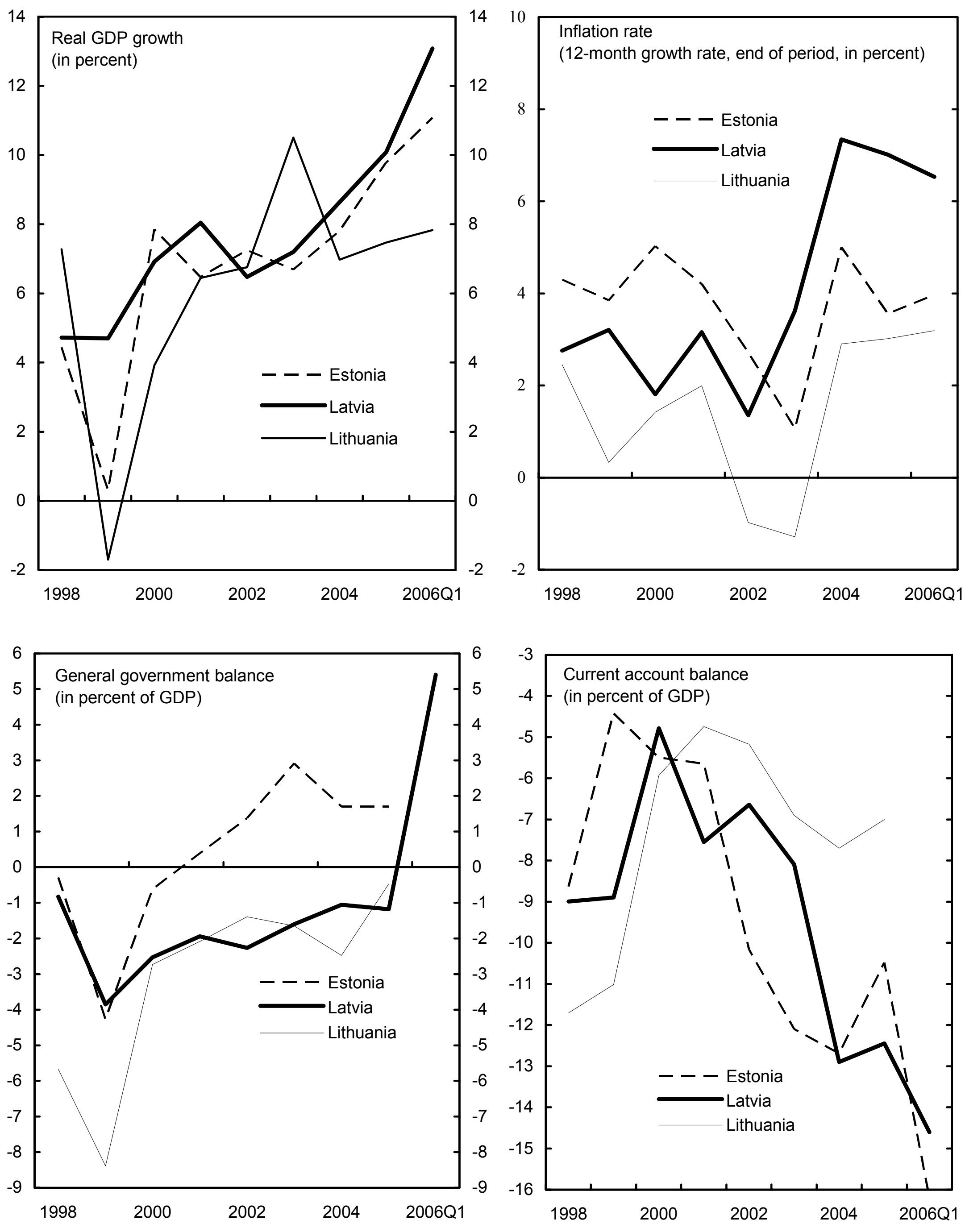
Latvia's macroeconomic, financial and structural policies have generally been consistent with Fund advice, particularly during the period covered by a series of stand-by arrangements, the most recent of which expired at end-2002. More recently, however, when overheating pressures emerged and credit growth accelerated, Fund policy advice had less resonance.

Fiscal policy: In recent years, the authorities have adhered less closely to the Fund's fiscal policy recommendations. Control over government spending has tended to ease toward year-end through the introduction of supplementary budgets that have spent part of the overperformance of tax revenues. In addition, differences in perceptions regarding macroeconomic conditions at the time of the 2005 consultation, as well as the receipt of sizable EU grants and spending pressures in advance of the October 2006 elections, resulted in a significant loosening of fiscal policy, at odds with Fund advice (PIN: http://www.imf.org/external/np/sec/pn/2005/pn05109.htm).

Monetary and exchange rate policy has been consistent with the narrow-band currency peg and supportive of eventual adoption of the euro. In line with Fund advice, liquidity management shifted from foreign-exchange swaps to open market operations, and an appropriate harmonization of reserve requirements began already in 2000. In response to rapid credit growth, Latvian and euro-area reserve requirement rates have diverged recently.

Financial sector: The 2001 FSAP assessed the supervisory framework as good and concluded that the establishment of a unified supervisory agency proceeded smoothly. Since then, the authorities have addressed many technical FSAP recommendations to further strengthen supervisory capacity. However, in contrast to Fund advice, the minimum capital adequacy ratio (CAR) was lowered from 10 percent to 8 percent in late-2004, and limits on banks' open positions in euros were lifted at the beginning of 2005. A series of amendments aimed at eliminating previously-identified deficiencies in the AML/CFT framework were adopted in 2005 and an AML ROSC was carried out in March 2006. An FSAP update is planned for early 2007.

Figure 1. The Baltics: Macroeconomic Performance, 1998–2006Q1

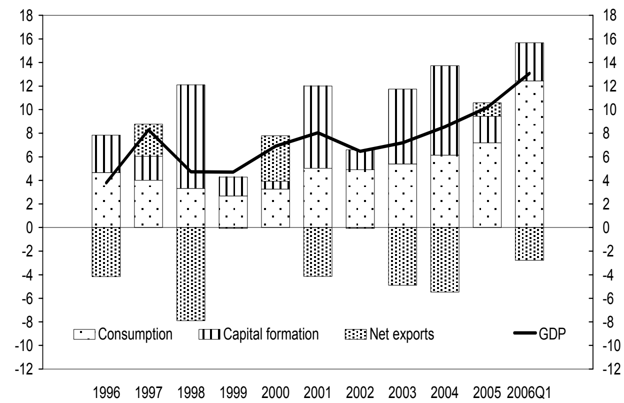


Sources: Country authorities and Fund staff estimates.

II. Recent Developments

3. **The economy is currently expanding at break-neck speed, supported by negative real interest rates, EU grants, and strong real wage increases**. GDP growth reached 13 percent in the first quarter of 2006, following on from 10¼ percent in 2005. Consumption and capital formation remain the main drivers of demand while, on the production side, growth was particularly strong in construction and domestic trade. These patterns reflect the very rapid increase in household credit and sizable spending on EU-related projects and transfers, which nearly doubled to 3¼ percent of GDP in the first full year of EU membership in 2005. While external demand contributed positively to growth in 2005, this proved to be one-off, with a strengthening of imports and some weakening of exports leading to a negative contribution from net exports in early 2006.

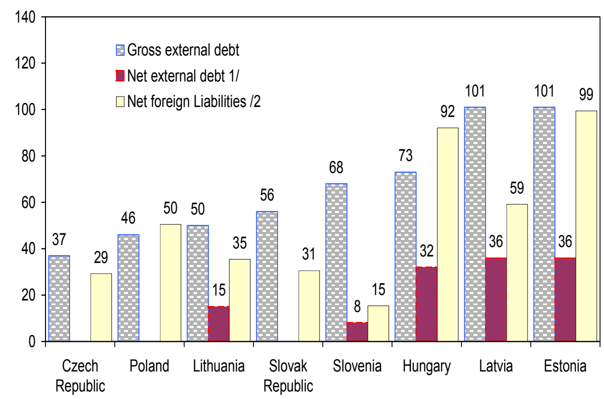
Contributions to GDP Growth, 1996-2006Q1
(1995 constant price, in percent)



Sources: Eurostat and Fund staff estimates.

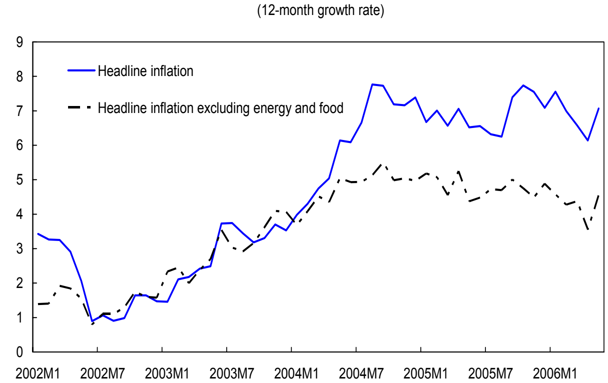
4. **With overheating becoming entrenched, the current account deficit and inflation have ratcheted up**. Reflecting its role as the primary outlet for domestic demand pressures, the current account deficit remained above 12 percent of GDP in 2005 and widened further in early 2006 (Figure 2, Table 2). Imports have grown strongly on the upswing in demand, while a worsening terms of trade (including as a result of higher oil prices), higher income earnings on inward FDI (mostly accruing to banks) and, more recently, weakening export volumes have added to external imbalances. As a result, gross external debt rose to 101 percent of GDP in 2005, with net debt a much more moderate 36 percent of GDP. Headline inflation remains in excess of 6½ percent (year-on-year)—reflecting rising world energy prices and harmonization of food prices (both of which have a much greater

External Debt and NFL, 2005
(In percent of GDP)



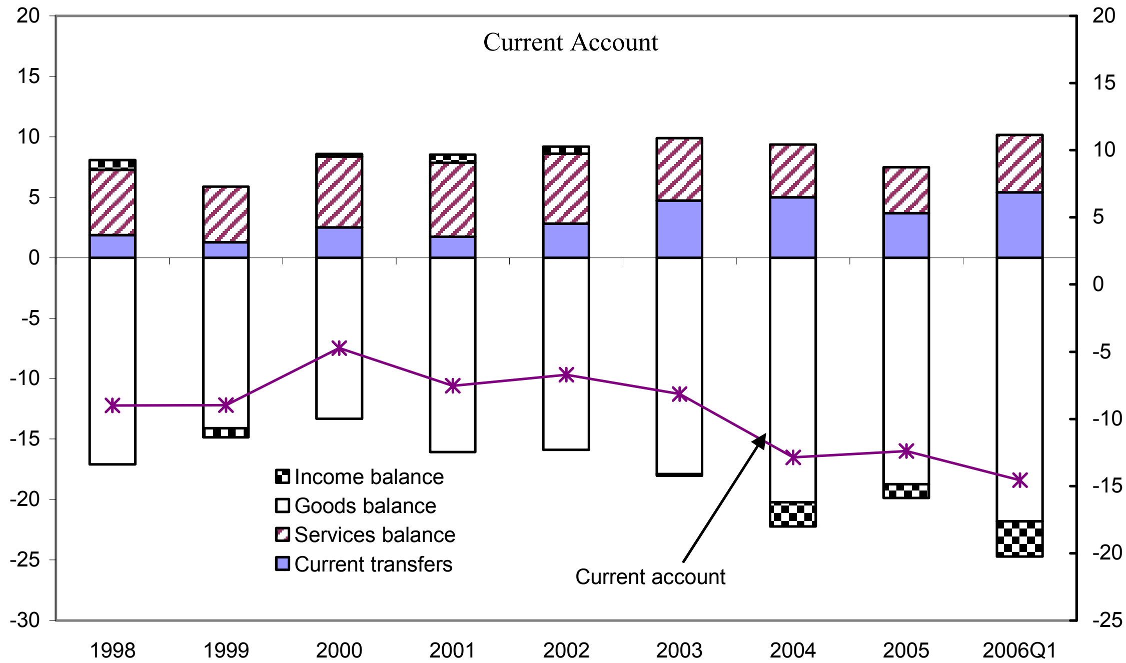
Sources: IFS, National Authorities, and Fund staff calculations.
1/ Net external debt data for Hungary corresponds to 2005 Q3.
2/ NFL data for the Czech Republic corresponds to 2005 Q3, Poland corresponds to 2004.

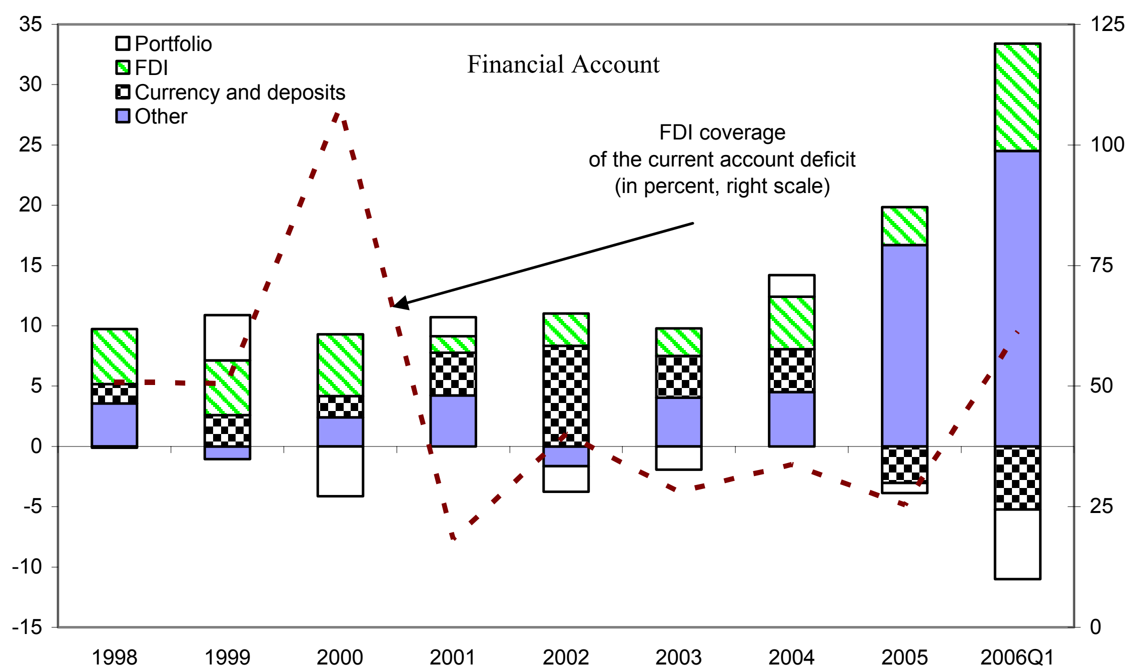
Latvia: Headline Inflation, 2002–06
(12-month growth rate)



Source: Eurostat.

Figure 2. Latvia: External Sector, 1998–2006Q1
(In percent of GDP)

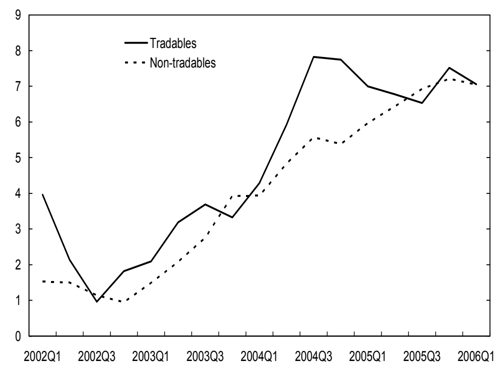




Sources: Country authorities and Fund staff estimates.

weight in Latvia's than in EU15 CPI baskets). Beyond the headline figure, nontradables inflation has risen significantly to 7 percent, reflecting the strength of demand pressures that have allowed firms to expand markups and achieve record profits. Staff estimates that the positive output gap that emerged in late-2004 widened to 1–2 percent of GDP at end-2005/early 2006.

Latvia: Tradable and Non-tradable Inflation, 2002-06
(12-month growth rate)



Source: Eurostat and Fund calculations.

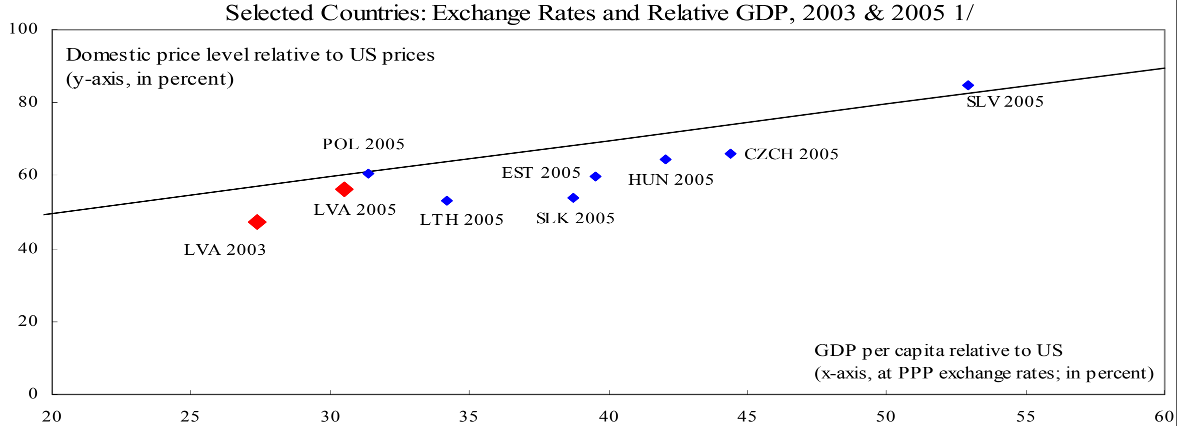
5. **From a relatively strong starting position, external competitiveness is being eroded by exceptionally strong wage growth**. Until recently, solid growth in export volumes and rising shares in major export markets suggested that Latvian industry enjoyed a favorable competitiveness position (Figure 3). In addition, comparisons of actual wage and price levels relative to predicted values indicate that Latvia's exchange rate was slightly undervalued in 2004-05, albeit by a smaller amount than in 2003. However, with job-rich growth and heavy post-accession migration to EU countries (officially estimated at 5 percent of the labor force) pushing the unemployment rate down by 2½ percentage points to 7¾ percent over the two years to early 2006, the labor market has tightened considerably.

Selected countries: Wage Competitiveness, 2004

	Actual	
Country	Wage (US$)	Ratio of Actual to Predicted [1]
Latvia	326	0.79
Czech Republic	663	1.19
Estonia	556	1.21
Hungary	674	1.20
Lithuania	392	0.95
Poland	529	1.04
Slovak Republic	508	0.96

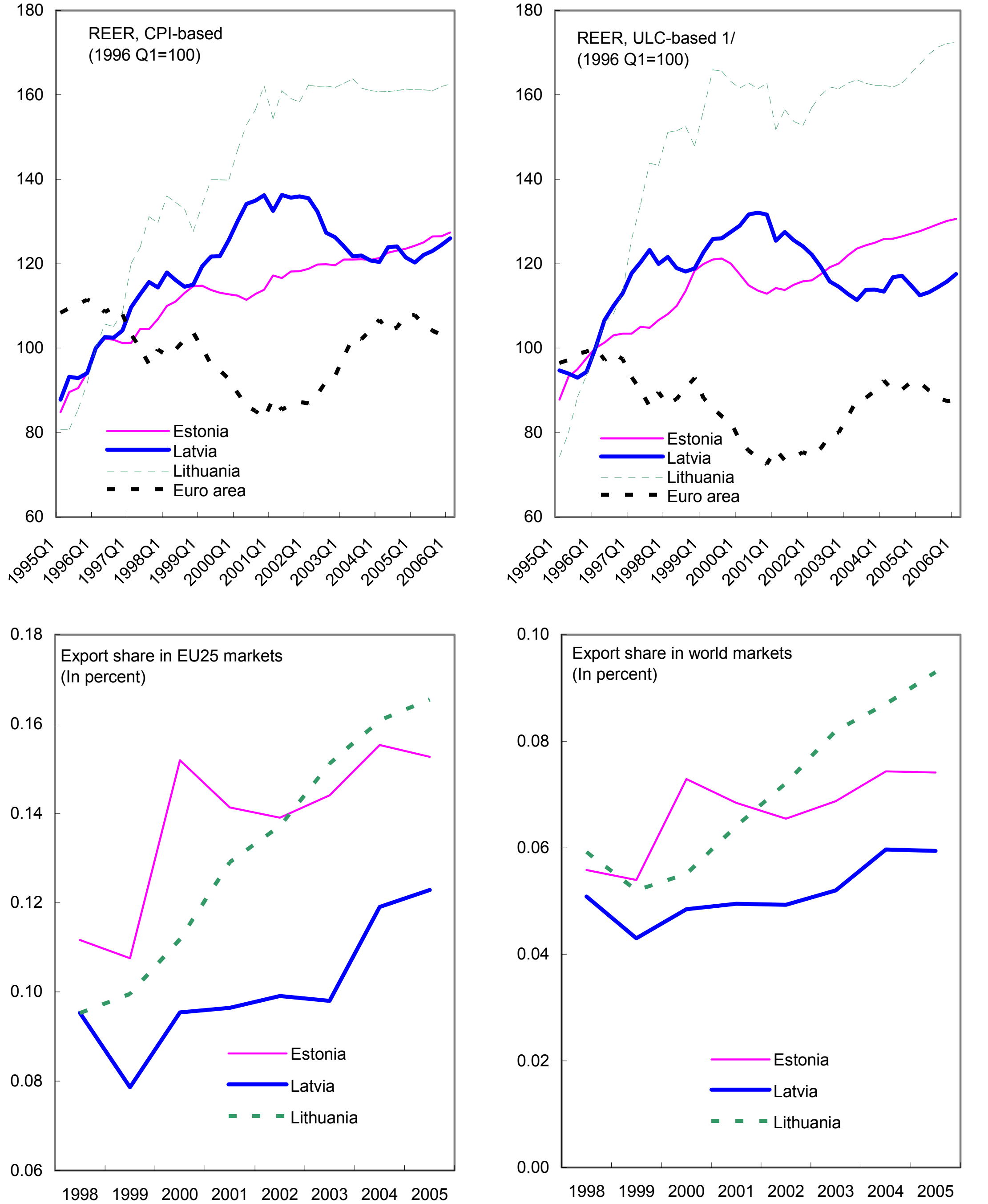
Sources: International Labor Organization, World Bank Development Indicators and staff calculations.
[1] Predicted wages are derived using the model in Krajnyak and Zettelmeyer (1997), where actual wages are regressed on proxies for technology and the K/L ratio.

Selected Countries: Exchange Rates and Relative GDP, 2003 & 2005 1/



Sources: IMF, World Economic Outlook; and staff calculations.
1/ Line derived from a regression of PPP exchange rates (domestic prices relative to US prices) and real GDP per capita, in PPP terms, for 179 countries, based on 2005 data.

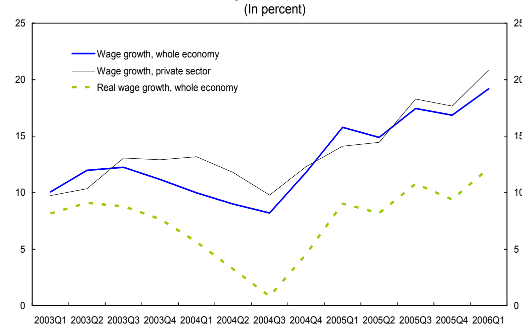
Figure 3. The Baltics: Real Effective Exchange Rates and Export Penetration, 1995–2005



Sources: Country authorities; Eurostat; Direction of Trade; and International Financial Statistics.
1/ Economy wide, based on 25 trading partners for the Baltics, 23 trading partners for the Euro area.

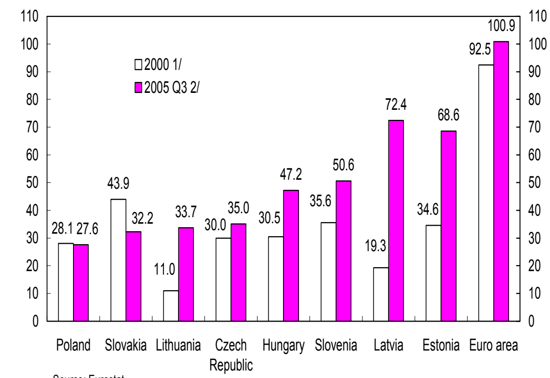
As a result, and together with de facto wage indexation, nominal wage growth has accelerated steadily over the past two years to reach more than 19 percent (year-on-year) in the first quarter of 2006. This acceleration has outpaced productivity improvements by a wide margin, leading to an appreciation of the unit labor cost-based real exchange rate (ULC-REER).

Latvia: Wage developments, 2003-06
(In percent)



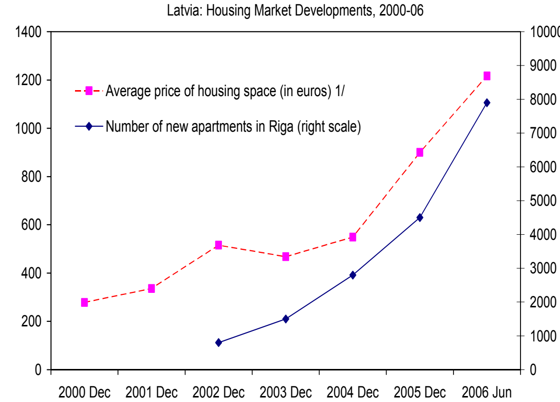
Sources: Country authorities; Eurostat; and Fund staff calculations.

Bank Loans to Private Sector Residents, 2000 and 2005 Q3
(In percent of GDP)



Source: Eurostat.
1/ Data for the Czech Republic is of 2002.
2/ For Latvia, latest observation is 2006 Q1. Using rolling annual GDP.

Latvia: Housing Market Developments, 2000-06



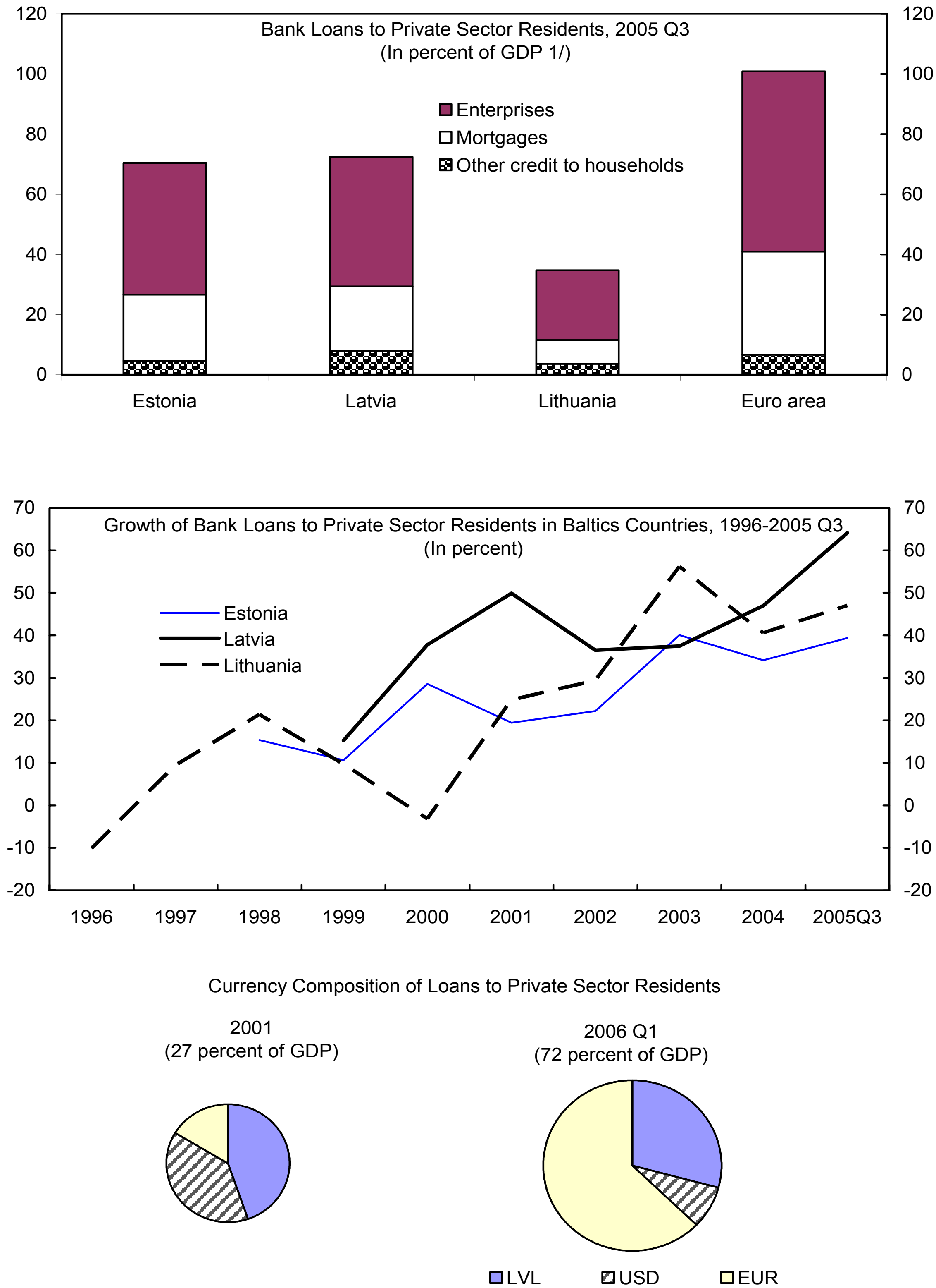
Source: Latio Real Estate.
1/ Price per square meter in standard type block house.

6. **Rapid financial deepening continues, increasing bank exposures to credit and market risk**. Credit to private sector residents grew nearly 65 percent in 2005, and the loan to GDP ratio reached 70 percent, triple the level in 2000 and the highest in the EU8. New loans are skewed toward household mortgages—which almost doubled to 20 percent of GDP (though still well below the EU15 average of 48 percent)—and are increasingly denominated in euros (Figure 4). As a result, housing prices have grown sharply (an annual rate of about 50 percent through mid-2006) to reach relatively high levels.[3] While banks' financial soundness indicators remain strong—with very low nonperforming loans (NPLs) and high profitability in both the Nordic-dominated segment (serving mainly residents) and the segment catering primarily to nonresidents[4] (Table 3)—these measures are backward looking. With the real estate sector now accounting for nearly half of total loans, direct and indirect euro exposures having risen sharply (reflecting both the lifting of limits on open euro positions following the repeg of the lats to the euro and the rapid expansion in euro-denominated loans to mostly-unhedged households) and banks dealing with NRDs increasing their domestic loan portfolios, risks have increased. Moreover, balance sheet mismatches have widened significantly over the

[3] According to the European Council of Professional Realtors (CEPI), average apartment prices per square meter were €1,200 in Riga, against for example €1,500 in Berlin in 2005.

[4] Substantial outflows of nonresident deposits (NRDs) from two small banks identified as potentially involved in money laundering reduced the share of NRDs in total deposits by 10 percentage points to 40 percent in the year to March 2006. There were no systemic effects from this episode.

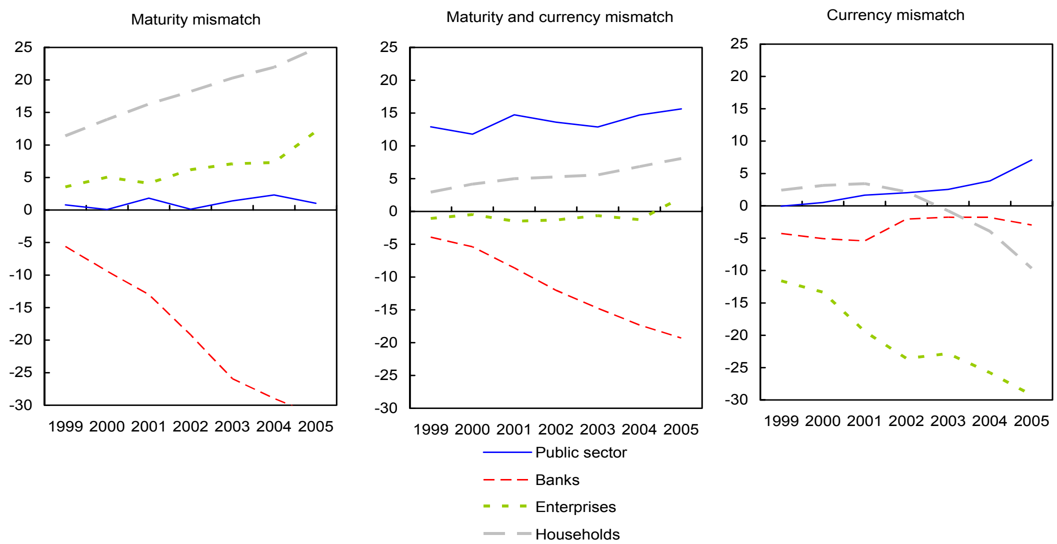
Figure 4. Latvia: Bank Loans to Private Sector Residents



Sources: Bank of Latvia; Eurostat and Fund staff calculations.
1/ For Latvia, latest observation is 2006 Q1. Using rolling annual GDP.

past year. An FSAP update, planned for early 2007, will analyze these vulnerabilities and the potential for cross-border contagion. The March 2006 ROSC concluded that substantial strengthening of the AML/CFT framework was achieved in recent years—bringing it closer to the international standard—and that implementation has improved, but that sustained efforts are needed to counter significant reputational risks arising from business with non-residents.

Latvia: Balance Sheet Mismatches
(In percent of GDP) 1/



Sources: Bank of Latvia and Fund staff calculations.

1/ Balance sheet mismatches indicate vulnerability to macroeconomic shocks. Maturity mismatch (short-term debt assets less short-term debt liabilities) indicates exposure to rollover and interest-rate risk; currency mismatch (debt assets less debt liabilities in foreign currency) indicates exposure to exchange rate movements; and maturity and currency mismatch (short-term debt assets less short-term debt liabilities, both in foreign currency) indicates exposure to rollover and exchange rate risk. Data indicates that (i) banks' direct exchange rate risk is modest but growing, and inherent to financial intermediation, their maturity mismatch is significant; (ii) the corporate sector is very prone to exchange rate fluctuations; (iii) households' exposure to exchange rate shifts increased sharply in 2005 on strong growth in foreign currency denominated loans; (iv) the public sector is insulated against rollover risks but exposed to joint maturity and currency mismatch, due to the BoL's sizable foreign currency reserves.

7. **Notwithstanding a modest headline deficit, fiscal policy has been expansionary**. Despite a broadly stable headline deficit of 1¼ percent of GDP (on a national definition), government spending increased sharply in 2005, covered by cyclically-buoyant revenues and EU grants, and leading to a demand impulse of nearly 1 percent of GDP (Table 4).[5] For 2006, a further substantial stimulus is in prospect as implementation bottlenecks associated with spending EU grants recede, and other spending is covered by a widening of the targeted deficit (¼ percentage point of GDP) and privatization receipts (¾ percentage points of GDP). Significant overperformance of tax revenues relative to budget continued into 2006 which—

[5] On an ESA95 basis, the general government delivered a surplus of 0.2 percent of GDP in 2005. The difference in these measures reflects mainly ¾ percentage points of expenditure in advance of the disbursement of grants from the EU.

as in previous years—risks being used to fund additional spending. Looking ahead, the government is planning a phased 10 percentage point reduction in the personal income tax (PIT) rate to 15 percent beginning in 2007 in order to bring it into line with the corporate income tax and to encourage legalization of the shadow economy.

8. **Monetary policy appropriately continues to lean against the wind of strong demand and credit growth, but its effectiveness is limited by fully open capital markets and the narrow-band exchange rate peg**. With little autonomous leeway to influence the pace of economic activity, the BoL has relied on a significant phased increase in the burden of reserve requirements—raising the rate and broadening the base in recent years.[6] But with still sizable spreads between interest rates on credits and banks' funding costs (Figure 5), such measures are likely to exert at best only a temporary moderating effect on credit growth. Subsequent to the mission, the BoL raised its refinancing rate by ½ percentage point to maintain the interest rate spread following the ECB's policy actions in the first half of this year.

III. Report on the Discussions

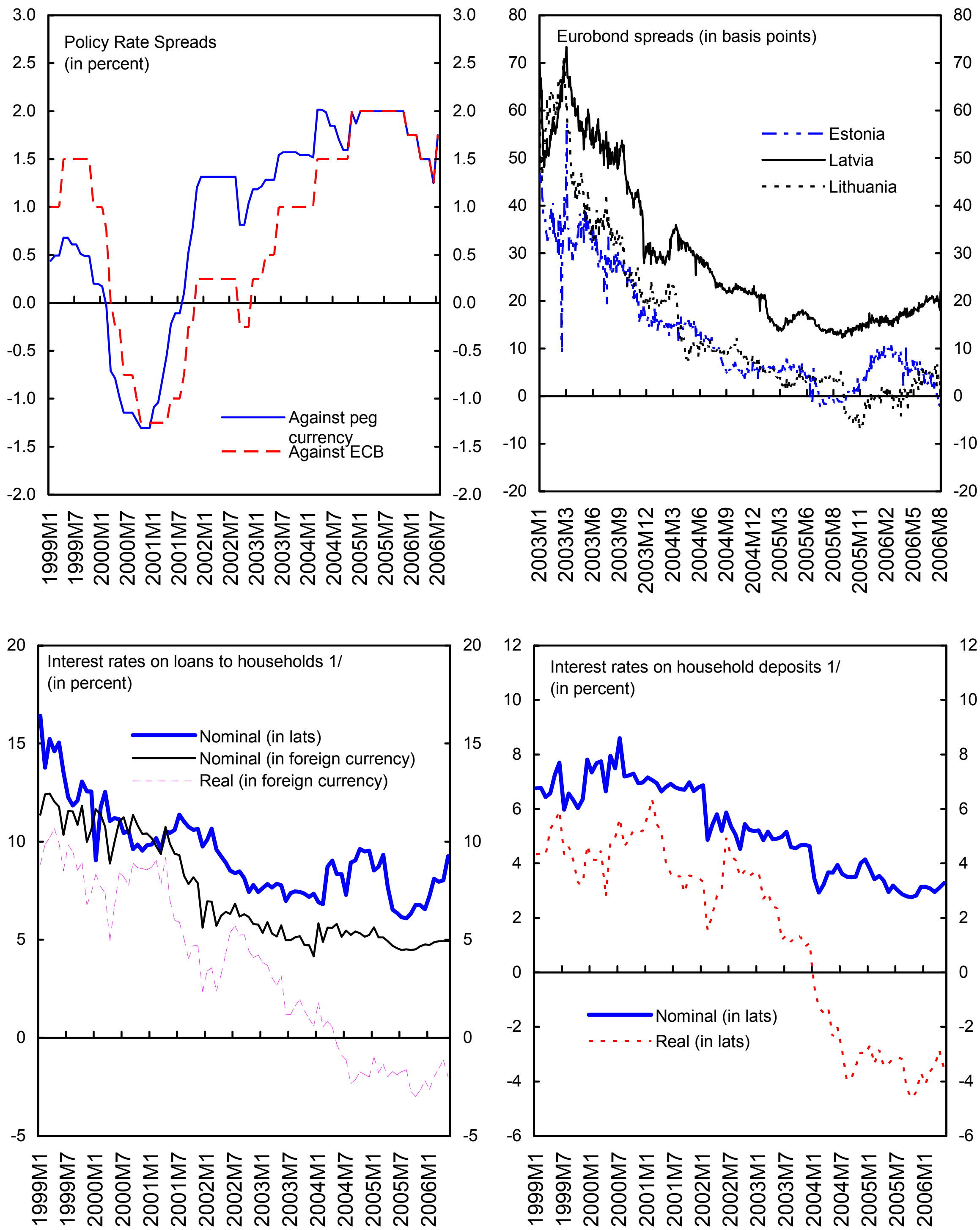
9. **The discussions focused on an assessment of conjunctural macroeconomic and financial sector risks, and the need for policy action**. The authorities and staff shared the view that EU accession and the deepening real and financial sector integration that it brought were fuelling economic activity, but Government officials also saw a substantial contribution from temporary factors. The mission took the view that measures were urgently needed to moderate domestic demand in order to narrow imbalances, preserve external competitiveness, bring forward compliance with the Maastricht criteria, and limit vulnerabilities ahead of euro adoption. Government officials were, however, more sanguine in their assessment of economic developments and, accordingly, were not planning a significant change in the course of fiscal or other policies. The discussions also explored policy options to moderate credit growth and enhance financial stability, as well as structural measures to ensure medium-term competitiveness in the context of very rapid wage growth.

A. Macroeconomic Outlook and Vulnerabilities

10. **Government officials interpreted current macroeconomic developments as largely benign**. Finance Ministry officials welcomed Latvia's dynamic growth as essential to deliver income catchup within a reasonable time horizon; they also considered the economy to be only mildly overheated at present. Other senior government officials attributed the rise in inflation mainly to convergence in wage and price levels, rather than to overheating. They

[6] The rate was increased gradually from 3 to 8 percent (against 2 percent in the euro area), and the base broadened to include liabilities to foreign banks and all liabilities with a maturity in excess of two years.

Figure 5. Latvia: Monetary and Financial Indicators



Sources: Latvian authorities; ECB; Bloomberg; and Fund staff calculations.

1/ Owing to changes in reporting tables, data since 2004 is not fully consistent with earlier periods.

took the view that the rapid pace of infrastructure spending should be maintained to prevent growth bottlenecks and enhance competition that otherwise could add to inflation. It was also suggested that the legalization of the shadow economy had recently gathered pace (as indicated by rapid growth in VAT receipts), thereby significantly inflating measured GDP growth.[7]

11. **BoL officials were less sanguine, and saw overheating as a concern that was unlikely to subside in the near term**. Rapid GDP growth, in combination with high core inflation (headline excluding energy and food) and widening external imbalances, were seen as indicative of a sizable positive output gap. High and rising capacity utilization rates and the growing number of unfilled job vacancies also pointed to Latvia's advanced cyclical position.

12. **The mission expected domestic demand to strengthen in the coming months, underpinned by rapid growth in private consumption and gross fixed investment.** By contrast, weakening competitiveness, and a narrowing of food-price differentials with other EU members would likely contribute to a moderation in net exports. All told, for 2006 as a whole, the mission projected growth to rise to 11 percent, the current account deficit to widen to 14 percent of GDP, and core inflation to remain stuck at around 5¾ percent (with headline inflation moderating on account of smaller increases in world energy prices).

13. **Beyond this year, the mission saw a gradual unwinding of recent economic imbalances as its central scenario, but with a distinctly more disruptive outcome possible were imbalances to remain unchecked**. Rising household debt servicing costs, a gradual slowing of credit (Box 2), and weakening external competitiveness would, under the

Box 2. Credit Growth Forecast

With credit behavior significantly impacting the growth outlook, a key question is how long rapid credit growth is likely to persist. Commercial bank representatives considered Latvia to be some considerable distance from credit saturation, the point where the credit-to-GDP ratio stabilizes. They expected credit ratios to converge to Nordic levels (an average 114 percent of GDP, but considerably higher in some countries), with future credit continuing to be channeled primarily into mortgages. Nonetheless, the pace of credit expansion was expected to slow as borrowing costs—which had declined rapidly on falling spreads, the shift from higher interest rate lat- and dollar-denominated loans to euro loans, and lengthening maturities—approached their minimum.[1/] With mortgage loan penetration still modest (13 percent of households), however, banks saw some potential for expanding their client base, although the relatively low incomes of most of the population and house prices that had reached very high levels would put limits on this process in the near term. All told, staff expects credit to expand by more than 40 percent per year on average during 2006-07, compared with 64 percent in 2005.

[1/]The corollary of declining borrowing costs has been rising asset—primarily real estate—prices.

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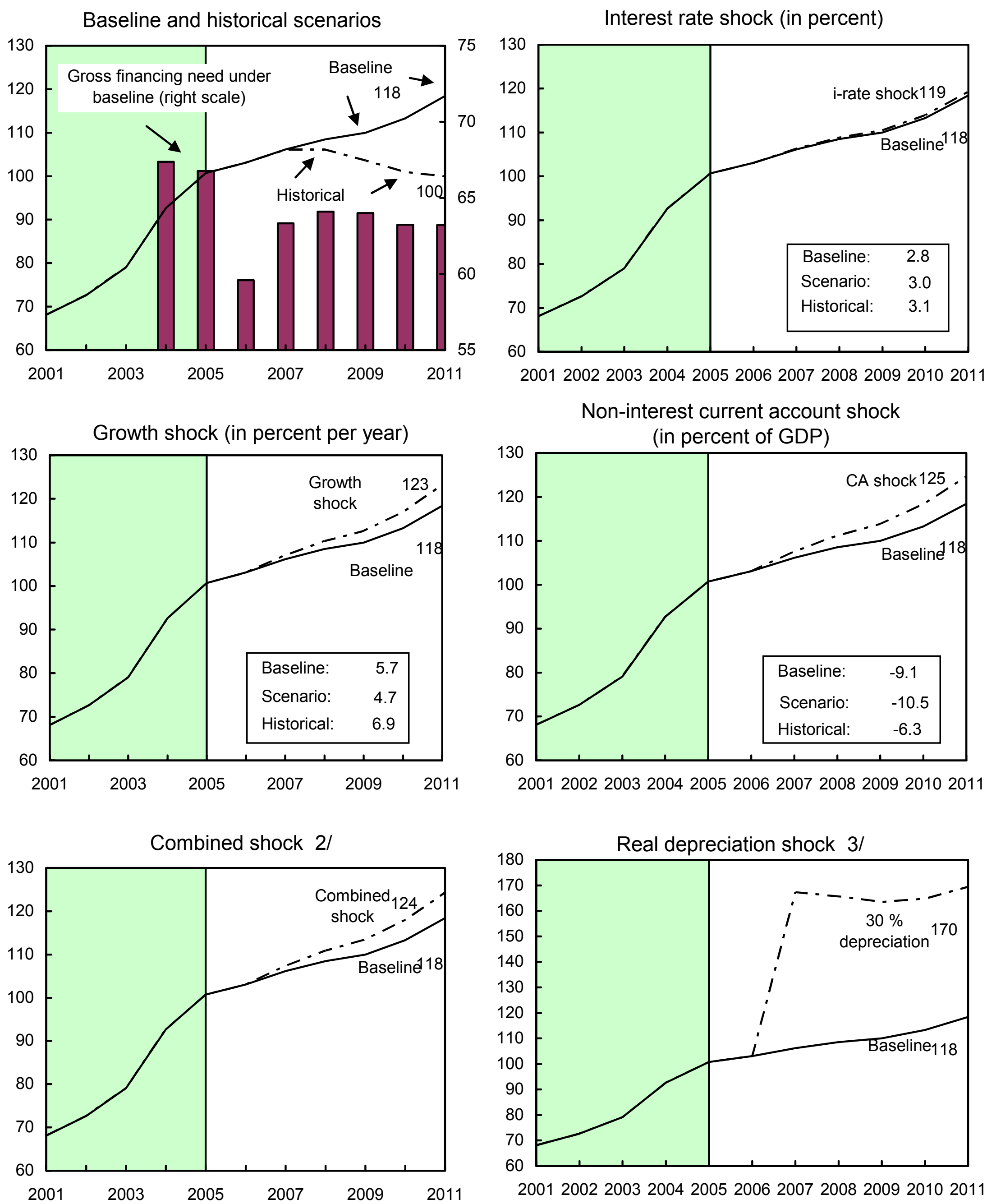
[7] The very rapid growth in VAT collections is likely to reflect primarily a shift in the structure of GDP toward consumption and imports and away from VAT-exempt exports.

baseline, gradually induce a slowdown in demand. This would contribute to a moderation in inflation and a real depreciation of the lats which would support external adjustment (Box 3, Table 5). But even under this soft-landing scenario, the output gap would continue to widen, the current account deficit would decline only slowly, gross external debt would continue to mount (Figure 6, Table 6), and the Maastricht inflation criterion would not be met by the end of the projection period (2011). There are genuine risks, moreover, that negative real interest rates and a substantial increase in EU-financed spending could frustrate this adjustment, while an extended euro exile, coupled with continuing large current account deficits and growing unhedged currency exposures, could call into doubt the viability of the gradual adjustment scenario itself.

14. **BoL officials viewed rapid income convergence and accompanying imbalances as posing significant risks, while some of the mission's other interlocutors saw a helpful role for foreign banks in mitigating such risks.** BoL officials took the view that high debt levels and large currency and real estate exposures raised the risks around the soft landing scenario, particularly given the delay in euro adoption. However, private sector analysts saw the prominent role of foreign parent banks in funding external imbalances (Box 4) as helping to insulate Latvia from possible adverse shifts in sentiment toward emerging market countries because foreign banks have their own funding sources and, moreover, exercise strong oversight over the activities of their subsidiaries. The mission pointed to the sharp rise in balance sheet (especially currency) mismatches of households and, to a lesser extent, banks over the past year as evidence of growing vulnerabilities (Table 7) and cautioned that, were banks to reassess their positions, markets could move suddenly and abruptly.

Figure 6. Latvia: External Debt Sustainability: Bounds Tests[1/] (External Debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ One-time real depreciation of 30 percent occurs in 2007.

Box 3. Stabilizing Latvia's External Liabilities

Servicing Latvia's large external liabilities and moderating its dependence on foreign savings will involve a sizable adjustment in the level and composition of the current account. Lane and Milesi-Ferretti (LM)(2006) show that to stabilize net external liabilities (NFL) relative to GDP, Central and Eastern European countries need to strengthen considerably their trade balances (or, more specifically, their balances on the goods, services, current transfers, labor income, and capital accounts—the "gstl&k" balance) to make room for servicing debt and equity capital. To get an indication of the magnitude of adjustment in Latvia, one possible approach is to consider what size of current account deficit would stabilize net external liabilities at some benchmark level.

Latvia: NFL-Stabilizing Trade Balance

		2003	2004	2005	2006 Q1	Stabilizing levels 1/ 2/
		(In percent of GDP) 3/				
a	Goods and services	-12.7	-15.9	-15.0	-17.1	-11.1
b	Current transfers	4.7	5.0	3.7	5.4	4.9
c	Wage income	1.5	1.6	2.3	2.6	3.0
d	Capital account	0.7	1.0	1.2	1.7	2.0
a+b+c+d	gstl&k	-5.8	-8.3	-7.8	-7.3	-1.2
	NFL	-43.2	-51.6	-58.9	-61.7	-51.4

Sources: Official data and Fund staff calculations.

1/ Real output growth is assumed to be 6.8 percent. Current transfers, wage income and the capital account are set at long-term averages

2/ NFL is assumed to stabilize at an average for non-industrial countries equal to -51.4 percent of GDP. Projected assets and liabilities for 2011 are reduced by the same ratio to generate this value.

3/ Actual data for 2003-2006Q1.

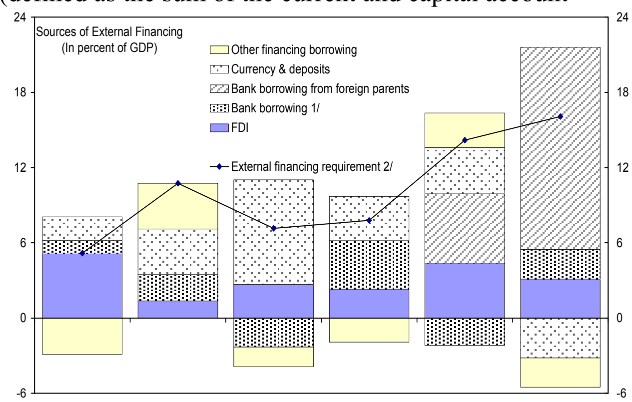
Applying LM's methodology, and using country-specific rates of return, Latvia would need to achieve a gstl&k deficit of 1.2 percent of GDP over the medium term (against an actual deficit of 7.8 percent of GDP in 2005) to stabilize NFL-to-GDP at 51½ percent (the average level for nonindustrial countries, a possible benchmark).[2/] With substantial increases projected in current and capital transfers and wage income, reflecting rising EU grants and repatriation of labor earnings from Latvians working abroad, this implies a needed improvement in the goods and services balance of 4 percent of GDP relative to 2005. Factoring in the responsiveness of import demand to (i) the additional inflows and (ii) the adverse balance sheet effects arising from a real depreciation, some improvement in competitiveness (of around 8 percent—but with significant uncertainty surrounding this estimate) would achieve this adjustment. Part of this would come from unwinding prevailing overheating pressures, with the rest from gradual productivity gains (see ¶27).

[1/] For a discussion of the causes of Latvia's external imbalances and associated risks, see "Integration, External Imbalances and Adjustments: The Latvian Experience" by K. Miyajima and G. Gray in *Republic of Latvia—Selected Issues*.

[2/] Indeed, even to stabilize NFL at 59 percent—the level at end-2005—would require a gstl&k adjustment of 6¼ percentage points of GDP.

Box 4. Sources of External Financing

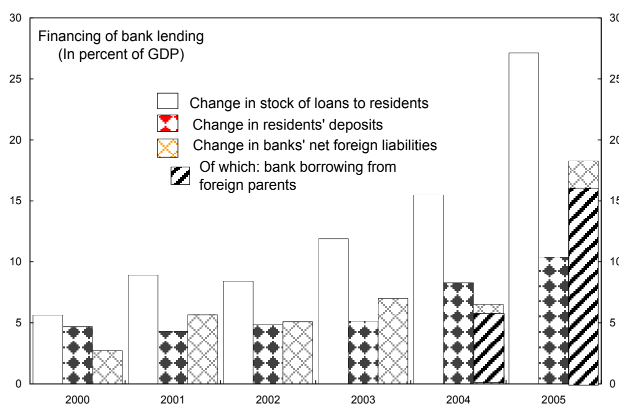
A sharp increase in external financing since 2000 has been accompanied by a marked shift in its composition. Latvia's financing requirement (defined as the sum of the current and capital account deficits, errors and omissions, and changes in reserves) shifted up from 5¼ percent of GDP in 2000 to 16 percent of GDP in 2005. At the beginning of this period, FDI was the primary source of funding, surpassed later by currency and deposits (reflecting the placement of deposits by nonresident corporates and individuals in Latvian banks). Since 2004, however, external bank borrowing—including from foreign parent banks—has become the dominant source of foreign financing, reaching 18½ percent of GDP in 2005. In 2005, some two-thirds of new loans from parents were for durations in excess of one year.



Sources: Bank of Latvia and Fund staff calculations.

1/ For 2000-03 this includes all borrowing by banks; for 2004-05 it excludes loans banks received from their foreign parents.
2/ Sum of the current and capital account deficits, errors and omissions, and change in reserves.

The counterpart to this increase in bank foreign borrowing has been the rapid expansion in bank lending to residents that is not covered by accumulation of residents' deposits. With deposits increasing at a much slower pace than credits, rising net foreign liabilities of banks (including borrowing from parents) have made up the shortfall. In 2005, when loans to residents grew by 27 percentage points of GDP, two-thirds of domestic credit expansion was funded through an increase in net foreign indebtedness of banks.



Sources: Latvian FCMC and Fund staff calculations.

B. Macroeconomic Policies

15. **The mission considered that an upfront tightening of macroeconomic policies was needed to contain near-term overheating pressures, and to reduce the size and duration of the subsequent economic slowdown relative to the baseline scenario** (Table 5). Under an accelerated-adjustment scenario, a sizable front-loaded fiscal adjustment would initiate a more restrained path for real wages and credit expansion directly through taxing real estate and slowing public sector wage growth, and indirectly by fostering more realistic expectations regarding medium-term growth prospects that would moderate bank lending and ease demands for rapid wage catchup. Relative to the baseline, this scenario would deliver slower near-term growth, a more rapid unwinding of the output gap, lower inflation (the Maastricht inflation criterion could be met in 2010-11), a more depreciated real exchange rate, a smaller current account deficit, and a leveling-off of foreign liabilities by 2010. Moreover, with a more gradual accumulation of vulnerabilities in the external and financial sectors, it would reduce the risk of a hard landing that remains inherent to the baseline.

Fiscal policy

16. **The mission cautioned that, in view of the extent of overheating concerns, fiscal policy should, at a minimum, refrain from adding to demand pressures emanating from the private sector**. The authorities viewed fiscal policy as striking an appropriate balance between prudence and the need to satisfy public investment requirements and to redress public-private sector wage disparities. Finance Ministry officials pointed to the very low level of public debt, the balanced budget position (on an ESA 95 basis) in 2005, and the substantial surplus built up so far in 2006 as evidence of Latvia's restrained fiscal policy. The mission responded that a very rapid increase in government spending in recent years had been masked by substantial inflows of EU grants (which are recorded as revenue) and strong cyclical conditions, thereby keeping fiscal balances in check even as the fiscally-induced demand stimulus has been substantial (Box 5). Moreover, government authorizations of EU-funded projects undertaken by the private sector and the signaling effect of large public sector wage increases had also added to demand.

Box 5. Estimating the Demand Effects of Fiscal Policy

In addition to standard adjustments for cash-versus-accrual accounting, estimating the demand effects of fiscal policy involves correcting for the impact of EU grants. This can be done by treating net EU grants (receipts less contributions to the EU) as financing since these grants fund higher fiscal spending, whereas contributions to the EU budget raise fiscal spending, but do not generate domestic demand.

In applying these adjustments to the Latvian context, it should be noted that the budget includes in revenue all grants ("extended" government), even if final beneficiaries are in the private sector (a corresponding expenditure item reflects on-payment to final beneficiaries).[1/] Alternatively, a "narrow" government concept would include in revenue and expenditure only EU grants for which the government is the final beneficiary and the expenditures undertaken with these funds. On either definition, the appropriate concept for assessing the demand effects of fiscal policy is the change in the accrual-adjusted balance excluding net EU grants.

Latvia: Demand Effects of Fiscal Policy, 2005-08
(In percent of GDP)

	Extended Government 1/					Narrow Government 2/				
	Actual	Budget	Staff Baseline			Actual	Budget	Staff Baseline		
	2005	2006	2006	2007	2008	2005	2006	2006	2007	2008
Revenues excluding EU grants and privatization receipts	33.2	33.8	34.7	34.4	33.3	33.2	33.8	34.7	34.4	33.3
Expenditures and net lending excluding payments to EU	36.2	39.8	38.1	38.3	37.5	34.2	37.3	36.2	36.3	35.3
Accrual adjustments 3/	0.3	0.4	0.3	0.6	1.3	0.3	0.4	0.3	0.6	1.3
Accrual general government balance	-2.6	-5.7	-3.1	-3.2	-2.9	-0.6	-3.1	-1.2	-1.3	-0.7
Demand effects of fiscal policy and EU grants	0.9	3.2	0.9	0.6	0.1	-0.2	2.5	0.7	0.3	-0.4
Memorandum items:										
Headline balance	-1.2	-1.5	-1.2	-1.0	-0.9					
EU grants	2.8	4.8	3.1	3.9	4.3	1.3	2.4	1.6	1.9	2.0
Payments to the EU	0.8	1.0	0.9	1.0	1.0	0.8	1.0	0.9	1.0	1.0

Sources: Ministry of Finance and Fund staff calculations and forecasts.

1/ Includes economy-wide EU grants in revenue and expenditure.
2/ Includes in revenue and expenditure only EU grants for which the government is the final beneficiary.
3/ Adjusts for increase in post-accession lengthening of VAT collection lag in 2004 (0.4% of GDP), and the cumulative loss of revenues due to second-pillar pension reform (amounting to 0.3% of GDP in 2005, 0.4% in 2006, 0.7% in 2007 and 1.5% in 2008).

Under the narrow government definition, staff expects a demand stimulus of ¾ percent of GDP in 2006—significantly less than implied by the budget (2½ percent of GDP) due primarily to capacity constraints in spending EU grants—with a smaller stimulus in 2007. With the private sector receiving a sizable share of EU funds, the 2006 demand injection under the extended government concept rises to near 1 percent of GDP. How the demand stimulus ultimately affects GDP will depend on spending propensities and multiplier effects.

1/ EU grants are recorded as revenue on a cash basis in the Latvian budget, but on an accrual basis (i.e., when actually spent) under ESA95.

17. **The mission stressed the need for expenditure restraint in 2006 and a sizable front-loaded adjustment in 2007–08**. In 2006, revenue overperformance should be saved in full and any supplementary spending authorizations offset by spending cuts elsewhere. For the next two years, an ambitious, front-loaded improvement in the fiscal balance should be implemented to reverse the earlier demand injections and partially offset the private sector stimulus. The 0.1 percentage point of GDP annual deficit reduction built into the authorities' 2005 Convergence Program falls well short of this requirement because it implies high real expenditure growth. Rather, staff sees the need to contain real expenditure growth in 2007 and 2008 to 4½ percent and ½ percent respectively (against 9½ percent and 4½ percent implicit in the Convergence Program) in order to counter the considerable public and private demand stimulus already in train. This should be achieved through broad-based

Latvia: Fiscal Policy under the Baseline and Accelerated-Adjustment Scenarios, 2004-08 1/
(In percent of GDP)

	2004	2005	2006 Budget	2006 Baseline	2007 Baseline	2008 Baseline	2007 Staff target	2008 Staff target
Revenues excluding EU grants and privatization receipts	31.9	33.2	33.8	34.7	34.4	33.3	34.3	32.9
Expenditures and net lending excluding payments to the EU	34.4	36.2	39.8	38.1	38.3	37.5	35.6	33.5
Accrual general government balance 2/	-2.0	-2.6	-5.7	-3.1	-3.2	-2.9	-0.7	0.7
Demand effects of fiscal policy and EU grants	0.5	0.9	3.2	0.9	0.6	0.1	-1.9	-1.3
Memorandum items:								
Headline balance	-1.1	-1.2	-1.5	-1.2	-1.0	-0.9	0.8	1.9
EU grants	2.1	2.8	4.8	3.1	3.9	4.3	3.2	3.4
Real growth in expenditure (excl payments to the EU)	8.1	16.0	10.4	16.8	9.6	4.4	4.5	0.5

Sources: Ministry of Finance and Fund staff calculations and forecasts.
1/ Includes economy-wide EU grants in revenue and expenditure. Staff Target is consistent with the accelerated-adjustment scenario (table 5).
2/ Adjusts for increase in post-accession lengthening of VAT collection lag in 2004 (0.4% of GDP), and the cumulative loss of revenues due to second-pillar pension reform (amounting to 0.3% of GDP in 2005, 0.4% in 2006, 0.7% in 2007 and 1.5% in 2008).

expenditure rationalization, including self-financed spending, and by sequencing EU-funded projects according to priority while deferring to the extent possible under EU rules those projects (e.g., in construction) that would likely intensify pressures in already overheated sectors. These policies would produce a headline fiscal surplus of ¾ percent of GDP in 2007 and near 2 percent of GDP in 2008. Moreover, the proposed reduction in the PIT rate—which would boost households' purchasing power at a time of already very buoyant demand—should be put on hold.

18. **Officials were mindful of the advisability of avoiding a procyclical fiscal policy, but saw limited policy options.** Finance ministry officials noted that preparations were already underway for a relatively modest supplementary budget to cover unanticipated costs of hosting several international events, to be implemented after the October elections. They further predicted that a sizable overperformance of the budget target would be infeasible this year in view of pre-election spending pressures and large public sector wage increases. While they did not expect significant changes in fiscal policy even after the elections (in part reflecting an increase in EU funding in 2007), they considered it prudent from both cyclical and budgetary perspectives to tie the PIT reduction to the launch of universal income and asset declarations (planned for 2008), which they expected to yield a compensating boost to tax revenues.

Latvia: Disbursements and Commitments from the EU budget
(In percent of GDP)

	2004	2005	2006	2007	2008-13
Disbursements of EU funds 1/					
Receipts from the EU	2.1	2.8	3.1	3.9	4.0
Payments to the EU budget	0.7	0.8	0.9	1.0	1.0
Net receipts from the EU	1.4	2.0	2.2	2.9	3.0
EU budget commitments (annualized) 2/					
Entitlements	5.0	4.9	4.4	3.7	3.7
Absorption rate (in percent) 3/	41.1	56.8	71.8	…	…

Sources: Ministry of Finance, Staff forecast and calculations.

1/ Actual data and Fund staff projections.
2/ Latvia's estimated entitlements under EU budgets. For the 2004-06 budget period, in percent of 2005 GDP. For the 2007-13 period, in percent of 2010 projected GDP.
3/ For 2004-06, receipts from the EU as a share of EU budget entitlements.

Monetary and credit policies

19. **BoL officials considered that the phased increase in reserve requirements had achieved some measure of success in slowing credit growth, but were weighing the benefits of additional policy tools.** They viewed the reserve requirement policy as having helped to contain bank lending because—by tightening lats liquidity conditions—temporary upward pressure was exerted on money market rates. Moreover, since remuneration rates are below banks' funding costs, higher and more broadly applicable reserve requirements acted to raise bank lending rates on both lats- and euro-denominated loans. With liquidity ratios at several of the most active banks declining close to the current 30 percent minimum, the authorities were considering increasing the liquidity requirement to 50 percent, a step officials believed would dampen credit growth going forward.

20. **While welcoming the broadening of the reserve requirement base, the mission cautioned against further moves that could introduce distortions**. While the recent base widening to encompass long-term liabilities had helped to eliminate a loophole, the mission doubted that a further tightening of reserve or liquidity requirements would appreciably slow overall credit volumes since borrowing could readily be diverted to nonbanks or offshore in order to circumvent the measures. Moreover, by increasing lat relative to euro interest rates, further currency substitution of loans would likely result and, because foreign subsidiaries have ready access to liquidity from parent banks, the impact would fall disproportionately on locally-owned banks.

21. **With most new credit directed to the undertaxed real estate sector, the mission advocated tax-based measures to moderate mortgage lending**. The generous tax treatment of real estate and its uneven enforcement was acting to fuel speculative activity in land and housing. The mission advocated broadening the PIT base to include capital gains on all real properties (with the exception of an individual's primary residence provided it had

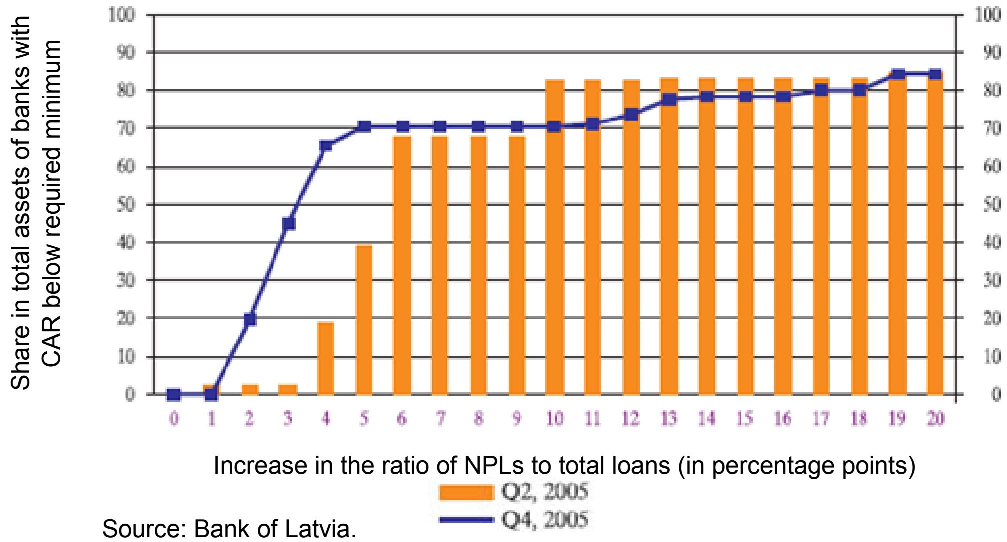
been in the owner's possession for more than three years).[8] Complementing this with more accurate reporting of the transaction price in the land register, which forms the base for the property transfer tax, would also help to better identify capital gains. In response to these suggestions, Finance Ministry officials reported that a Working Group tasked with improving the accuracy of prices in the land register had been established; however, political support for a more comprehensive taxation of capital gains appeared to be weak.

C. Financial Sector Issues

22. **The mission's interlocutors confirmed that intensifying competition among banks had contributed to a softening of loan standards, but views differed as to whether risks had increased materially**. Banking representatives acknowledged that the search for market share had led to an easing of mortgage origination standards, with lengthened maturities, higher loan-to-value and debt-to-income ratios, more loan issuance at floating rates and in foreign currencies to unhedged households, and the introduction of bullet loans. Nonetheless, the Latvian Financial and Capital Markets Commission (FCMC) and banking representatives did not consider that risks had increased significantly because household debt remained low (29 percent of GDP), the buoyant housing market allowed underlying collateral to be readily sold, while euro adoption delay—if held to three-four years—would not bring into question the currency peg. However, BoL officials reported that with capital adequacy and liquidity ratios declining in recent years, its stress tests indicate that banks' capacity to absorb a modest reduction in credit quality has deteriorated. The mission agreed, and stressed that prevailing favorable macroeconomic conditions were a large factor behind current very low NPL ratios. In the event of a significant tightening of global liquidity conditions against the Latvian context of mostly variable rate loans, growing loan penetration of households with more modest debt-servicing capacity would add to risks in the banking sector. Moreover, a correction in house prices would impair loan quality, curtail lending, and generate a sustained dampening effect on economic growth.

[8] Current law exempts from PIT capital gains on properties owned for more than one year, with no limit on the number of exempted properties.

Latvia: Results of the Sensitivity Stress Tests for Credit Risk 1/



Source: Bank of Latvia.

1/ The results indicate that a hypothetical 4 percentage point increase in the ratio of NPLs to total loans at end-2005 would reduce the CAR of six banks—accounting for more than 65 percent of the sector's assets—below the prudential minimum of 8 percent. A similar-sized shock on mid-2005 data would leave the CAR of only two banks—with a market share of less than 20 percent—below 8 percent.

23. **Regulatory options to contain the buildup in vulnerabilities associated with rapid credit growth are limited in the EU context**.[9] In a setting where banking services may be offered by local banks, foreign branches, and cross-border providers, the authorities explained that domestic prudential regulations that are stricter than elsewhere in the EU may easily be evaded by booking loans offshore. Moreover, they noted, with the introduction of Basel 2, all EU members will be expected to implement uniformly the EU's Capital Requirements Directive, leaving little room for stricter national implementation of the Directive, including in the areas of risk weighting of mortgages and loan-to-value rules. The mission considered that shifting credit risk to offshore banks that can better bear risk has its advantages, but urged that remaining policy flexibility be utilized appropriately. In particular, the delay in euro adoption, the exchange rate risks associated with sizable external imbalances, and the growing currency mismatches on banks' balance sheets all point to the need to treat the euro in the same manner as other foreign currencies in assessing capital charges and setting prudential limits on net open positions. The mission also saw considerable scope for increasing borrowers' awareness of the currency, interest rate, and

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[9] For a discussion of recent credit developments and possible policy responses, see "Latvia – Aspects of Rapid Credit Growth" by V. Prokopenko in the upcoming Selected Issues Paper for 2006.

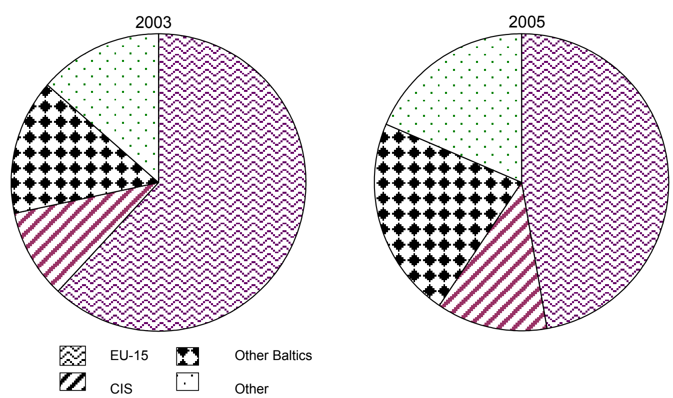
house price risks associated with borrowing, and for banks to better explain the implications of different loan options and to inform borrowers of debt repayment obligations under various adverse macroeconomic scenarios.

24. **The mission stressed that risks from rapid credit expansion and the impending shift to Basel 2 call for strengthening relations with home-country supervisors and improving domestic supervisory oversight and macroprudential analysis**. Large foreign subsidiary banks confirmed that, under Basel 2, a single credit-risk model would be applied throughout entire banking groups. The FCMC assured the mission that, while the home supervisor has final authority over internal risk models applied in host countries, the Latvian supervisor would remain actively engaged in the oversight of the domestic financial sector and maintain close cooperation with its Nordic counterparts. The mission stressed the need for the FCMC to thoroughly review banks' internal credit risk models and the appropriateness of local calibrations. It further emphasized the need—in coordination with relevant foreign supervisors—to be proactive in ensuring that banks maintain sufficient capital to adequately cover direct and indirect risks in their portfolios. In addition, the mission recommended that the BoL's stress testing be refined to include simulations that internalize feedback relationships among macroeconomic variables, borrower solvency, and the level of bank capital, and that steps be taken to obtain relevant data on household incomes, principal repayments, and foreign currency earnings.

D. Competitiveness, Labor Market, and Structural Policies

25. **Strong emigration, along with very rapid economic growth, were seen as helping to close the wage gap with richer EU countries, but also as an emerging threat to Latvia's competitiveness**. The authorities and private analysts noted that recent emigration had been concentrated among the unemployed, the low-skilled, and construction workers.[10] This reflected a number of factors—including the nature of employment opportunities in host countries (mainly Ireland and the UK), the domestic sectors where vacancies have risen most sharply, and the relatively large wage differential for low-skilled workers. Nonetheless, labor market experts reported that

Latvia: Direction of Exports
(Share of total)



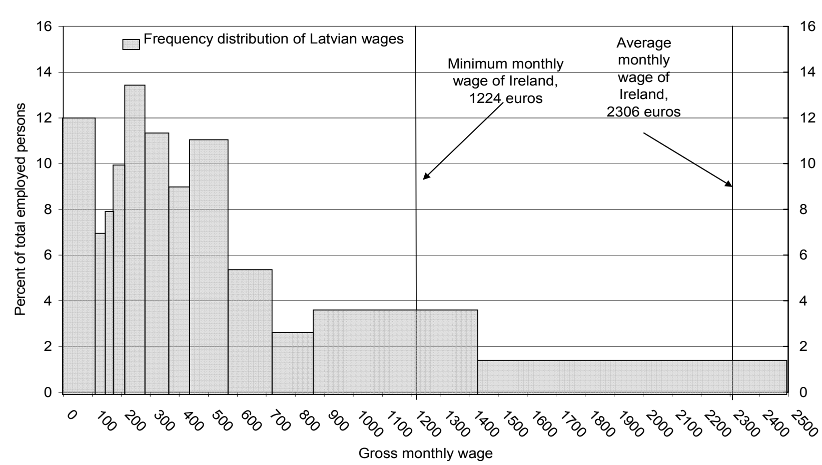
Sources: Latvian CSB and Fund staff calculations.

[10] This is confirmed by the drop in the youth unemployment rate from 18¼ percent in 2004 to 13 percent in 2005.

upward pressure on wages—primarily at the low end of the distribution—had created ripple effects throughout the wage structure. BoL officials considered that, while the ULC-REER in 2005 was some 12 percent below its 2001 peak, recent trends were worrisome, particularly in view of moderating export growth and the recent decline in the share of exports going to the EU15. The mission observed that a range of indicators suggest that until recently Latvia enjoyed a modest competitiveness premium, but that recent wage and price developments had absorbed much of this initial advantage. They therefore called on the authorities to dampen expectations of rapid wage convergence unsupported by productivity gains and to abolish indexation of public-sector wages in order to eliminate the distortionary effect this has on private-sector wage expectations.

26. **A variety of tradeoffs were presented to the mission regarding the appropriate policy response to Latvia's growing labor shortages.**[11] Some analysts called for expanding inward migration to alleviate shortages and dampen wage pressures. However, policymakers generally considered that this would have the effect of replacing domestic low-cost workers with imported ones, thereby holding down wages and promoting further emigration. The mission saw a role for targeted temporary immigration of high-skilled workers to relieve growth bottlenecks, and cautioned that Latvia's current labor shortages may be short lived if growth were to slow at home or in those countries where Latvians are currently working. To boost domestic labor supply while moderating demand, the mission recommended easing the pace of economic growth, improving productivity in the public sector to free up labor, and further increasing labor force participation by raising the untaxed minimum under the PIT.

Latvia and Ireland: Comparison of Monthly Wage Levels, 2005
(In euros)



27. **There was widespread agreement that to sustainably narrow the wage gap while preserving competitiveness would require a continuous upgrading of Latvia's product mix, rather than a change in the exchange rate parity**. The mission observed that Latvia has been slow to transform its product mix away from low-tech, low-skill goods in direct competition with low-cost countries (Box 6), which may help to explain Latvia's declining

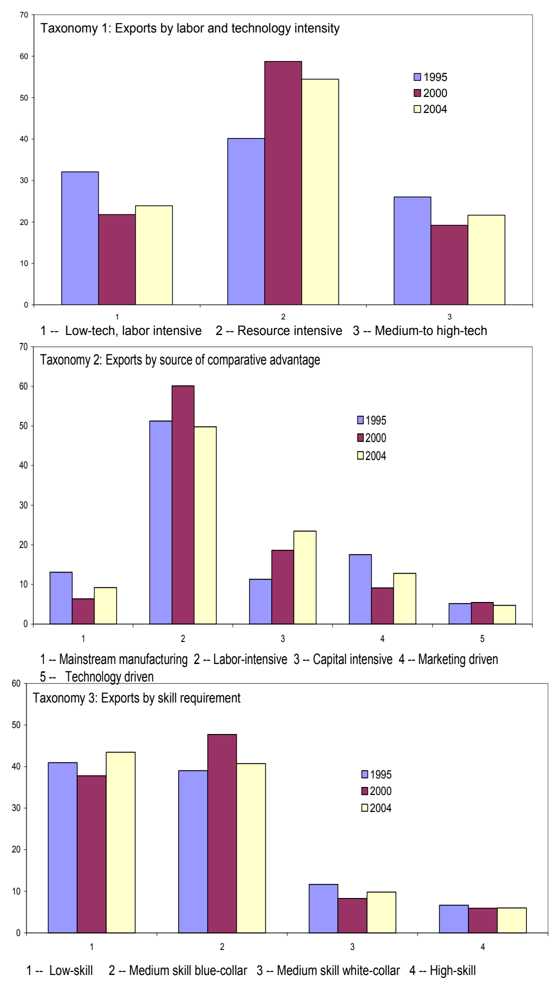
[11] For a discussion of labor emigration in the context of macroeconomic growth theory, see "Labor Outflows, Capital Inflows, and Income Convergence in Latvia" by A. Brunner in the upcoming Selected Issues Paper for 2006.

penetration of EU15 markets. It therefore considered that Latvia's medium-term competitiveness would need to be safeguarded by moving up the value chain, to bring forth productivity gains that could sustainably underpin wage growth. To this end, the mission suggested that EU funds be used to their best advantage to: build human capital through improving education outcomes and increasing business scientific know-how; facilitate absorption of domestic and foreign technologies; integrate local firms into multinational production chains; and improve infrastructure for viable sectors. The authorities and business representatives agreed with this assessment and reported that, in adjusting to higher wages, some sectors had begun to introduce labor-saving technologies, though the need for substantial further progress was widely recognized.

Box 6. Latvia's Export Structure

In the aftermath of the Russia crisis, Latvia successfully reoriented the destination of its exports, but failed to transform its product structure. Exports therefore remain concentrated in resource- and labor-intensive goods (wood and wood products comprise 30 percent of exports), embodying inputs of low- and medium-skill blue collar workers. Among the EU8, Latvia has—by a wide margin—the largest share of low-tech, labor-intensive exports which compete directly with low-cost countries.[1/] In contrast to several other new EU members which are moving up the technology ladder, in recent years Latvia has seen some regression in the skill- and technology-content of its exports.

[1/] This is consistent with the findings of "The Dynamics of Product Quality and International Competitiveness", in the accompanying multi-country selected issues paper.



Sources: UN Comtrade and Fund staff calculations.

IV. STAFF APPRAISAL

28. **The steady catch-up in living standards relative to the EU15 since the mid-1990s has been a significant achievement; however, the current exuberant pace of economic growth brings substantial risks that could disrupt future convergence gains.** Both private and public demand are pushing the economy well above its supply capacity and, as a consequence, high inflation and large current account deficits are becoming entrenched, adding to the economy's already high external debt burden. Rapidly tightening labor markets and unrealistic expectations of a quick narrowing of the wage gap with the EU are amplifying risks of a wage-price spiral. While Latvia has to date enjoyed adequate competitiveness, recent wage and price developments are rapidly eroding this advantage. Households, corporates and banks are taking on large euro exposures, even though exchange rate risk will remain a fact of life in the period leading up to euro adoption. Strong housing demand, falling borrowing costs and speculative activity are fuelling an acceleration in house prices and there is now a concern that a bubble is emerging.

29. **Steering the economy away from its overheated path and moderating vulnerabilities are the key challenges**. Restraining private and public sector demand in the near term is essential to reduce the need—going forward—for a substantial and protracted slowdown in growth in order to moderate price and wage inflation and restore competitiveness. A front-loaded adjustment, moreover, is desirable to limit the buildup of vulnerabilities in the external and financial sectors to reduce the risk of a disruptive unwinding of imbalances, and to bring forward compliance with the Maastricht criteria, thereby limiting the risks inherent in a prolonged delay in euro adoption.

30. **While Latvia's economic setting limits the availability and effectiveness of standard policy options, a broad range of measures—if pursued as a coherent and clearly-communicated policy package—could generate significant results**. In the context of very rapid credit growth, macroeconomic and financial stability concerns are inherently interrelated, calling for a combination of demand management and prudential measures. Reining-in credit growth, unwinding the fiscal stimulus that has already been injected, and securing an environment in which wage growth moves in line with productivity gains are key elements of the policy package that is needed to reduce inflation, strengthen competitiveness, and restore the current account to a sustainable level. A communications strategy that fosters realistic expectations about income prospects and sets a feasible—though ambitious—revised target date for euro adoption will help boost the credibility of the package. However, in the event that higher private sector savings do not materialize, fiscal policy will need to shoulder a greater share of the macroeconomic adjustment.

31. **With overheating apparent, fiscal policy must at a minimum avoid adding to the already considerable demand pressure emanating from the private sector**. Achieving this goal will require a sizable front-loaded fiscal consolidation. As an immediate step, any overperformance of revenues should be saved in full. Beyond this, an ambitious adjustment

is needed to reverse the fiscal stimulus added in recent years and to partially offset private demand injections. This should be achieved by restraining real spending, focusing on own-financed items and those EU-funded projects likely to exacerbate bottlenecks, for example in infrastructure. In addition, the planned reduction in the PIT rate should be put on hold until overheating pressures have dissipated.

32. **The BoL should continue to lean against the wind of strong demand and credit growth, but policies that would introduce distortions should be avoided**. The recent broadening of the reserve requirement base to encompass long-term liabilities is welcome, and monetary policy should continue to track changes in the euro policy rate. But raising the minimum liquidity ratio or further increasing the reserve requirement rate could divert bank lending offshore and to less-regulated nonbanks, while leaving the overall pace of credit growth largely unaffected. Moreover, these measures would promote further currency substitution of loans, and place domestically-owned banks that cannot avail themselves of additional liquidity from foreign parents at a disadvantage.

33. **The generous tax treatment of real estate needs to be curtailed to dampen speculative activity and to moderate credit growth**. To eliminate the loophole in the PIT, realized capital gains on personal real estate holdings should be treated as income unless the property is the individual's primary residence and has been owned for more than three years. More accurate reporting of the transaction price in the land register at the time of purchase should be enforced to correctly measure capital gains and assess the base for the real estate transfer tax.

34. **Efforts to strengthen the regulatory and supervisory framework are needed to help restrain the buildup of risks in the financial and real estate sectors**. Growing currency mismatches and the revision to the euro timetable suggest that the FCMC should amend prudential regulations to ensure that the euro is treated as any other foreign currency until euro adoption. The imperative for close and effective cooperation with foreign supervisors will increase with the introduction of Basel 2, and the FCMC will need to ensure that foreign subsidiaries' credit-risk models are fully appropriate to the relatively unseasoned Latvian financial market, and that banks hold capital cushions sufficient to protect against a possible increase in credit and market risk. Further refinements to the BoL's stress testing framework should also be considered to better simulate the feedback channels between adverse macroeconomic shocks and the financial sector. To sharpen supervision and oversight, more accurate data are needed on household incomes and debt servicing costs, distribution of loans by size, and the share of unhedged households. Better education of households about risks associated with borrowing is also needed.

35. **Safeguarding external competitiveness and avoiding a wage-price spiral in the context of a tightening labor market calls for maintaining wage discipline while easing labor market bottlenecks**. Slowing domestic demand, improving productivity in the public sector, and further increasing labor force participation would mitigate labor market pressures.

Allowing temporary immigration on a limited scale should also be considered to relieve growth bottlenecks related to the scarcity of higher-skilled workers. Fostering realistic expectations about the future pace of wage level convergence—including through the signaling effect of public sector wages—would help to underpin the health of the tradables sector.

36. **Boosting export performance while transitioning from a low- to a moderate-wage country will require Latvian firms to scale the technology ladder**. With most of Latvia's exports concentrated in low value-added products, moving up the value-added chain would deliver productivity improvements to support growth in real incomes. Doing so will require improving Latvia's attractiveness to long-term investors through a credible commitment to macroeconomic stability, reducing "red tape," and exploiting the potential catalytic role of EU funds to build human capital and business know-how, while facilitating the absorption of new technologies.

37. It is recommended that the Article IV consultation with Latvia remain on the standard 12-month cycle.

Table 1. Latvia: Selected Economic Indicators, 2002–07

	2002	2003	2004	2005	Staff Projections 2006	2007
Output, prices, and employment	(Annual growth rate, in percent)					
Real GDP	6.5	7.2	8.6	10.2	11.0	9.0
Private consumption	7.4	8.2	9.5	11.4	13.5	10.0
Public consumption	2.2	1.9	2.1	2.7	11.0	7.0
Gross fixed investment	13.0	12.3	23.8	18.6	19.0	13.0
Stockbuilding (contribution to growth)	-1.6	2.9	0.7	-4.0	-0.3	-0.1
Exports of goods and services	5.4	5.2	9.4	20.7	10.2	8.0
Imports of goods and services	4.7	13.1	16.6	13.5	17.1	11.1
Gross national savings (in percent of GDP)	19.6	20.3	21.3	21.2	22.9	24.3
Gross capital formation (in percent of GDP)	26.7	28.8	33.1	34.2	36.4	37.2
Private investment (in percent of GDP)	25.4	27.3	31.2	32.1	33.8	34.4
Net exports (in percent of GDP)	-9.7	-12.6	-15.6	-14.3	-17.4	-17.9
Consumer price index (average; in percent)	1.9	2.9	6.2	6.8	6.6	6.3
(End-of-period; in percent)	1.4	3.6	7.3	7.0	6.4	5.9
Unemployment rate (LFS definition; in percent) 1/	12.0	10.6	10.5	8.7	...	...
Real net wage 1/	5.8	7.8	2.4	9.6	...	...
Consolidated general government 2/	(In percent of GDP)					
Revenue	32.5	33.0	34.0	35.8	37.8	38.3
Expenditure and net lending	34.8	34.6	35.0	37.0	39.0	39.3
Fiscal balance	-2.3	-1.6	-1.1	-1.2	-1.2	-1.0
Gross general government debt	13.5	14.4	14.5	13.2	10.4	...
Money and credit	(Annual percent change, unless otherwise stated)					
Broad money (millions of lats)	1,865	2,259	2,868	3,985	...	...
Broad money (M2X)	21.0	21.1	27.0	38.9	...	...
Lats broad money	24.3	23.4	23.4	33.1	...	...
Credit to nongovernment	36.5	37.5	47.0	64.3	...	...
Residents' FX deposits (U.S. dollar millions)	921	1,170	1,742	2,203	...	...
Residents' FX deposits (percent of M2X)	29.3	28.0	31.3	32.8	...	...
Interest rates (annualized)						
BoL basic rate	3.0	3.0	4.0	4.0	...	...
Money market (one month)	3.5	4.1	4.1	4.4	...	...
Balance of payments	(In percent of GDP, unless otherwise stated)					
Gross official reserves (U.S. dollar millions)	1,327	1,535	2,022	2,361	3,026	3,673
(In months of prospective imports of GNFS)	2.7	2.3	2.2	2.5	2.6	2.8
Current account balance	-6.6	-8.1	-12.9	-12.4	-14.0	-13.7
Trade balance	-15.8	-17.8	-20.3	-18.9	-21.6	-21.8
Exports of goods and services	40.5	41.7	43.7	47.3	45.2	43.1
Imports of goods and services	-50.6	-54.4	-59.5	-62.3	-63.3	-61.7
Gross external debt	72.7	79.1	92.7	100.7	103.2	106.2
Net external debt 3/	19.6	22.3	28.2	35.6	39.1	42.5
Exchange rates						
Lats per U.S. dollar (Annual average)	0.618	0.571	0.540	0.565	0.562	0.550
(yoy percent change, + means appreciation)	1.6	8.2	5.8	-4.3	...	...
REER (annual average; CPI based, 1995=100)	130.8	122.9	123.2	121.1	...	...
(yoy percent change, + means appreciation)	-3.5	-6.0	0.2	-1.7	...	...

Sources: Latvian authorities; Eurostat; and IMF staff estimates.

1/ Year-average.

2/ National definition. Includes economy-wide EU grants in revenue and expenditure.

3/ Gross external debt liabilities minus gross external debt assets and international reserves.

Table 2. Latvia: Balance of Payments, 2002–07

	2002	2003	2004	2005	Staff Projections 2006	2007
	(In millions of U.S. dollars)					
Current Account	-624	-910	-1,766	-1,960	-2,678	-3,147
Goods	-1,479	-2,003	-2,781	-2,967	-4,144	-5,022
Exports	2,545	3,171	4,221	5,306	6,128	7,045
Imports	-4,024	-5,174	-7,002	-8,273	-10,271	-12,067
Services	537	576	602	603	680	742
Credits	1,239	1,506	1,780	2,160	2,526	2,880
Debits	-701	-930	-1,178	-1,556	-1,847	-2,137
Income	54	-13	-272	-178	7	90
Current transfers	263	530	685	582	780	1044
Official	37	83	109	54	...	...
Private	226	447	576	528	...	...
Capital Account	21	76	144	193	358	538
Current and Capital Account	-603	-834	-1623	-1767	-2320	-2610
Financial Account	675	810	1,554	2,002	2,320	2,610
Direct Investment	250	256	596	497	708	718
Portfolio Investment	-199	-216	247	-133	-70	-2
Financial Derivatives	13	6	-48	-76	-50	-60
Other Investment	613	832	1,156	2,238	2,267	2,531
Trade Credits, Loans and Other	-165	446	661	2,719	1,902	2,114
Deposits	778	387	494	-481	365	417
Reserve assets (minus implies net accumulation)	-2	-69	-397	-524	-536	-577
Errors and omissions	-71	24	69	-235	0	0
	(In percent of GDP)					
Current account balance	-6.6	-8.1	-12.9	-12.4	-14.0	-13.7
Trade balance	-15.8	-17.8	-20.3	-18.9	-21.6	-21.8
Merchandise exports	27.3	28.3	30.7	33.6	32.0	30.6
Merchandise imports	-43.1	-46.1	-50.9	-52.4	-53.6	-52.4
Services, income & transfers balance	9.2	9.8	7.4	6.4	7.7	8.1
Current and Capital Account	-6.5	-7.5	-11.8	-11.2	-12.1	-11.3
Capital Account	0.2	0.7	1.0	1.2	1.9	2.3
Financial Account	7.2	7.2	11.3	12.8	12.1	11.3
Direct Investment	2.7	2.3	4.3	3.1	3.7	3.1
Portfolio investment	-2.2	-2.0	1.7	-0.8	-0.3	0.0
Financial derivatives	0.1	0.1	-0.3	-0.5	-0.3	-0.3
Other Investment	6.5	7.4	8.5	14.2	11.8	11.0
Reserve assets (minus implies net accumulation)	0.0	-0.6	-2.9	-3.3	-2.8	-2.5
Memorandum items:						
Net Direct Investment in Latvia	27.8	26.9	30.3	29.8	28.4	27.3
Net Portfolio investment in Latvia	-4.1	-4.8	-2.1	-3.1	-3.0	-2.5
Other Net Investment in Latvia	30.8	34.1	37.5	47.9	51.6	54.9
Reserve Assets	13.7	13.0	14.1	15.7	15.8	15.9
Gross External Debt	72.7	79.1	92.7	100.7	103.2	106.2
o/w Short-term Debt	43.0	48.0	53.2	49.7	48.5	47.8
Net External Debt 1/	19.6	22.3	28.2	35.6	39.1	42.5
o/w Short-term Debt	3.1	6.9	6.0	2.8	2.3	1.8
	(percentage change)					
Value Growth (percent)						
Exported Goods	11.4	15.2	26.0	31.7	15.0	12.4
Imported Goods	10.3	19.0	28.2	23.9	23.4	14.9
Terms of Trade, GNFS	-1.4	2.5	2.2	-1.7	0.0	0.6
Ratio of Reserve Assets to ST Debt (in percent)	31.8	27.1	26.4	31.5	32.6	33.4

Sources: Latvian authorities; and Fund staff estimates.

1/ Gross external debt liabilities minus gross external debt assets and international reserves.

Table 3. Latvia: Financial Soundness Indicators, 2002–05
(In percent)

	2002	2003	2004	2005
All banks				
Capital adequacy	13.1	11.7	11.7	10.1
Annual growth of bank loans	30.8	41.6	46.1	59.0
NPLs to gross loans	2.0	1.4	1.1	0.7
NPLs net of provisions to capital	2.4	0.9	0.1	0.1
ROA (after tax)	1.5	1.4	1.7	2.1
ROE (after tax)	16.4	16.7	21.4	27.1
Liquid assets to short term liabilities	62.1	57.9	58.1	52.3
FX liabilities to total liabilities 1/	71.8	71.0	74.6	76.3
Net open positions in FX to capital 1/	3.7	7.1	5.4	15.0
Resident banks 2/				
Capital adequacy	13.2	11.1	11.1	9.5
Annual growth of bank loans	96.0	44.5	46.1	67.6
NPLs to gross loans	1.4	1.1	0.9	0.6
NPLs net of provisions to capital	1.4	0.5	-0.9	-0.4
ROA (after tax)	2.0	1.5	1.8	2.0
ROE (after tax)	19.4	16.0	21.9	27.4
Liquid assets to short term liabilities	43.6	39.7	39.9	38.6
FX liabilities to total liabilities 1/	55.4	56.1	61.0	68.6
Net open positions in FX to capital 1/	2.1	6.4	4.1	16.8
Assets of banks dealing with residents/ total banking system assets	49.5	51.1	51.3	59.2
Nonresident banks 3/				
Capital adequacy	12.9	12.6	12.6	12.2
Annual growth of bank loans	-26.1	34.7	46.1	37.5
NPLs to gross loans	3.2	2.0	1.8	1.0
NPLs net of provisions to capital	3.7	1.4	1.1	0.6
ROA (after tax)	1.1	1.4	1.7	2.2
ROE (after tax)	13.8	17.5	21.0	26.8
Liquid assets to short term liabilities	77.1	69.8	68.7	63.1
FX liabilities to total liabilities 1/	87.6	86.5	88.8	87.7
Net open positions in FX to capital 1/	5.9	7.7	6.8	13.0
Assets of banks dealing with non-residents/ total banking system assets	50.5	48.9	48.7	40.8

Sources: Bank of Latvia and FCMC.

1/ Including euro-denominated liabilities/positions.
2/ Banks dealing primarily with residents are defined as banks in which non-resident deposits are less than 20 percent of their non-MFI deposits.
3/ Banks dealing with non-residents are defined as banks in which non-resident deposits exceed 20 percent of their non-MFI deposits.

Table 4. Latvia: Consolidated General Government, 2002–06[1/]
(In millions of lats, unless stated otherwise)

	2002	2003	2004	2005	Budget 2006
Revenue	1,874	2,107	2,522	3,200	3,827
Tax revenues	1,598	1,783	2,025	2,546	2,946
Corporate income tax	110	94	128	181	239
Income tax and social security contributions	848	929	1,077	1,260	1,393
Taxes on goods and services	576	690	746	1,020	1,230
Other taxes	65	69	75	85	9
Non tax revenues	131	150	197	224	271
Self-earned revenue	101	112	128	162	142
Grants	12	8	10	9	2
Other level government payments	4	5	8	8	0
Foreign financial assistance	28	50	154	252	466
Expenditure	2,022	2,213	2,600	3,298	3,981
Non-capital expenditure	1,806	1,989	2,351	2,908	3,448
Current expenditure	829	945	1,087	1,318	1,545
Wages and salaries	394	457	531	633	733
Interest payments	47	51	55	53	75
Subsidies and grants	930	993	1,209	1,537	1,828
Capital expenditure	216	223	249	390	533
Investment	127	110	109	198	308
Net lending	-17	-3	1	7	-9
Fiscal surplus(+)/ deficit(-)	-130	-102	-78	-105	-145
			(In percent of GDP)		
Revenue	32.5	33.0	34.0	35.8	39.4
Tax revenues	27.8	27.9	27.3	28.5	30.3
Corporate income tax	1.9	1.5	1.7	2.0	2.5
Income tax and social security contributions	14.7	14.5	14.5	14.1	14.3
Taxes on goods and services	10.0	10.8	10.0	11.4	12.7
Other taxes	1.1	1.1	1.0	1.0	0.1
Non tax revenues	2.3	2.3	2.7	2.5	2.8
Self-earned revenue	1.8	1.8	1.7	1.8	1.5
Grants	0.2	0.1	0.1	0.1	0.0
Other level government payments	0.1	0.1	0.1	0.1	0.0
Foreign financial assistance	0.5	0.8	2.1	2.8	4.8
Expenditure	35.1	34.6	35.0	36.9	41.0
Non-capital expenditure	31.4	31.1	31.7	32.5	35.5
Current expenditure	14.4	14.8	14.7	14.7	15.9
Wages and salaries	6.8	7.1	7.2	7.1	7.5
Interest payments	0.8	0.8	0.7	0.6	0.8
Subsidies and grants	16.2	15.5	16.3	17.2	18.8
Capital expenditure	3.8	3.5	3.3	4.4	5.5
Investment	2.2	1.7	1.5	2.2	3.2
Net lending	-0.3	0.0	0.0	0.1	-0.1
Fiscal surplus(+)/ deficit(-)	-2.3	-1.6	-1.1	-1.2	-1.5
Memorandum items:					
Primary balance	-1.5	-0.8	-0.3	-0.6	-0.7
General government debt	775	923	1,079	1,064	…
as a percentage of GDP	13.5	14.4	14.5	13.2	…

Sources: Ministry of Finance; and Fund staff estimates.
1/ National definition. Includes economy-wide EU grants in revenue and expenditure.

Table 5. Latvia: Macroeconomic Framework, 2001–11
Baseline and Accelerated Adjustment Scenarios
(In percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
						Staff Projections					
Baseline (gradual adjustment) scenario											
Investment	26.6	26.7	28.8	33.1	34.2	36.4	37.2	36.5	36.3	35.5	34.6
Private	25.5	25.4	27.3	31.2	32.1	33.8	34.4	33.5	33.3	32.7	31.8
Public	1.1	1.3	1.5	1.9	2.1	2.6	2.8	3.0	3.0	2.8	2.8
Domestic saving	19.6	20.3	21.3	21.2	22.9	24.3	25.9	26.7	27.3	26.9	26.4
Private	18.5	19.4	19.7	20.4	20.7	21.5	22.1	22.5	22.9	22.5	22.0
Public 1/	1.5	1.1	1.7	1.1	3.0	3.5	4.4	4.9	5.1	5.0	5.1
Foreign saving 2/	-7.1	-6.4	-7.4	-11.8	-11.2	-12.1	-11.3	-9.8	-9.1	-8.6	-8.2
Memorandum items:											
GDP real growth (year-on-year in percent)	8.0	6.5	7.2	8.6	10.2	11.0	9.0	6.7	5.0	4.1	3.8
CPI inflation (average, year-on-year in percent)	2.5	1.9	2.9	6.2	6.8	6.6	6.3	5.8	5.2	4.1	3.6
Current account balance	-7.6	-6.6	-8.1	-12.9	-12.4	-14.0	-13.7	-12.4	-11.5	-11.0	-10.6
Headline fiscal balance	-1.9	-2.3	-1.6	-1.1	-1.2	-1.2	-1.0	-0.9	-0.6	-0.5	-0.4
External debt											
Gross	68.1	72.7	79.1	92.7	100.7	103.2	106.2	108.6	110.1	113.4	118.5
Net 3/	16.5	19.6	22.3	28.2	35.6	39.1	42.5	44.8	47.3	50.7	54.2
Net foreign direct investment	1.4	2.7	2.3	4.3	3.1	3.7	3.1	3.2	2.8	2.4	2.4
Accelerated adjustment scenario											
Investment	26.6	26.7	28.8	33.1	34.2	36.4	35.4	33.5	32.5	33.5	34.6
Private	25.5	25.4	27.3	31.2	32.1	33.8	33.4	31.5	30.3	31.2	31.8
Public 1/	1.1	1.3	1.5	1.9	2.1	2.6	2.0	2.0	2.2	2.3	2.8
Domestic saving	19.6	20.3	21.3	21.2	22.9	24.3	26.8	27.3	28.4	30.6	32.3
Private	18.0	19.1	19.6	20.2	20.0	20.8	21.5	20.7	21.3	23.3	25.1
Public	1.5	1.1	1.7	1.1	3.0	3.5	5.3	6.6	7.1	7.3	7.2
Foreign saving 2/	-7.1	-6.4	-7.4	-11.8	-11.2	-12.1	-8.6	-6.2	-4.2	-2.8	-2.3
Memorandum items:											
GDP real growth (year-on-year in percent)	8.0	6.5	7.2	8.6	10.2	11.0	6.7	5.8	4.2	3.6	4.5
CPI inflation (average, year-on-year in percent)	2.5	1.9	2.9	6.2	6.8	6.6	6.3	5.2	4.2	2.8	2.7
Current account balance	-7.6	-6.6	-8.1	-12.9	-12.4	-14.0	-10.5	-8.3	-6.1	-4.9	-4.6
Headline fiscal balance	-1.9	-2.3	-1.6	-1.1	-1.2	-1.2	0.8	1.9	2.5	2.8	2.8
External debt											
Gross	68.1	72.7	79.1	92.7	100.7	106.9	101.6	94.5	89.4	87.2	87.0
Net 3/	16.5	19.6	22.3	28.2	35.6	39.5	37.1	34.1	32.1	31.0	30.8
Net foreign direct investment	1.4	2.7	2.3	4.3	3.1	3.7	3.1	3.2	2.8	2.4	2.4

Sources: Latvian authorities; and Fund staff estimates.
1/ Includes 2nd pillar contributions. Accrual basis.
2/ Defined as the sum of the current account deficit and the capital account deficit.
3/ Gross external debt liabilities minus gross external debt assets and international reserves.

Table 6. Latvia: External Debt Sustainability Framework, 2002–2011
(In percent of GDP, unless otherwise stated)

	Actual				Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	72.7	79.1	92.7	100.7	**103.1**	**106.2**	**108.5**	**110.0**	**113.3**	**118.4**	**-8.1**
Change in external debt	4.6	6.4	13.6	8.0	2.4	3.1	2.4	1.5	3.3	5.1	
Identified external debt-creating flows (4+8+9)	-3.8	-6.5	-5.4	-2.4	2.2	3.7	3.9	4.7	5.3	5.1	
Current account deficit, excluding interest payments	5.0	6.3	11.0	10.3	11.7	11.2	9.8	8.8	8.2	7.7	
Deficit in balance of goods and services	10.0	12.7	15.9	15.0	18.1	18.6	17.3	16.2	15.4	14.6	
Exports	40.5	41.7	43.7	47.3	45.2	43.1	42.1	41.2	41.2	41.4	
Imports	50.6	54.4	59.5	62.3	63.2	61.7	59.4	57.4	56.5	56.0	
Net non-debt creating capital inflows (negative)	-3.2	-2.5	-3.6	-2.7	-2.6	-2.2	-2.3	-1.9	-1.6	-1.5	
Automatic debt dynamics 1/	-5.7	-10.3	-12.8	-10.1	-6.8	-5.3	-3.6	-2.1	-1.3	-1.0	
Contribution from nominal interest rate	1.6	1.8	1.9	2.1	2.3	2.4	2.6	2.7	2.8	2.9	
Contribution from real GDP growth	-3.9	-4.4	-5.6	-8.2	-9.1	-7.7	-6.2	-4.8	-4.1	-4.0	
Contribution from price and exchange rate changes 2/	-3.4	-7.8	-9.1	-4.0	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	8.4	13.0	19.0	10.5	0.2	-0.6	-1.5	-3.3	-1.9	0.0	
External debt-to-exports ratio (in percent)	179.2	189.5	212.3	213.1	228.3	246.3	257.8	266.7	275.3	286.0	
Gross external financing need (in billions of US dollars) 4/	4.3	5.9	9.3	10.6	11.4	14.6	17.0	19.1	20.7	22.5	
in percent of GDP	46.1	52.8	67.4	66.8	59.6	63.3	64.1	64.0	63.2	63.2	
Scenario with key variables at their historical averages 5/					**103.1**	**106.1**	**106.1**	**103.6**	**101.0**	**100.0**	**-12.6**
Key Macroeconomic Assumptions Underlying Baseline											
Real GDP growth (in percent)	6.5	7.2	8.6	10.2	11.0	9.0	6.7	5.0	4.1	3.8	
GDP deflator in US dollars (change in percent)	5.2	12.0	13.0	4.5	9.1	10.3	7.8	7.2	5.4	4.8	
Nominal external interest rate (in percent)	2.6	3.0	2.9	2.6	2.8	2.8	2.8	2.8	2.8	2.8	
Growth of exports (US dollar terms, in percent)	10.3	23.7	28.4	24.7	15.7	14.7	12.4	10.2	9.5	9.5	
Growth of imports (US dollar terms, in percent)	10.8	29.3	34.3	20.6	22.9	17.2	10.8	8.8	8.0	7.8	
Current account balance, excluding interest payments	-5.0	-6.3	-11.0	-10.3	-11.7	-11.2	-9.8	-8.8	-8.2	-7.7	
Net non-debt creating capital inflows	3.2	2.5	3.6	2.7	2.6	2.2	2.3	1.9	1.6	1.5	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = 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.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

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

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 7. Latvia: Selected Vulnerability Indicators, 2001–06

	2001	2002	2003	2004	2005	2006 1/	Latest Observation
Key economic and market indicators							
Real GDP growth (in percent)	8.0	6.5	7.2	8.6	10.2	13.1	*Q1, 2006*
CPI inflation (period average, in percent)	2.5	1.9	2.9	6.2	6.8	6.3	*Q2, 2006*
Short-term (ST) interbank rate, 1-month RIGIBOR (eop, in percent)	6.3	3.5	4.1	4.1	4.4	4.7	*July 27, 2006*
Eurobond secondary market spread (bps, eop)	91	70	32	22	16	19	*July 27, 2006*
Exchange rate NC/US$ (eop)	0.64	0.59	0.54	0.52	0.59	0.57	*June 30, 2006*
Exchange rate NC/US$ (period average)	0.63	0.62	0.57	0.54	0.56	0.55	*Jun-06*
External sector							
Exchange rate regime	Lats pegged to the SDR (+-1% band)←→Pegged to the euro (+-1% band)						
Current account balance (in percent of GDP)	-7.6	-6.6	-8.1	-12.9	-12.4	-14.6	*Q1, 2006*
Net FDI inflows (in percent of GDP)	1.4	2.7	2.3	4.3	3.1	8.9	*Q1, 2006*
Exports (in percentage change of US$ value, GNFS)	7.9	13.2	24.7	33.3	26.0	7.8	*Q1, 2006*
Real effective exchange rate index (Dec 95=100, period average)	135.5	130.8	122.9	123.2	121.1	124.8	*May-06*
Gross international reserves (GIR, in US$ billion)	1.2	1.3	1.5	2.0	2.4	2.7	*Mar-06*
GIR in percent of ST debt at remaining maturity (RM) excluding non-resident deposits	104.9	94.6	75.0	84.3	89.6	...	*Dec-05*
GIR in percent of ST debt at RM including banks' non-resident FX deposits.	40.3	31.8	27.1	26.4	31.5	...	*Dec-05*
Net international reserves (NIR, in US$ billion)	1.2	1.3	1.5	2.0	2.3	2.7	*Mar-06*
Total gross external debt (ED, in percent of GDP)	68.1	72.7	79.1	92.7	100.7	101.4	*Q1, 2006*
Of which: ST external debt (original maturity, in percent of total ED)	54.3	59.2	60.7	57.4	49.4	46.9	*Q1, 2006*
ED of domestic private sector (in percent of total ED)	86.8	89.1	91.0	91.0	93.4	93.1	*Q1, 2006*
Total gross external debt (in percent of exports of GNFS)	165.4	179.2	189.5	212.3	213.1	...	*Dec-05*
Gross external financing requirement (in US$ billion) 2/	1.0	1.3	1.7	3.6	3.8	...	*Dec-05*
Public sector (PS) 3/							
Overall balance (in percent of GDP)	-1.9	-2.3	-1.6	-1.1	-1.2	...	*Dec-05*
Primary balance (in percent of GDP)	-1.0	-1.5	-0.8	-0.3	-0.6	...	*Dec-05*
Debt-stabilizing primary balance (in percent of GDP) 4/	-0.4	-0.3	-0.3	-0.6	-0.8	...	*Dec-05*
Gross PS financing requirement (in percent of GDP) 5/	3.7	3.4	2.7	4.7	1.8	...	*Dec-05*
General government gross debt (in percent of GDP)	14.9	13.5	14.4	14.5	13.2	...	*Dec-05*
Financial sector (FS) 6/							
Capital adequacy ratio (in percent)	14.2	13.1	11.7	11.7	10.1	10.9	*Q1, 2006*
NPLs in percent of total loans	2.8	2.0	1.4	1.1	0.7	0.6	*Q1, 2006*
Provisions in percent of NPLs	80.4	95.5	89.4	99.1	98.8	105.4	*Q1, 2006*
Return on average assets (in percent)	1.5	1.5	1.4	1.7	2.1	2.2	*Q1, 2006*
Return on equity (in percent)	19.0	16.4	16.7	21.4	27.1	28.6	*Q1, 2006*
FX deposits held by residents (in percent of total deposits held by residents)	...	...	36.6	38.3	39.9	40.4	*Q1, 2006*
FX loans to residents (in percent of total loans to residents)	...	...	56.1	60.9	70.0	70.9	*Q1, 2006*
Credit to private sector (percent change) 7/	49.8	36.5	37.5	47.0	64.3	...	*Q1, 2006*
Memorandum item:							
Nominal GDP in billions of U.S. dollars	8.3	9.3	11.2	13.7	15.8	...	*Q4, 2005*

Sources: Latvian authorities, and Fund staff calculations.

1/ Latest observations as indicated in the last column.
2/ Current account deficit plus amortization of external debt.
3/ Public sector covers general government.
4/ Relevant variables for calculations - i.e., growth rates, interest rates, etc, are averaged over the last five years.
5/ Overall balance plus debt amortization.
6/ Financial sector includes commercial banks.
7/ Total loans less loans to the public sector and transit loans, provided to both residents and non-residents.

APPENDIX I. LATVIA: FUND RELATIONS

(As of July 31, 2006)

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

General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	126.80	100.0
Fund holdings of currency	126.76	99.97
Reserve position in Fund	0.06	0.04

SDR Department:	**SDR Million**	**Percent of Allocation**
Holdings	0.10	N.A.

Outstanding Purchases and Loans: None

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:** None

Exchange Arrangements:

The currency of Latvia is the lats, which was introduced in March 1993 to replace the Latvian ruble. The exchange rate was pegged to the SDR from February 1994 to December 2004, within a ±1 percent band. On January 1, 2005, the lats was repegged to the euro at the rate € 1 = 0.703 lats, and on April 29, 2005, Latvia entered ERM2, maintaining the previous band width. On August 23, 2006 the lats was equal to US$ 1.83. Latvia's exchange system is free of restrictions on the making of payments and transfers for current international transactions. Latvia maintains security-related exchange restrictions pursuant to UN Security Council resolutions and EC Council regulations, which have been notified to the Fund under Decision No. 144-(52/51), adopted August 14, 1952.

Article IV Consultation:

Latvia is on the 12-month consultation cycle.

The 2005 Article IV staff report was issued on July 15, 2005 (Country Report No. 05/282). The last Article IV Board discussion took place on July 27, 2005. The Public Information Notice No. 05/109 was released on August 10, 2005.

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) during February 14–28, 2001. The Financial Sector Stability Assessment (FSSA) report was discussed at the Board on January 18, 2002, together with the 2001 Article IV staff report (Country Report No. 02/10). An AML/CFT assessment mission took place during March 8-24, 2006, and the report is under preparation.

ROSC Modules

Standard/Code assessed	Issue date
Code of Good Practices on Fiscal Transparency	March 29, 2001
Code of Good Practices on Transparency in Monetary and Financial Policies	January 2, 2002
Basel Core Principles for Effective Banking Supervision	January 2, 2002
CPSS Core Principles for Systemically Important Payment Systems	January 2, 2002
IOSCO Objectives and Principles of Securities Regulation	January 2, 2002
IAIS Core Principles	January 2, 2002
OECD Corporate Governance Principles	January 2, 2002
Data Module	June 23, 2004

Technical Assistance:

TECHNICAL ASSISTANCE FROM THE FUND, 1999–2004

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

TECHNICAL ASSISTANCE FROM THE FUND, 1999–2004

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

Resident Representative:

The resident representative office was closed in December 2004.

Fourth Amendment:

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

APPENDIX II. LATVIA: STATISTICAL ISSUES

Data provision to the Fund is adequate for surveillance purposes. In addition, the authorities maintain 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 its specifications for the coverage, periodicity, and timeliness of the data, and for the dissemination of advance release calendars. Also, 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 (MOF), and the customs authorities.

Building on extensive Fund assistance for statistical improvements through the placement of Resident Statistical Advisors from 1996 to 2000, further advice on statistical matters has been provided by EUROSTAT as a part of the EU accession process.

A data ROSC mission in September 2003 found that the national accounts, the consumer and producer price indices, government finance statistics (GFS), monetary and balance of payments statistics generally follow internationally accepted guidelines on concepts and definitions, scope, classification and sectorization, basis of recording, and valuation. The consumer price index (CPI), however, excludes the services of owner-occupied dwellings. The MOF should continue to be supported in its program to adopt the accrual standards of the *Government Finance Statistics Manual 2001* (*GFSM 2001*) for expenditures and in its practice of including all income and expenditure of the general government sector within the Treasury accounting and statistical system. Monetary statistics should provide for greater detail in the classification of the liabilities of depository corporations by subsectors of the general government.

National accounts

The CSB compiles and publishes quarterly national accounts using the production and expenditure approaches on a regular and timely basis, largely following the *1993 System of National Accounts (SNA 1993)* and the 1995 *European System of Accounts (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 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. Meanwhile, official national accounts include an adjustment for under-recording. Additional data for the expenditure-based accounts are obtained from household budget surveys and other surveys from the State Treasury and ministries.

Prices

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. Following advice from EUROSTAT, the weights in the CPI basket are now revised annually. Also, the weights in the producer price index are updated annually and the index covers almost three quarters of total industrial activity. The CSB publishes export and import unit value and volume indices.

Government finance statistics

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. The 2005 *Government Finance Statistics Yearbook* contains cash data in the *GFSM 2001* format for 2004. Government finance data up to the month of December 2005 have been published in the *International Financial Statistics*.

Monetary statistics

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 provided weekly 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.

Latvia has adopted the ECB framework for compiling and reporting monetary statistics, which provides the same detailed information as the Standardized Report Forms recommended by the IMF to its member countries for reporting monetary data.

Balance of payments statistics

The BoL assumed responsibility for compiling the balance of payments statistics from the CSB in early 2000, and since 2001 it has published monthly data. The data collection program is a mix of quarterly surveys supplemented by the monthly information of the international transactions reporting system (ITRS), banking statistics and administrative sources. The three quarterly surveys employed to derive source data are: (1) a survey of foreign investment covering data for direct, portfolio and other investment, and related income flows of non-financial enterprises, (2) a survey of transportation and intermediary services, and (3) a survey on other services.

The data source for general merchandise is foreign trade statistics compiled monthly by the CSB, which, after becoming part of the European Union (the 1st of May 2004) include, monthly data from the Intrastat report for intra-EU transactions and data from customs cargo declarations for the extra-EU transactions. The Data ROSC mission of September 2003 noted the 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, survey techniques need to be further improved. 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 of imported inputs. While these methodological improvements are welcome, revisions of past data have been reported in February 2005 only from 2000 onwards in respect of current transfers (credits) and exports of goods for processing. The resulting break in the data series still limits 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 issues were also highlighted by the Data ROSC mission of September 2003.

LATVIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
AS OF JULY 31, 2006

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality – Accuracy and reliability[8]
Exchange Rates	6/30/06	7/4/06	M	M	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	6/30//06	7/21/06	M	M	M		
Reserve/Base Money	6/30/06	7/5/06	M	M	M	O, O, LO, O	O, O, O, O, O
Broad Money	5/31/06	7/5/06	M	M	M		
Central Bank Balance Sheet	6/30/06	7/5/06	M	M	M		
Consolidated Balance Sheet of the Banking System	5/31/06	7/5/06	M	M	M		
Interest Rates[2]	5/31/06	7/6/06	M	M	M		
Consumer Price Index	06/06	7/19/06	M	M	M	O, LO, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]						O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government							
Stocks of Central Government and Central Government-Guaranteed Debt[5]							
External Current Account Balance	Q1 2006	7/07/2006	Q	Q	Q	O, O, O, O	O, O, O, O, O
Exports and Imports of Goods and Services	Q1 2006	7/19/2006					
GDP/GNP	Q1 2006	7/19/2006	Q	Q	Q	O, O, O, O	O, LO, LO, LO, LO
Gross External Debt							

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published in July 2004, and based on the findings of the mission that took place during September 2003 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO),or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by Tuomas Saarenheimo, Executive Director for Republic of Latvia and Juris Kravalis, Senior Advisor to Executive Director
October 4, 2006

On behalf of our Latvian authorities we would like to thank staff for the constructive dialogue in Riga and the well balanced report. We welcome the choice of topics for the Selected Issues paper and are in a broad agreement with staff's analyses and recommendations.

Macroeconomic Outlook and Risks

Our authorities share staff's assessment that, along with a strong economic performance and a remarkable real convergence, overheating pressures have been strengthening recently. From the medium-term perspective robust growth has been largely driven by such fundamental factors as capital deepening, technological innovations, increasing utilization of labor stock and efficiency gains leading to a substantial growth of total factor productivity. However, as correctly argued by staff, deepening European integration and the prospects of the euro adoption, in combination with historically lax international monetary conditions, have resulted in a substantial decrease in nominal interest rates and sizable foreign inflows fuelling domestic demand. While initially the surge in inflation was mainly supply-side driven, the ongoing economic acceleration, widening of the output gap, changing growth composition, and tightening of the labor market indicate that overheating pressures are becoming more prominent in posing risks to macroeconomic stability and delaying the timetable for the euro adoption.

Along with the risks associated with overheating and accumulation of imbalances in the economy, in our opinion some risk-mitigating factors should have been more emphasized in the staff report. Though our authorities are fully aware that the recent exceptionally strong wage growth, should it continue in the medium-term, is a threat to external competitiveness, there is rather mixed evidence about the extent to which the recent deceleration of export growth has been influenced by the decline in external competitiveness. First, as shown also in the staff report, the recent real appreciation of the lats still compares rather favorably on the backdrop of a sizable past real depreciation and could partly be attributed to equilibrium phenomena. The rapid wage growth, though increasingly exerting pressure on unit labor costs, has been accompanied by sizable productivity gains, especially in the tradable sector. Second, the recently moderate growth of market shares is at least partly driven by price fluctuations in the world markets for several commodities having substantial share in Latvia's export. Another risk-mitigating factor is the nature of foreign inflows. External imbalances are mostly financed by the banking sector's long-term inter-company loans, i.e., loans from the parent institutions located predominantly in the EU countries that diminish the risks of sudden stops or reversals of foreign inflows.

Overall, given the increasing degree of the country's economic integration, it seems fair to conclude that economic developments in Latvia are increasingly dependent on the external environment and external policy actions, and to this end the domestic policy package should be assessed against the expected changes in the international policy stance.

Macroeconomic Policies

Our authorities acknowledge that macroeconomic policies should be considered in light of the present economic developments and emerging challenges. We welcome staff's support for the recent monetary policy measures and recognize that even though having repercussions on the money market and to some extent containing further credit growth, these measures alone are not sufficient to bring the economy back to a sustained growth path given the liberal capital markets and the fixed exchange rate.

We have taken note of staff's concerns regarding possible implications of further increasing banks' minimum liquidity ratio and reserve requirements. Nevertheless, our previous experience shows that, in the absence of other central banks' instruments for containing credit growth, such measures, while not entirely efficient, have a considerable signaling effect and influence banks' behavior towards more caution in lending activities. Considering excessive credit growth as the core problem, we are of the opinion that such measures are still justifiable and would not exclude further actions in this field. Moreover, with global interest rates increasing, the impact of these measures on reducing credit growth may become more substantial.

Nevertheless, in light of the currency peg strategy, the heaviest part of the adjustment burden must fall on other policies, as correctly noted in the staff report, by shaping a comprehensive, well communicated and credible policy package. Front loading fiscal consolidation, maintaining sound financial system, ensuring wage discipline, easing labor market bottlenecks and boosting export performance by pursuing policies supportive to scaling the technology ladder, as recommended by staff, are instrumental to this end.

The fiscal policy in Latvia is broadly in line with the requirements of the Stability and Growth Pact. Since 2001 the budget deficit has been relatively small and declining. The level of the total general government debt has also been low. Our authorities have clearly expressed their ambition to continue lowering the level of the budget deficit to 1.3 percent of GDP until 2008 and to achieve gradually a balanced budget in the longer run.

Our authorities agree that fiscal restraint would be useful to counter the sizable demand stimulus which is already under way in Latvia. However, several factors have to be taken into account when considering such options as saving revenue over performance in full in 2006 or sharply curtailing spending growth in 2007–2008. A sharp spending reduction may affect not only the overheated sectors, but also those sectors that are of crucial importance to the economic and social development in Latvia. Given the increasing degree of the country's economic integration in the EU, easier access to foreign capital and the potential for further financial deepening, the necessary adjustments required in some policy areas could be disproportionate, and in some cases larger than practically feasible. Our estimates suggest that, for example, any reasonable degree of fiscal adjustment, even as ambitious as the one portrayed in staff's accelerated-adjustment scenario, would not be sufficient to compensate for the significant externally driven monetary stimulus in the medium-term provided that external environment stays unchanged.

Against this background, in the present situation an appropriate fiscal policy option for Latvia is to plan budget expenditure in the medium-term in line with the country's development strategy in general and operational strategies of central government institutions in particular. Recently the government has taken the necessary steps to enhance strategic planning and implement the medium-term budget by adopting the concept documents that envisage full implementation of the medium-term budgeting from year 2008.

Financial Sector Issues

Our authorities appreciate staff's comprehensive insight into the current situation, challenges and opportunities of the Latvian financial sector. The challenge faced by policy makers in Latvia arises from the integration of the European banking system with an evolving legal framework and enhanced convergence of supervisory practices on the one hand, and not fully solved home-host arrangements on the other, particularly in the case when the relative systemic importance of entities within a financial group in the host and the home country differs. The authorities consider the Fund as a useful forum for discussing possible measures for strengthening the coordination mechanism between home and host authorities. In this regard, we look forward to the results of the ongoing Nordic-Baltic Financial Sector Project.

Latvia's integration in the EU has had an effect on our supervisory framework. Thus, in late 2004 the decision to lower the capital adequacy ratio from 10 to 8 percent was taken because of the need to ensure a level playing field in the single European financial market for local banks and branches of the EU banks. We believe that 8 percent is appropriate to the level of risks taken by banks and risk-based supervision that ensures adequate measures to be taken by individual institutions if weaknesses are identified. This will be further strengthened by amendments to the legislation implementing the Capital Requirements Directive (Basel II) effective from January 1, 2007. These amendments, inter alia, provide the supervisor with the power to require a bank to have capital above the level calculated in the standard way.

On January 1, 2005, limits on open positions in the euro were lifted following the re-pegging of the lats from the SDR to the euro. However, in the current situation the authorities share staff's view that open positions in the euro should be treated like any other foreign currency and consider suspending the previously taken decision. Nevertheless, in our opinion, staff somewhat overestimates bank exposures to credit and market risks. Banks have prudent risk management policies and their open currency positions are hedged. Moreover, there is a capital charge for the net foreign currency position, including in the euro. The liquidity ratio of the majority of banks with a higher euro open position is close to the banking sector's average that is well above the regulatory minimum.

While we acknowledge that bank lending is only partially covered by local deposits, recently the value of domestic deposits has increased by an impressive 44 percent (end March 2005 – end March 2006). Furthermore, we consider that in Latvia's context there is no empirical evidence whatsoever of non-resident deposits increasing prudential risks. Also, such deposits are generally concentrated in banks that specialize in servicing foreign clients and the majority of the respective funds are matched by placements in the OECD countries' banks or investments in fixed income securities.

The authorities agree with staff that, in the event of a significant tightening of global liquidity conditions, a growing loan penetration of households with a more modest debt-servicing capacity would add to risks to the banking sector. However, we do not share staff's view that correction in house prices would impair the quality of loans. The Latvian legislation clearly stipulates that loans can only be extended if a customer proves sufficient cash flow as a primary source of repayment of the principal and interest, and there is no persuasive evidence on the impact of a potential reduction in the market value of collateral on the cash flow of customers. Nevertheless, more data on credit portfolio of banks would foster our supervising capacities, thus the authorities are working to enhance considerably the credit register. We also share staff's view that the current situation in credit markets calls for more comprehensive and accurate information on household finances, and are planning to introduce additional surveys to tackle household income and debt issues.

The authorities would like to emphasize that a substantial strengthening of legal measures and law enforcement has ensured a comprehensive and efficient AML/CFT framework in Latvia. Latvia's compliance was verified by the Fund's assessors in May, 2006 and approved in the MONEYVAL Committee of the Council of Europe on September 15, 2006. We would also like to stress that the AMF/CFT rules apply equally to residents and non-residents. Thus, we do not fully share staff's conclusion that business with non-residents automatically involves reputational risks.

Structural Issues

All in all, our authorities still see the competitiveness as adequate in the near future and such a view was recently supported also by the World Economic Forum ranking Latvia in the 36th place which is an improvement from the previous year, and places Latvia before a number of European Union member states. However, we welcome staff's support for the policies shaped to safeguard competitiveness in the medium-term by moving up the value added chain and increasing productivity further. The authorities are determined to use EU funds for building human capital by improving education outcomes and increasing business scientific know-how. A number of measures defined in the *National Lisbon Program of Latvia for 2005 – 2008* are aimed at improving the education, human capital, research and development and innovations, etc. The operational programs for the utilization of EU funds, which have been approved by the government, also contain measures for improvements in the above mentioned fields. In addition, the operational programs focus specifically on developing enterprises, in particular SMEs. Also, implementation of the *National Lisbon Program* is already facilitating the introduction of new technologies in resource and labor intensive industries, thus permitting the production of high value added goods. Recent trends witness an increase in the share of those goods, for example, in the wood-processing industry.

The authorities consistently work on improving the business environment through implementing the annual Action Plan and supervising the effects of administrative procedures on business. Thus, Action Plan for 2006 envisages targeting the tax policy and administration, improving the legal environment, reducing ”red tape” and developing financing instruments to facilitate SMEs seed capital and venture capital financing.

In response to rising labor shortages, our authorities consider raising the minimum wage and untaxed minimum though they will still remain the lowest in the EU. We share staff’s call for maintaining wage discipline. At the same time, our authorities acknowledge that after Latvia’s accession to the EU, efficiency of domestic wage restrictions may be rather limited due to changes in wage formation mechanisms. Wage developments are becoming increasingly decoupled from productivity changes, and wage adjustments are determined by cross-country conditions rather than cross-sectoral.

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IMF Executive Board Concludes 2006 Article IV Consultation with the Republic of Latvia

On October 4, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Latvia.[1]

Background

The Latvian economy has made remarkable strides since the mid 1990s combining, for the most part, macroeconomic stability with rapid income convergence. Relative to the 15 original European Union members, per capita income in purchasing power parity terms has climbed 16 percentage points, among the fastest of the eight new Eastern European member states (EU8). Inflation performance was also commendable until recently. While current account deficits were larger than for most other EU8, they were broadly consistent with Latvia's income and growth potential. Nonetheless, reliance on foreign savings over an extended period has caused net foreign liabilities to approach 60 percent of GDP in 2005.

Since 2004, the economy has experienced an integration-related boom. Deepening European integration brought lower nominal interest rates, large disbursements of EU grants and external inflows to domestic banks. As a result, GDP growth increased to record levels, and a positive output gap emerged. Consumption and capital formation have been the main drivers of demand while, on the production side, growth has been particularly strong in construction and domestic trade. These patterns reflect the very rapid increase in household credit and sizable spending on EU-related projects and transfers, which nearly doubled in the first full year of EU

[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.

membership in 2005. Unemployment has fallen sharply, due to extensive outward migration of labor as well as the strength of the growth, reaching 7¾ percent. Headline inflation has remained in excess of 6¼ percent (year-on-year), reflecting higher core inflation as well as rising world energy prices and the harmonization of food prices. The current account deficit has remained above 12 percent of GDP.

Rapid financial deepening has continued, increasing bank exposures to credit and market risk. Credit to private sector residents grew nearly 65 percent in 2005, and the loan to GDP ratio reached 70 percent. While banks' financial soundness indicators remain strong, the real estate sector now accounts for nearly half of total loans. Direct and indirect euro exposures have risen sharply, reflecting both the lifting of limits on open euro positions following the repeg of the lats to the euro and the rapid expansion in euro-denominated loans to mostly-unhedged households. As a result, balance sheet mismatches have widened over the past year.

Notwithstanding a modest headline balance, fiscal policy has been expansionary. Monetary policy continues to lean against the wind of strong demand and credit growth, but its effectiveness is limited by fully open capital markets and the narrow-band exchange rate peg. With little autonomous leeway to influence the pace of economic activity, the Bank of Latvia (BoL) has relied on a significant increase in the burden of reserve requirements—raising the rate and broadening the base in recent years.

Strong growth is expected to continue in 2006. The ongoing credit boom and faster real wage growth are expected to support private domestic demand, while increasing net EU grants will boost public spending. Growth is projected to rise to 11 percent, and output will remain above potential. The current account deficit is projected to widen to 14 percent owing to rapid import growth, as well as rising profits of foreign investment, particularly in the banking sector. Core inflation is likely to remain stuck at around 5¾ percent, although headline inflation may moderate on account of smaller increases in world energy prices.

Executive Board Assessment

Executive Directors praised the authorities for their sound macroeconomic management and far-reaching structural reforms over the past decade, which have fostered rapid economic growth and helped deliver impressive gains in Latvia's living standards since the mid-1990s. However, Directors were concerned that the current exuberant economic expansion, while underpinned by the process of EU integration, is tilted excessively toward domestic demand, bringing with it substantial risks that could disrupt future progress with income convergence. In particular, Directors observed that the economy is now operating above its supply capacity, with high price and wage inflation weakening Latvia's international competitiveness advantage, even as the private sector is taking on sizable foreign-currency denominated liabilities.

Directors considered that the key policy challenge is to steer the economy away from its overheated path and to moderate vulnerabilities. Restraining private and public demand in the near term was seen as crucial to limiting the buildup of external and financial sector vulnerabilities. A front-loaded adjustment was also seen as bringing forward compliance with the Maastricht criteria for euro adoption, thereby limiting the duration of exposure to risks inherent to remaining outside the euro area.

Directors acknowledged that Latvia's economic setting—with a currency peg and an open capital account—constrains the availability and effectiveness of standard policy options, but considered that a broad range of measures—if pursued as a coherent and clearly-communicated package—could yield significant results. They recommended that this package should focus on reining-in the pace of credit growth, unwinding the fiscal stimulus that has already been injected, and securing an environment in which wage growth is tied to productivity gains. To boost the credibility of the package, several Directors advised that a feasible, though ambitious, revised target date for euro adoption be announced.

Directors counseled that, at a minimum, fiscal policy should avoid adding to the already considerable demand pressure emanating from the private sector. As an immediate step, this would require saving in full all revenue overperformance this year. Directors also urged the authorities to limit the scale of any supplementary spending appropriations and to undertake offsetting expenditure reductions. Beyond this year, they stressed that an ambitious front-loaded adjustment is necessary to reverse the fiscal stimulus added in recent years and to partially offset private demand injections. To achieve this goal, Directors recommended restraining real spending, focusing on own-financed items and those EU-funded projects likely to exacerbate bottlenecks, and postponing the planned reduction in the personal income tax rate until overheating pressures have dissipated. Directors noted that, in the event the envisaged private sector savings do not materialize, fiscal policy would need to shoulder a larger burden of the adjustment. They observed that the authorities' plans to enhance strategic planning and implementation of a medium-term budgeting framework would help to move away from the practice of supplementary budgets.

Directors commended the monetary authorities for instituting policies that lean against the wind of strong demand and credit growth, including the recent broadening of the reserve requirement base, and recommended that domestic policy interest rates continue to track those of the euro area. However, they urged caution with respect to other measures, including raising the minimum liquidity ratio and the reserve requirement rate, that could divert bank lending offshore and to less-regulated nonbanks and promote further currency substitution, while leaving the overall pace of credit growth largely unaffected.

Directors viewed the generous tax treatment of real estate as contributing to the very rapid growth in mortgage credit and house prices. They recommended broadening the base of the personal income tax to include realized capital gains on real estate holdings, excluding on long-term primary residences. Directors also called for more accurate reporting of the transaction price at the time of purchase to correctly measure capital gains and assess the base for the real estate transfer tax.

Directors called for strengthening the supervisory framework and macroprudential analysis in order to constrain the buildup of risks in the financial sector. In view of growing currency mismatches and delayed euro entry, they advised that prudential regulations governing banks be amended to treat the euro as any other foreign currency. Directors emphasized that the introduction of Basel 2 would increase the need for close and effective cooperation with foreign supervisors of banks with Latvian subsidiaries or branches, and to ensure that subsidiaries' credit-risk models are fully appropriate to the Latvian financial market. They also recommended refining stress-testing scenarios to better simulate the effects of macroeconomic shocks, and called for better educating households about the risks associated with borrowing. Directors looked forward to the 2007 Financial Sector Assessment Program update, which they saw as an opportunity to further address issues related to risks in the financial sector. They welcomed the strengthening of the Anti-Money Laundering/Combating Financing of Terrorism framework, but called for continued vigilance to safeguard Latvia's position as a regional financial center.

In the context of the tightening of the labor market, Directors underscored the need to maintain wage discipline and better link compensation to performance, including through the signaling effect of public-sector wages, in order to safeguard external competitiveness and prevent the emergence of a wage-price spiral. They noted that reducing overheating, improving productivity in the public sector, and further increasing labor force participation would mitigate wage pressures. Directorsn also considered that limited inward immigration could relieve growth bottlenecks arising from skilled-labor shortages. To sustainably underpin real income growth while boosting export performance, Directors noted the need for Latvian firms to move up the value-added chain. This would require improving Latvia's attractiveness to long-term investment through a credible commitment to macroeconomic stability, reducing bureaucratic hurdles, and exploiting the potential catalytic role of EU funds to build human capital and facilitate absorption of new technologies.

Republic of Latvia: Selected Economic Indicators

	2000	2001	2002	2003	2004	2005
	Changes in percent					
Real Economy						
Real GDP	6.9	8.0	6.5	7.2	8.6	10.2
Unemployment rate (ILO, end of period)	14.6	12.8	11.6	10.3	10.3	7.8
Consumer price index (end of period)	1.8	3.2	1.4	3.6	7.3	7.0
	In percent of GDP					
Public Finance						
General government balance	-2.5	-1.9	-2.3	-1.6	-1.1	-1.2
Total general government debt	12.8	14.9	13.5	14.4	14.5	13.2
External general government debt	7.0	8.7	7.8	7.1	8.0	6.6
	End-period; changes in percent					
Money and credit						
Reserve money	7.7	22.4	22.4	6.8	18.6	41.1
Broad money	27.9	20.8	21.0	21.1	27.0	38.9
Domestic credit (non-government)	37.8	49.8	36.5	37.5	47.0	64.3
	In percent of GDP unless stated otherwise					
Balance of payments						
Goods and non-factor services balance	-7.5	-10.0	-10.0	-12.7	-15.9	-15.0
Current account balance	-4.8	-7.6	-6.6	-8.1	-12.9	-12.4
International reserves (in months of imports)	2.5	3.2	2.7	2.3	2.2	2.5
Exchange rate						
Exchange rate regime	Pegged to the SDR 1/					
Exchange rate (lats per US$; period average)	0.607	0.628	0.618	0.571	0.540	0.565
Real effective exchange rate (Dec 1995=100) 2/	138.4	135.5	130.8	122.9	123.2	121.1

Sources: Latvian authorities and IMF staff estimates.

1/ On January 1, 2005 the lats was repegged to the euro.

2/ CPI-based, period average.