January 2002
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The Republic of Latvia: 2001 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Latvia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2001 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 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **November 6, 2002,** 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 December 20, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **January 18, 2002** updating information on recent developments.

- the Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its January 18, 2002 discussion** of the staff report that concluded the Article IV consultation.

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

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

Statistical Appendix
The Baltics—Medium-Term Fiscal Issues Related to EU and NATO Accession

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

Staff Report for the 2001 Article IV Consultation

Prepared by the staff representatives for the
2001 Consultation with the Republic of Latvia

Approved by Thomas Wolf and Liam P. Ebrill

December 20, 2001

- Discussions were held in Riga during October 24–November 6, 2001. The EU2-led Article IV mission overlapped with an FSAP follow-up mission.

- The staff representatives comprised Messrs. Mueller (head), McDonald, Beddies, Lundbäck (all EU2), Mr. Risager (PDR), and Ms. Merlino (research assistant, EU2). Mr. Odling-Smee and Mr. Lehmussaari, Executive Director for Latvia, joined the mission for two days. Mr. Knöbl, the Fund's resident representative in Riga, assisted the mission.

- The mission met with members of the government, including Prime Minister Bērziņš, Minister of Finance Bērziņš, Minister of the Economy Kalvitis, Minister of Welfare Požarnovs, Minister for Cooperation with International Institutions Zile; Bank of Latvia (BoL) Governor Mr. Repše; other senior government officials; members of parliament; and representatives of Transparency International, other NGOs, and the financial, business, and diplomatic communities.

- On April 20, 2001, the Executive Board approved a 20-month Stand-By Arrangement (SBA) in an amount of SDR 33 million (26 percent of quota). The authorities have indicated their intention to make no purchases under the arrangement.

- The staff is not proposing to complete the first review under the SBA at this time, as the mission was unable to reach understandings with the authorities on the budget for 2002. The Latvian authorities proposed, in a letter to the staff (Attachment I), fiscal, monetary and other targets for the first two quarters of 2002 which are consistent with an appropriate annual deficit target. However, the annual deficit under the adopted 2002 budget would imply a significant fiscal loosening in the second half of 2002. Nonetheless, if the current strong fiscal performance continues during the first quarter of 2002—including revenue collections in excess of the targeted amount—and the authorities are prepared to delay some expenditures, this could serve as a basis for resuming the discussions to complete the first program review under the SBA.

- Related papers that provide useful background for the upcoming Board discussion include the Statistical Appendix (SM/01/364) and the Financial Sector Stability Assessment (FSSA), which accompany this paper; the paper on "Labor Markets in Hard-Peg Accession Countries: The Baltics and Bulgaria" (SM/01/100); and the forthcoming paper on "The Baltics—Medium-Term Fiscal Issues Related to EU and NATO Accession."

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Attachments

Latvia: Basic Data

Social and demographic indicators					
Area	64,589 sq. km.				
Population	2.4 million				
Urban	68.2 percent				
Rate of population growth	-0.6 percent per year				
Life expectancy at birth					
Male	64.9 years				
Female	76.0 years				
Infant mortality rate (per 1,000 births)	10.4				
Hospital beds (per 10,000 inhabitants)	87.3				
Physicians (per 10,000 inhabitants)	34.4				

	1996	1997	1998	1999	2000
	In percent of GDP				
Shares of gross domestic product at current prices					
Agriculture and hunting	6.7	4.0	2.5	2.3	2.2
Forestry and logging	0.8	0.8	1.0	1.3	1.4
Fishing	0.3	0.2	0.2	0.3	0.4
Mining and quarrying	0.1	0.1	0.1	0.1	0.1
Manufacturing	18.2	19.4	15.4	13.4	12.8
Electricity, gas, and water	4.6	4.3	4.6	3.9	3.5
Construction	4.1	4.2	5.9	6.2	6.0
Services	52.3	54.0	56.4	59.9	61.9
Taxes and subsidies	12.7	12.8	13.8	12.5	11.8
GDP					
Nominal GDP (in millions of lats)	2,829	3,275	3,589	3,897	4,333
GDP per capita (in lats)	1,131	1,321	1,460	1,637	1,826
Real GDP (percentage change)	3.3	8.6	3.9	1.1	6.6
Unemployment rate (end of period)	7.2	7.0	9.2	9.1	7.8
Consumer prices (percentage change, end-period)	13.1	7.0	2.8	3.2	1.8
General government finances	In millions of lats, unless otherwise stated				
Total revenue	1,057	1,352	1,529	1,561	1,620
(in percent of GDP)	37.4	41.3	42.6	40.0	37.4
Total expenditure	1,104	1,332	1,554	1,707	1,764
(in percent of GDP)	39.0	40.7	43.3	43.8	40.7
Financial balance	-47	20	-25	-146	-144
(in percent of GDP)	-1.7	0.6	-0.7	-3.8	-3.3
Net lending	5	10	3	7	0
(in percent of GDP)	0.2	0.3	0.1	0.2	0.0
Fiscal balance	-52	10	-27	-153	-143
(in percent of GDP)	-1.8	0.3	-0.8	-3.9	-3.3
Money and credit (end-period)					
Net foreign assets	445	619	415	364	538
Broad money	628	871	923	997	1275
Domestic credit	366	479	647	745	1062
Velocity (level)	5.0	4.1	4.0	4.2	3.8
Balance of payments					
Total exports (GNFS)	1,440	1,669	1,841	1,708	1,984
Total imports (GNFS)	1,669	1,947	2,327	2,110	2,360
Current account balance	-154	-201	-380	-380	-302
(in percent of GDP)	-4.2	-5.1	-9.8	-9.8	-6.9
Official reserves (in months of imports of goods and nonfactor services)	2.8	2.5	2.9	2.9	2.6
Exchange rate, lats per US$, end-period	0.556	0.590	0.569	0.583	0.613

Sources: Latvian authorities; and Fund staff estimates.

Executive Summary

Latvia has experienced high growth and low inflation over the last two years. Real GDP grew by 6½ percent in 2000 and 8¾ percent in the first half of 2001, and it appears that strong growth was sustained at least through the third quarter of 2001. This investment-led growth has been aided by continued price stability, in part reflecting the successful exchange rate peg: consumer price inflation was about 3 percent in both 2000 and 2001. Market sentiment toward Latvia remains favorable, as seen by the successful Eurobond issue in November. The current account deficit fell in 2000 and in the first half of 2001, but remains high and appeared to be widening in the second half of the year. Foreign direct investment inflows continue to be strong, covering about three-fifths of the current account deficit and helping to keep external debt at a moderate level.

Prudent macroeconomic policies underlie this excellent economic performance. As of October, the government was on track to meet its 2001 fiscal deficit target of 1.7 percent of GDP, compared to 3.3 percent in 2000 and close to 4 percent in 1999. Monetary policy has continued to be geared to supporting the peg of the lats to the SDR. A recent Financial Sector Stability Assessment (FSSA) found that the Latvian financial system appears to be generally robust and, overall, well-regulated. Latvia moved quickly after September 11 to prepare legislation that would more comprehensively cover terrorist financing. Negotiations on EU accession are proceeding well, and have helped reinforce the drive toward structural reform.

The staff expects that slower growth among Latvia's major trading partners would lead to a reduction in external demand; nevertheless, with domestic demand (particularly for investment) remaining strong, Latvia would experience moderate growth in 2002, at around 4½ percent. The combination of weaker external demand and continued strong domestic demand could put further pressure on Latvia's current account deficit, which could be exacerbated by the planned 2002 budget deficit of 2.7 percent of GDP. While no agreement could be reached on an appropriate fiscal deficit for 2002, thus preventing the staff from recommending completion of the first program review at this time, deficit targets for the first and second quarters were agreed that are in line with an annual deficit target of about 1½ percent of GDP. Noting the uncertain external environment, the staff indicated that in the event of a more pronounced slowdown in Latvian growth it would support using the automatic fiscal stabilizers, provided that the current account and its financing did not give rise to concern.

Competitiveness remains adequate, and the staff supported the authorities' intention to retain the existing exchange rate peg until shifting to a euro peg following accession to the EU. The Bank of Latvia has decided to discontinue issuing long-term foreign exchange swaps, and will limit its use of short-term swaps. Discussions covered the emergence of interest rate spreads relative to the anchor currency basket, the continuing large inflows of non-resident deposits, and the relatively rapid growth of credit to the private sector, as well as the need to closely monitor developments in these areas.

I. Introduction

1. **The Executive Board concluded the 2000 Article IV consultation on June 30, 2000.** Directors commended Latvia's long-standing commitment to macroeconomic stability and noted the success of structural reforms in creating a flexible market economy. Directors supported the fiscal tightening that had been undertaken, but cautioned that more rapid fiscal adjustment would be needed should the current account deficit fail to decline or FDI fall short of expectations. While welcoming improvements in the financial sector prudential framework, they stressed the need to closely monitor credit expansion. The exchange rate peg remained appropriate, but Directors stressed the importance under such a regime of continued structural reform and prudent fiscal policy. Following the authorities' request, the 2000 Article IV staff report was placed, without deletions, on the Fund's external website.

2. **Relations with the Fund and the World Bank are summarized in Appendices I and II.** Latvia has accepted the obligations of Article VIII and maintains an exchange system free of restrictions on payments and transfers for current international transactions.

II. Recent Economic Developments and Performance under the Program

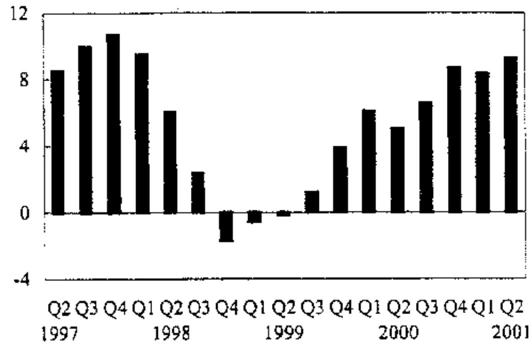
3. **Latvia has experienced high growth and low inflation over the last two years** (Table 1 and Figure 1). Real GDP grew at 6½ percent in 2000 and 8¾ percent in the first half of 2001. Indicators such as industrial output, transport activity, retail sales, fiscal revenues, and private sector credit suggest that strong growth continued in the third quarter, despite lower EU growth. The official unemployment rate has declined to about 7½ percent, but high unemployment persists in rural areas and mainly reflects geographical immobility among workers (SM/01/100). Even with a possible slowdown late in the year, growth is likely to exceed the 6 percent rate underlying the economic program by about one percentage point. This robust growth performance at a time when major trading partners are experiencing declining growth is examined in Box 1.

4. **Continued price stability, aided by the successful exchange rate peg, has helped support investment-led growth.** Twelve-month consumer price inflation has remained low (3.3 percent in October) and is on track to meet the authorities' 3 percent objective for 2001, despite the impact on food prices of animal diseases in Europe and poor mid-year weather in Latvia. Wage growth has lagged behind GDP growth, while the minimum wage (LVL 60 per month, following a LVL 10 increase earlier this year) remains low.

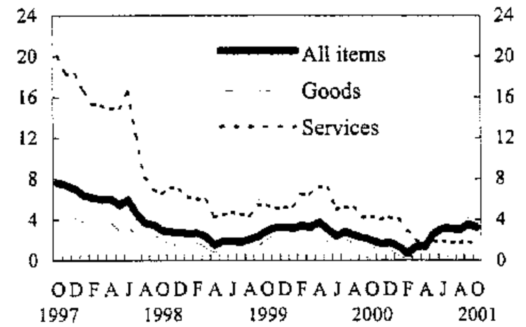
5. **All performance criteria under the program to date were observed and, based on end-October data, all end-December performance criteria are within reach.** Two of the three structural benchmarks for June were observed. The measures related to two of the three structural benchmarks for end-September were implemented with a two-week delay, as the government focused on difficult budget discussions (Table 2).

Figure 1. Latvia: Macroeconomic Indicators, 1997-2001

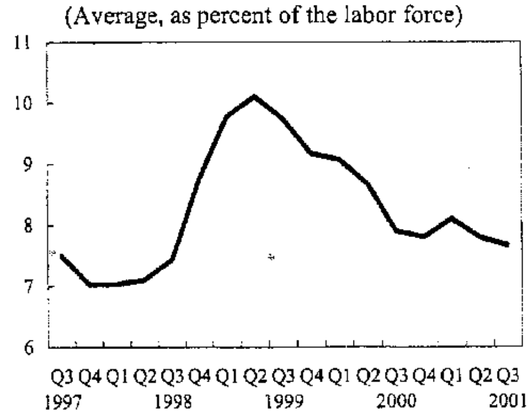
Real GDP Growth
(Percentage change over preceding four quarters)



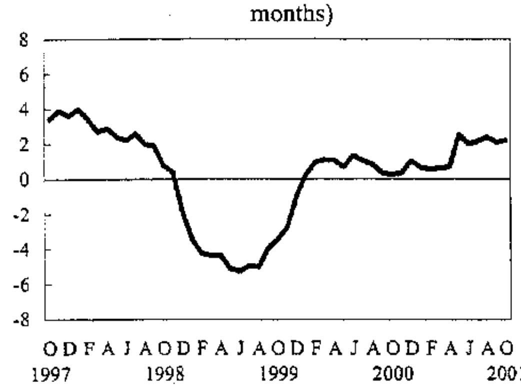
CPI Inflation in Goods and Services
(Percentage change over preceding twelve months)



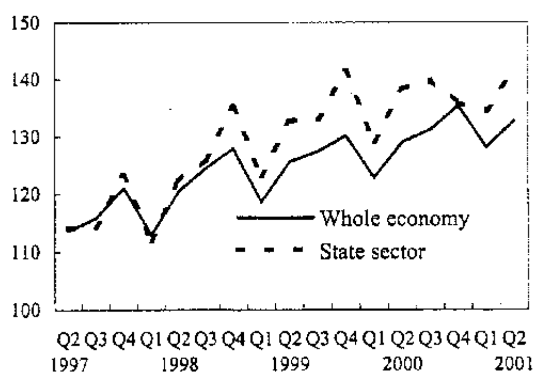
Registered Unemployment 1/
(Average, as percent of the labor force)



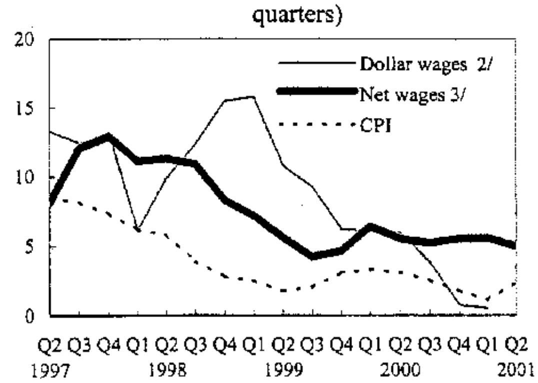
PPI Inflation
(Percentage change over preceding twelve months)



Real Wages
(Average 1993 = 100)



CPI, Dollar and Net Wages
(Percentage change over preceding four quarters)



Sources: Latvian authorities; and Fund staff estimates.
1/ Official data.
2/ Average monthly wage in the public sector, including public enterprises.
3/ Wages net of social taxes.

Box 1. Latvia's Growth Experience

The recent strong economic growth in Latvia has been driven by domestic demand, mainly investment, and has been broad based. Fixed capital formation grew by 10.8 percent in 2000 and 9.6 percent in the first half of 2001. Private consumption is growing slower than GDP, but accelerated in the first half of 2001. Both industry and services grew strongly in the first half of 2001. Key factors explaining this growth pattern include:

- *Macroeconomic stability has created a sound basis for continued transition and high long-run growth.*

- *The Russian crisis sparked a process of adjustment, leading to a jump in the share of exports to the EU from 49 percent in 1997 to 65 percent in 2000.* This adjustment has required substantial investment in capacity, technologies, marketing, legal advice, and improved management. As bad as the crisis was, it helped reinvigorate the transition process, which constitutes a basis for rapid growth.

- *The restructuring process accelerated by the Russian crisis has also had a positive effect on activities in the domestic market.* In the food industry, for example, imploding demand in the Russian market necessitated rapid adjustment that helped Latvian producers improve their domestic market position. This has also boosted demand for commercial services, which are supplied largely from within Latvia. The financial services sector was also forced by the Russian crisis to adjust, and has since recovered, been restructured and reached a higher degree of sophistication (see Boxes 3 and 6).

- *The trend has continued toward higher value-added production and exploiting economies of scale*, partly reflecting the orientation toward EU markets. This is seen, for example, in the wood sector (see Box 4) and in other manufacturing areas.

- *Latvian producers improved their competitiveness in the Russian and other BRO markets* (see Figure 3). The Russian recovery and increased oil exports have also raised the demand for transit through Latvia.

- *The prospect of EU accession in the near future* has stimulated domestic investment and helped attract strong FDI inflows.

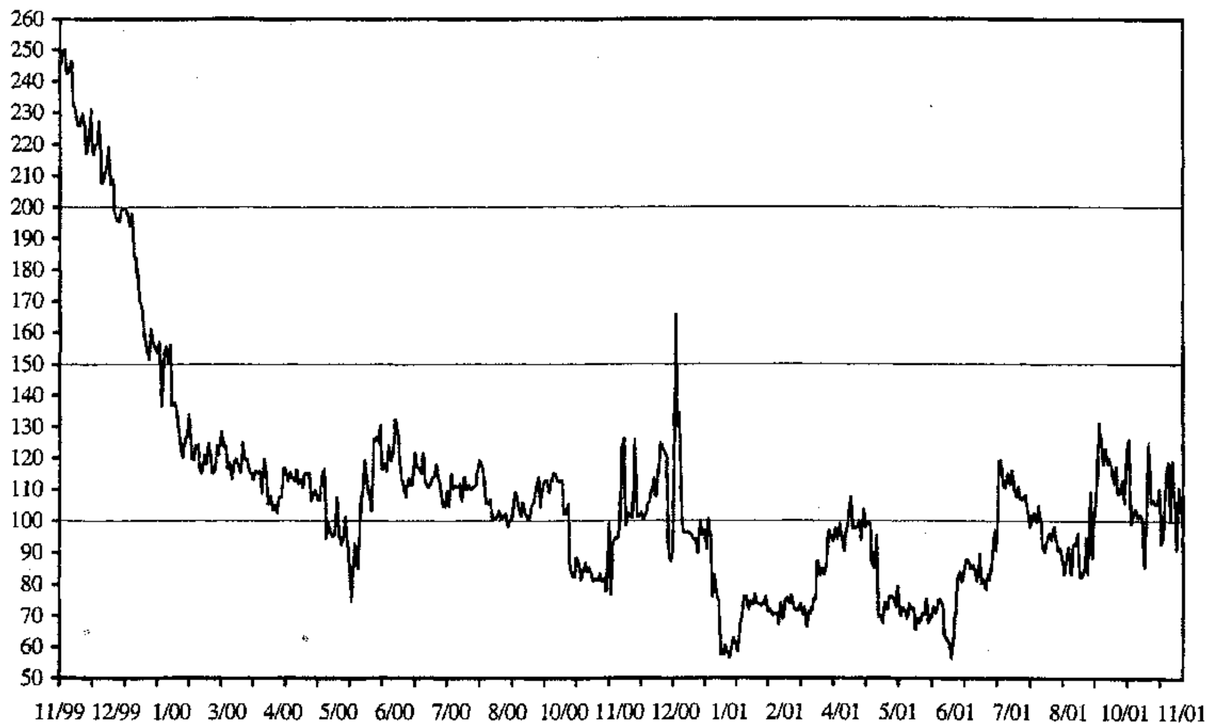
- *As the economy develops, a larger share of economic activity may be captured in the official statistics.*

These trends are set to continue in 2002. *First*, past investments should lead to greater capacity, improved technology, and scale economies. *Second*, consumption should continue growing as consumer confidence appears steady, unemployment is falling, and incomes are rising. *Third*, the declining trend in government investment will be reversed in 2002. *Fourth*, the reorientation towards the EU will continue, as accession approaches and industries further comply with EU norms. *Fifth*, modest wage increases, high profits, and enhanced productivity should ensure continued competitiveness, including, importantly, regarding Russia. Latvian exporters have previously shown resilience in the face of tough economic conditions. *Finally*, the Latvian economy is relatively diversified and growth has been broad based, so that even if some sectors weaken, others may show more positive developments.

Real GDP growth in 2002 should, nevertheless, slow from that in 2001. Long-run prospects for Latvian growth are very good, but Latvia will likely be affected by the global slowdown; the projected 4½ percent growth rate for 2002 would be 2½ percentage points less than in 2001. Growth in 2002 is projected to exceed that in advanced economy trading partners by about 2½ percentage points, compared to 3 percentage points in 2000 and over 5 percentage points in 2001. However, if the rebound of the world economy expected in late 2002 is significantly delayed, growth may be much weaker; the more pessimistic scenario (Table 7 and Section III.B) assumes that EU growth would be less than 1 percent and Latvian growth would then decline to 2½ percent.

6. **Market sentiment toward Latvia remains favorable.** Developments in emerging markets and the September terrorist acts caused a temporary rise in Latvia's Eurobond spread, but it is again below 100 points (Figure 2). Ratings agencies in August 2001 upgraded their outlook on Latvian long-term sovereign foreign currency debt and issued a positive report on the banking system. Despite the anticipated delay in completing the first review

Figure 2. Latvia: Yield of Latvia's Eurobond over a Comparable German Government Bond, 1999-2001 1/
(basis points)

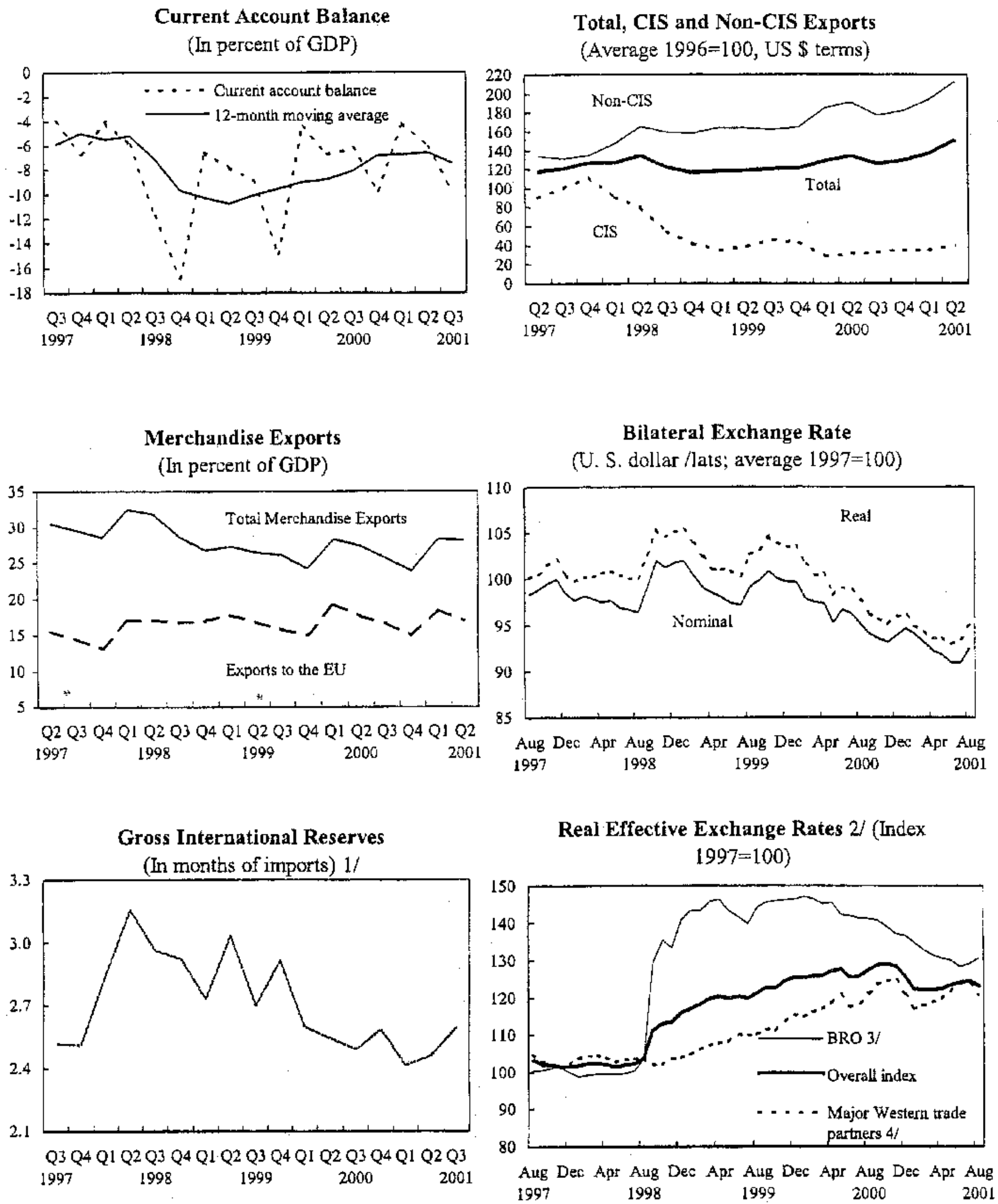


Source: DataStream.
1/ The difference between yields to final date, data type RYFL, as defined in DataStream.

under the SBA, Latvia successfully placed a second Eurobond in November 2001 (see Section III.C).

7. **After dropping markedly in 2000, the current account deficit fell to about 5.3 percent of GDP in the first half of 2001, from 5.7 percent a year earlier.** However, preliminary third quarter data indicate a widening that could imply that the annual current account deficit would exceed 7 percent of GDP (Table 3 and Figure 3). Merchandise exports grew by 12 percent in January-September, as a slowdown in exports of wood and wood products (exported mainly to the EU) was balanced by rapid growth of machinery, foodstuffs and textiles exports, demonstrating continued competitiveness and flexibility (Box 2). With economic activity in the EU slowing, the strongest export growth has occurred in the Baltic and CIS markets, reflecting their strong growth and a real depreciation of the lats versus the ruble. Merchandise imports have grown at about 14 percent during the period. Transport and other service exports have been affected by the slowdown in western Europe and stiffer competition among the Baltic countries for East-West transit trade.

Figure 3. Latvia: Exchange Rates and External Indicators, 1997-2001



Sources: Latvian authorities; and Fund staff estimates.

1/ Imports of goods and non-factor services.

2/ Trade-weighted, using INS-adjusted weights for 1997, to reflect recent changes in shares of trading partners.

3/ Comprising Belarus, Estonia, Lithuania, the Russian Federation, and Ukraine.

4/ Comprising Denmark, Finland, Germany, France, Italy, the Netherlands, Sweden, United Kingdom, and United States.

Box 2. Latvia's External Competitiveness

Developments since the last Article IV consultation suggest that the Latvian economy remains competitive and that the exchange rate of the lats is broadly appropriate. Operating under a fixed exchange rate regime, the ability of the economy to remain competitive even when subjected to a significant external shock was demonstrated by its resilience during the Russian crisis. More recently, faced with slowing growth in western European markets, exporters are reorienting toward other markets. Key to this performance are flexible labor market rules and the impact of progressive structural reforms to improve the business climate, foster international trade and promote FDI. Recent developments regarding competitiveness include:

- **Relative stability of the real effective exchange rate** (Figure 3). This follows the large real appreciation that resulted from the Russian crisis and the end of a period of appreciation of the lats against the major western trading partners that had mirrored the appreciation of the dollar (and SDR) against the euro. Reflecting inflation differentials, the lats has depreciated substantially against the ruble.

- **Good external performance, despite the real value of the lats remaining well above its level before the Russian crisis.** The current account balance improved by 3 percentage points in 2000, despite growth substantially higher than that of Latvia's advanced economy trading partners. The improvement continued into 2001 but has recently been reversed somewhat, as partner country growth has slowed.

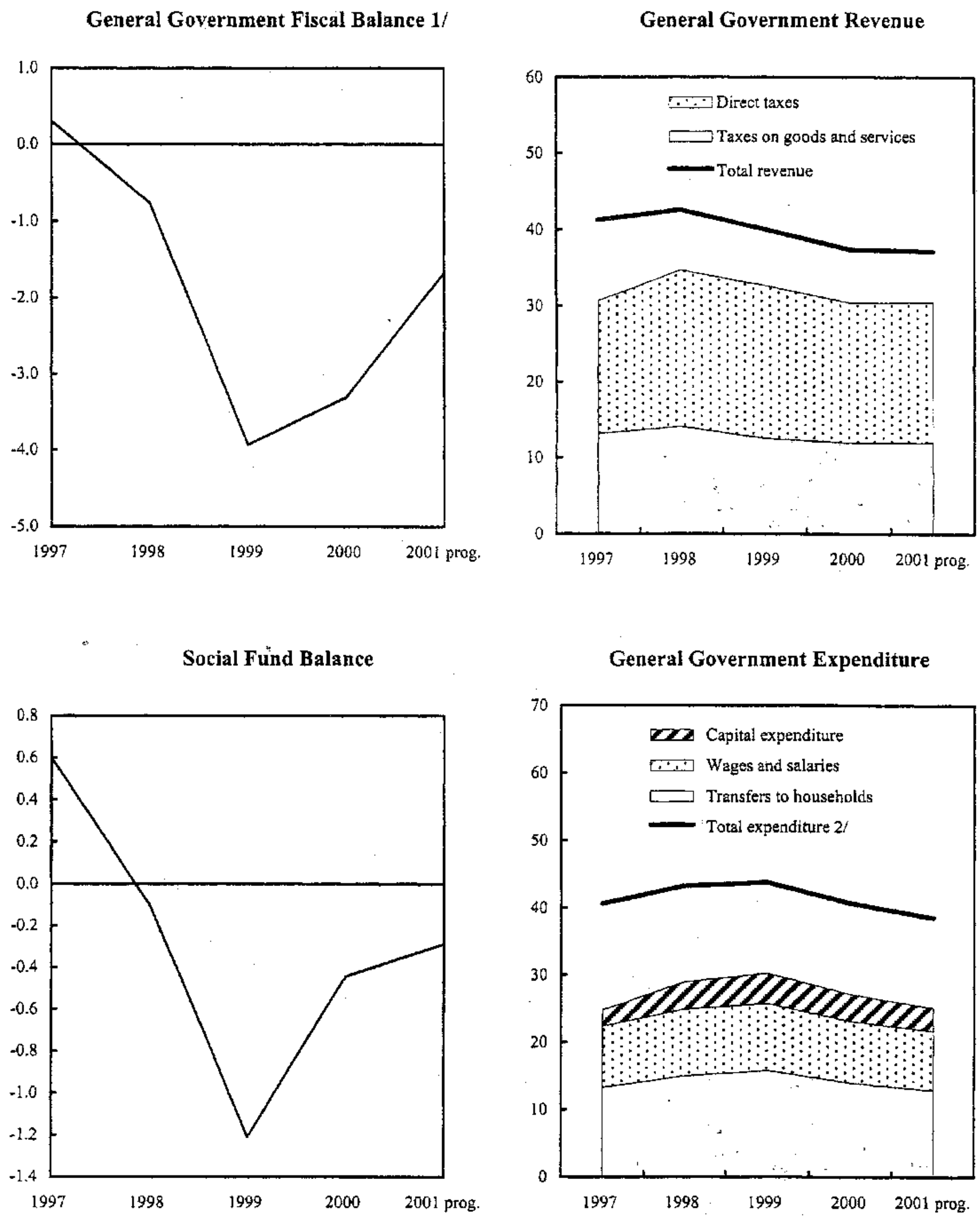
- **Productivity growth, which appears to be outpacing wages.** In 2000 and the first half of 2001, real wage growth was about 4 percentage points below real GDP growth. Unit labor costs (ULC) in manufacturing, when measured on a dollar basis, fell 8 percent in 2000 and 8½ percent in the first half of 2001; when measured against advanced economy trading partners, however, because of movements in the dollar-euro exchange rate, ULCs increased about 3½ percent in 2000 and then fell by 2 percent in the first half of 2001.

8. **Strong inflows of foreign direct investment (FDI) continued in the first nine months of 2001, financing three-fifths of the current account deficit and helping to keep external debt indicators at moderate levels.** External debt is equivalent to 66 percent of GDP, of which about a third is related to nonresident deposits in the Latvian banking system, which are largely matched by high-quality assets of similar maturities.

9. **Following the fiscal slippage in 2000, the general government deficit in the first nine months of 2001 was 1.4 percent of GDP** (Table 4 and Figure 4). The comfortable margin relative to the target was achieved mainly by restraining expenditures and net lending. Continuing administrative problems with excise taxes and a one-time shortfall early in the year in VAT revenues (reflecting changes to meet EU requirements) were largely offset by otherwise strong VAT collections and buoyant customs and property tax revenues. No new decisions to spend privatization receipts outside the budget have been taken and most such spending from earlier in 2001 was included in the supplementary budget adopted in June.

10. **The government has implemented a wide array of public sector reforms.** In April, Parliament approved amendments to the Excise Tax Law (structural benchmark) to harmonize tax rates, improve the monitoring of exemptions, and help detect smuggling.

Figure 4. Latvia: Fiscal Developments, 1997-2001
(In percent of GDP)



Sources: Latvian Ministry of Finance; and Fund staff estimates.
1/ Revenue excludes privatization receipts.
2/ Including interest payments and other current expenditures.

Pension Law amendments were submitted to parliament on June 28 (structural benchmark).[1] The structural benchmark on transferring all accounts of budget-financed institutions to the Treasury by end-June was missed, with the few accounts still outside the Treasury generally relating to co-financing of international projects. Although submitted to Parliament with a two-week delay, the 2002 budget draft included information on contingent liabilities, tax expenditures, quasi-fiscal activities, forecasting assumptions, and financing (structural benchmark). Implementing regulations for the Law on Public Agencies have been delayed (structural benchmark), but are to be adopted by mid-December 2001. The procurement law adopted in July 2001 will take effect from January 1, 2002. A public administration review of the Secretariat for Regional Development was completed ahead of schedule.

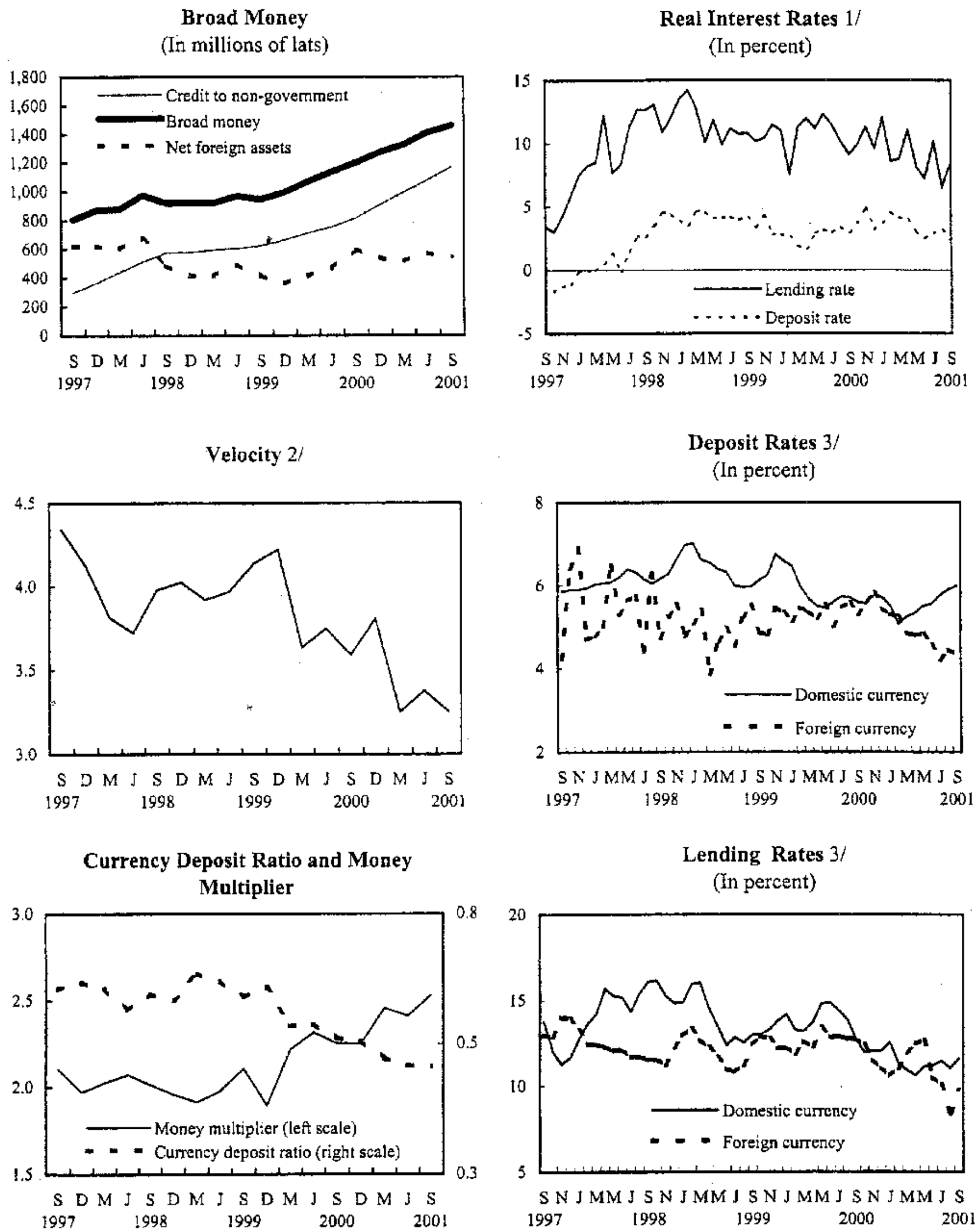
11. **Nonetheless, steps that could help prioritize and increase the efficiency of spending have progressed slowly.** The zero-based reviews of certain existing spending programs have not yielded any noteworthy budgetary savings. Medium-term budget planning, which is critical to the re-prioritization of spending, remains underdeveloped, although the Cabinet in April 2001 adopted an overall medium-term budget planning framework. Improvements in the targeting of social assistance have not been implemented; the introduction of a guaranteed minimum income scheme and a corresponding monitoring system to replace the current multiple social assistance programs have met resistance.

12. **Following the strong policy implementation in 2000, monetary developments continue to be broadly on track** (Tables 5 and 6, Figure 5). However, private sector credit growth could reach 40 percent by end-year. Monetary policy has at times been complicated by the government's issuance of medium-term bonds in excess of financing needs, with a view to fostering the development of domestic financial markets. This did not seem to dampen the supply of credit to the private sector, which continues to grow briskly. The BoL did not accommodate these issues with secondary market purchases, as it had in 2000, resulting in large liquidity swings in the banking system and rising short-term interest rates. Faced with strong demand for central bank credit from banks, the BoL used its open market and swap facilities to effect a liquidity tightening and to meet the end-June NDA target. The BoL also raised the rate offered on government deposits in order to attract funds from the banking system; it was reluctant to raise the Lombard rate, however, fearing the signaling effect of such a move. Tight monetary conditions were sustained through the third quarter.

13. **As foreseen under the program, the BoL began in April to reduce the volume of new issues of long-term foreign exchange swaps, while also reducing the stock of short-term swaps.** In this environment, the BoL has begun to make occasional outright foreign exchange purchases, particularly in October ($32 million).

[1] Under the draft provisions, working pensioners would be allowed to collect their full pension; early retirement would be eliminated; and indexing changes would emphasize wages over consumer prices. These changes were to take effect in April 2002, but the current parliamentary deliberations point toward a later implementation date.

Figure 5. Latvia: Monetary Developments, 1997-2001



Sources: Latvian authorities; and Fund staff estimates.
1/ Three-month average; computed using domestic 3-6 month interest rates and twelve month past inflation rate.
2/ Velocity is defined as nominal GDP over broad money.
3/ Three-month average; 3-6 months' maturity.

14. **The Financial Sector Assessment Program (FSAP) report found that the financial system appears to be generally robust and, overall, well-regulated (Box 3).** The FSAP identified no major sources of vulnerability, but stressed the need for vigilance in various areas.

15. **Latvia is adjusting legislation to more comprehensively cover terrorist financing.** The January 2001 summary report of The European Committee on Crime Problems and the OECD Financial Action Task Force (FATF) suggested Latvia had made significant progress in combating money laundering, but cited a need for improvements in enforcement and with respect to the speed of the legal process, the standards of proof, the confiscation regime, and information sharing. Latvia's financial intelligence unit, the Money Laundering Board (MLB), was established in 1998 to, among other things, analyze reports of suspicious transactions and forward relevant cases to the Prosecutor's Office. Closely following the September terrorist acts, legislative amendments prepared by the MLB were submitted to Parliament that would: (i) allow for the suspension of the movement of financial resources or other property should criminal activity be suspected, (ii) require banks to report all transactions of people on international terrorist lists, and (iii) permit international cooperation in fighting terrorism.

16. **The securities market lacks liquidity and remains small.** Capitalization of the Riga Stock Exchange at end-June 2001 remained at about 8 percent of GDP. The bond market mainly consists of government bonds (market share close to 90 percent), but recently benefited from the repeat issuance of mortgage bonds. Steps toward enhanced cooperation among the Baltic stock-exchanges and with those of western Europe are expected to help Latvian companies attract portfolio investment.

17. **Negotiations on European Union (EU) accession are proceeding well, with Latvia having completed negotiations on 22 of the 31 chapters.** The authorities are committed to closing all chapters by end-2002 to pave the way for accession in 2004. The Commission's November 2001 report on candidate countries' progress toward accession notes that Latvia is a functioning market economy that in the near term could cope with the competitive pressure within the Union—a key requirement for EU accession.

18. **With EU accession as a catalyst, substantial progress has been made with structural reforms, although large-scale privatization has experienced another setback.**[2] Divestiture of the Latvian Shipping Company (LASCO) was postponed shortly before the auction was to begin, due to incomplete submission of documentation and the nonpayment of

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[2] The World Bank is leading with respect to advice in all structural reform areas not directly in the Fund's expertise or of clear macroeconomic significance. Bank staff agreed with the Latvian authorities in October 2001 on measures to be taken under a second Programmatic Structural Adjustment Loan (PSAL II), but the Bank has decided to postpone presentation to its Board because of concerns over the 2002 budget.

Box 3: Main Findings under the Financial Sector Assessment Program

Latvia participated in the FSAP in February 2001. The main findings of the FSSA are summarized below:

Macroeconomic conditions have created an environment favorable to sustained financial sector development. Foreign investment has strengthened the banking sector, and banks are well capitalized, liquid, and profitable, although the financial system nonetheless is susceptible to an array of shocks. Stress tests provided evidence that the various shocks that were simulated would have only small effects on bank solvency. Close monitoring is, however, needed in certain areas, such as: (i) the current account deficit, (ii) rapid credit expansion (Box 6), (iii) the rising short-term interest rates and the differential with the SDR rate, (iv) significant non-resident deposits (about half of total deposits), and (v) possible exchange rate movements of Latvia's main trading currencies against the SDR.

The emergence of nonbank financial institutions does not pose a potential systemic risk at this time, due to the relatively light activity and the lack of strong linkages with the banking system. However, the growth of nonbank business and bank connectivity require close monitoring by the Financial and Capital Markets Commission (FCMC).

The FCMC, a unified financial sector supervisory authority, began operations on July 1, 2001 after a smooth and successful transition (EBS/01/44, Box 5). Issues such as staffing, strategic objectives, internal organization, decision making processes, and cooperation on policy and regulatory objectives and information sharing with the BoL have been adequately addressed. However, more emphasis may be needed on: (i) developing a risk-based supervisory approach, (ii) introducing a rating system for financial institutions, and (iii) developing an on-site examination manual for insurance companies.

Latvia largely complies with the Basel Core Principles for Effective Banking Supervision (BCP) (EBS/00/109, Box 1). Amendments to the Law on Credit Institutions, submitted to Parliament on October 12, 2001 (structural benchmark), would address the remaining weaknesses identified by the FSAP and are intended to bring Latvia into full compliance with the BCP. Anti-money laundering legislation appears appropriate, although enforcement needs improvement; the imposition of steep fines for failure to report suspicious activity is an important step. Latvia also largely observes the IAIS Core Principles for insurance supervision and the IOSCO principles for securities regulation. The legal framework for banking was found particularly robust. Latvia exhibits high policy transparency in virtually all areas in which it has been assessed (banking, insurance and securities regulation, monetary policy, and payment system oversight).

Latvia's systemic liquidity and safety net arrangements appear adequate. The BoL provides temporary liquidity support through its Lombard facility. The BoL also imposes appropriate market discipline; banking licenses are sometimes revoked and lender-of-last-resort loans are rare. Banks manage liquidity efficiently. The Deposit Guarantee Fund provides sufficient protection for depositors.

the security deposit by auction participants. By contrast, remaining government shares of Latvijas Gaze are being sold in three stages between July 2001 and February 2002, and this has, so far, yielded more privatization receipts than expected. The creation of competitive frameworks in the telecoms and energy sectors is progressing, with the super regulator, the Public Utilities Commission, beginning operations on October 1, 2001. The Telecommunications Law was adopted on November 1, 2001. The restructuring plan for Latvenergo has been progressing on schedule. Progress under the action plan to improve the business environment, drafted in close cooperation with the Foreign Investors Council, has been strong, including in the key areas of tax policy, tax administration, and customs and border crossing procedures.

III. Policy Discussions

A. Overview

19. **Macroeconomic policies in 2001 have sustained an environment conducive to investment-led and sectorally balanced growth, with low inflation.** Key factors underlying this performance have been fiscal discipline, the exchange rate peg, appropriately tight monetary policies, and implementation of key structural reforms. During discussions, the authorities were strongly committed to meeting the end-December targets under their economic program supported by the SBA, including a fiscal deficit of 1.7 percent of GDP.

20. **The discussions took place against the backdrop of an uncertain external environment and expenditure pressures associated with Latvia's strategic priorities (including EU and NATO accession) and the October 2002 parliamentary elections.** As a result of these pressures, the fiscal deficit under the government's 2002 budget would partly reverse the successful fiscal consolidation of the last two years and be significantly above what staff considers appropriate under Latvia's present circumstances of continued high growth and emerging pressure on the current account deficit. It should be noted that staff would have been willing to allow automatic stabilizers to work unimpeded but both the staff and the authorities expected growth in 2002 to remain strong, albeit somewhat lower than in 2001.

21. **These differences of view on the appropriate fiscal deficit could not be resolved during the discussions, preventing staff from recommending completion of the first program review at this stage.** The authorities have proposed fiscal targets for the first two quarters of 2002 that are consistent with an annual deficit target acceptable to staff of 1½ percent of GDP (Attachment 1). However, an abrupt fiscal loosening seems likely to occur in the second half of the year unless the deficit in the annual 2002 budget of 2¾ percent of GDP is revised. Thus, the staff felt there was no solid basis for completing the review at this time.

22. **Nevertheless, if the current strong fiscal performance continues during the first quarter of 2002, including revenue collections in excess of the targeted amount, this could serve as a basis for resuming the discussions to complete the first program review.** In addition, the authorities would need to present a credible and transparent fiscal tightening plan for the year as a whole; this may involve more ambitious revenue targets and delaying some expenditures, such as capital spending. However, the appropriate level of the fiscal deficit would need to be revisited if Latvia's outlook for 2002 were to change substantially.

23. **There was general agreement on the appropriate policies in other key areas, including monetary and exchange rate policy.**

B. Macroeconomic Framework and External Sector Prospects

Discussions focused on:

- ***The deteriorating external environment and its implications for Latvia***
- ***Assumptions underlying the medium-term macroeconomic framework***
- ***Projections of the external current account and its financing in 2001 and beyond***
- ***Vulnerabilities***

24. **The present external environment has introduced more than the usual amount of uncertainty in projecting the macroeconomic framework for late 2001 and for 2002.** There are early signs that the slowdown in western Europe has begun to affect Latvian exports, raising risks for the external balance and the prospect of a moderation of growth in Latvia. Based on lead indicators, and assuming a continuation of the current policy stance for the remainder of 2001, staff expects investment-led growth to decelerate in the fourth quarter of 2001, implying real growth for the year of 7 percent. Inflation would continue to be low, while the current account deficit could reach 7 percent of GDP (Table 7).

25. **The macroeconomic framework for 2002 and beyond is consistent with the mid-October WEO projection of 1.9 percent growth in Latvia's advanced economy partner countries and assumes a fairly short-lived global slowdown.** Growth under this baseline scenario would decelerate to 4½ percent, with subdued economic activity concentrated in the first half of the year. Slowing external demand and continued strong domestic demand (particularly for investment) would temporarily halt the downward trend of the current account deficit in 2002, while a recovery in western European markets would be reflected in a smaller current account deficit beginning in late 2002. Rising saving rates in the medium-term, owing mainly to fiscal consolidation, would allow for continued investment growth while leading to moderate declines in the overall savings-investment imbalance and, thus, the current account deficit. With sustained macroeconomic stability and further improvements in the business environment, FDI inflows would hold external debt in check.

26. **While recognizing the accomplishments in establishing a market economy, staff reiterated the importance of further structural reforms and additional improvements in the business climate**. Such gains would enhance productivity, promote FDI inflows, support export growth and sustain Latvia's generally low vulnerability to external shocks (Table 8). While such positive developments are also being observed in the wood sector, staff noted the high concentration of wood exports, which may give rise to some vulnerability to external shocks (Box 4).

Box 4: The Latvian Wood Sector

The wood sector plays a key role in Latvia's economy. Wood product exports account for about two-fifths of merchandise exports (i.e., equivalent to about 10 percent of GDP); nearly half of Latvia's land is covered by forest.

Wood product exporters have been under stress in recent years, as world prices fell about 15 percent in 1999–2000. Nevertheless, through restructuring, technology upgrading, cost cutting, and an aggressive export strategy, export sales increased during this period, reflecting strong volume growth of both sawn wood (which accounts for half of wood product exports) and of higher value-added products. A modest rebound of prices in 2001 has further stimulated growth in exports of furniture and other high value-added products, while exports of lower value-added products (like sawn and round wood) have been affected by slowing growth in the EU, the destination of over 80 percent of Latvia's wood product exports. Further restructuring and investment in new technologies will therefore be needed to help sustain growth in export volumes and continue raising the role of value-added products in the sector.

Latvia's Wood Product Exports, 1999–2001
(percent change)

	1999	2000	2001[a]
Exports (in U.S. dollars)	5.6	11.9	2.4
Price index (in U.S. dollars)	-9.7	-5.8	2.7
Price index (in lats)	-9.7	-3.1	3.5

Source: Staff calculations based on data from the Latvian Ministry of Agriculture.
[a] January–August over the same period of 2000

The establishment of a large-scale pulp mill is being considered by a consortium of foreign investors. This green field investment (about € 900 million, with annual production of 600,000 tons) would be very large by Latvian standards. While the overall desirability of the project would depend on its terms and conditions, it would provide Latvia with its first capability to produce pulp and thereby facilitate a better utilization of saw-milling by-products (including waste). By adding pulp to Latvia's product range, the economy would be less vulnerable to adverse price movements of low value-added products. These advantages would need to be weighed against any additional vulnerability that might result from increasing the overall economy's concentration in one sector (which could make Latvia more vulnerable to a downturn in wood product prices) and any concessions that Latvia might offer (such as subsidies, tax exemptions, or cutting quotas).

27. **Under a more pessimistic projection for the external environment,[3] Latvian growth in 2002 would be about 2 percentage points less than under the baseline scenario** (Table 7).[4] Such an external shock would be reflected during the first half of 2002 in a considerable contraction in investment (the main engine of growth in 2001)—including a reduction in FDI, which could adversely affect current account financing. On the other hand, lower investment activity could help contain the external current account deficit, even as external demand slipped. With an improved external environment, robust growth and the declining trend in the current account deficit would resume in 2003.

28. **Latvia's liberal merchandise trade regime is rated "1" on the Fund's 10-point scale of trade restrictiveness.** This reflects the virtual absence of nontariff barriers and a low simple average m.f.n. import tariff of 4½ percent. For 2002, the 0.5 percent m.f.n. rate will be eliminated and affected products moved to a zero rate. This will simplify customs processing and reduce the average m.f.n. rate to 4.3 percent (13.8 percent for agricultural goods, and 1.7 percent for other products), with a maximum rate of 55 percent.

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[3]Partner country growth would be 1½–2 percentage points less than in the baseline scenario.

[4]Latvia would be largely insensitive to moderate oil price changes: while a change in the oil price would affect the cost of oil products consumed, fees collected on the transshipment of Russian oil through Latvia would change in the opposite direction.

C. Fiscal Policy and Public Sector Reforms

Discussions focused on:

- ***The need to contain the 2001 budget deficit within the program targets***
- ***The inappropriateness of the 2002 draft budget***
- ***The need to persevere in the implementation of public sector reforms***
- ***Issuance of a second Eurobond***

29. **The government is on track to meet its 2001 fiscal deficit target of 1.7 percent of GDP, despite the adoption of a supplementary budget in June.** The Prime Minister reassured the staff that the government would not submit another supplementary budget this year. The authorities noted that in the event of a sudden revenue shortfall they would have some scope to constrain expenditures if needed to meet the annual deficit target. While strong growth has helped the fiscal performance, attaining the deficit target would represent a 1½ percentage point reduction from 2000 and the lowest deficit since the Russian crisis.

30. **While the authorities still intend to move toward a balanced budget in the medium-term, the 2002 budget (adopted on November 29, 2001) contains substantial spending increases and a deficit of 2¾ percent of GDP (including the projected costs of pension reform).**[5] This contrasts with the authorities' prior publicly expressed intentions—such as in the April 2001 Memorandum of Economic Policies (MEP) and the Pre-Accession Economic Program submitted to the EU in June 2001—of a deficit of 1 percent of GDP (excluding the costs of pension reforms) and could also adversely affect Latvia's credibility with international investors. The staff argued that the likelihood of strong growth in 2002 (albeit lower than in 2001) and the weakening external environment (which could erode Latvia's external position) called for continued fiscal consolidation, particularly given the key role fiscal policy plays under Latvia's fixed exchange rate regime to rein in the current account deficit. The staff also stressed that fiscal consolidation and substantial improvements in areas such as budget planning, tax administration, and the composition and efficiency of expenditures were the foundations of the SBA-supported program. Based on these factors, in the staff's view, a deficit of 1½ percent of GDP would be an appropriate ceiling.

31. **Staff reiterated that automatic stabilizers should be allowed to operate largely unimpeded in the event of a more pronounced economic downturn, provided that the current account and its financing do not give rise to concern.** According to staff estimates of the automatic stabilizers under the more pessimistic growth scenario described above, revenues could be lower by about 0.6 percent of (baseline) GDP while expenditures could increase by 0.2 percent of GDP, implying a fiscal deficit of 2.4 percent of GDP (Table 7). Low levels of public debt and the ability to tap domestic capital markets provide Latvia with a measure of fiscal flexibility which, along with other factors, suggests that a *moderate* and

[5] Projected costs of pension reform include a net cost of 0.2 percent of GDP due to pension amendments agreed with the World Bank, and a revenue loss of 0.2 percent of GDP from the diversion of social fund payments to the pension system's new second pillar (EBS/00/109).

temporary widening of the fiscal deficit would not raise significant vulnerability concerns. However, staff and the authorities viewed the baseline macroeconomic scenario as being more likely. In any case, adjusting for the automatic stabilizers using the authorities' higher budget deficit as a base could push the deficit to 3½ percent of GDP, thus reversing the fiscal consolidation gains of the last two years.

32. **Although the authorities considered it politically infeasible to change the budget law, they proposed to target fiscal deficits in the first and second quarters of 2002 consistent with an annual deficit of 1½ percent of GDP.** This leaves open the door to complete the first program review at a later stage. The staff views the authorities' intentions for the first two quarters positively, but remains concerned that election-related and other spending pressures that could emerge later in the year would make it very difficult for the authorities to hold the annual 2002 deficit much below that approved by parliament. The authorities hope to continue improving revenue performance; a significant over-performance could make room for many of the expenditure increases in the budget within the desired annual deficit ceiling of 1½ percent of GDP.

33. **The large spending increases reflect key strategic priorities, but also include substantial increases attributable to the upcoming elections.** The authorities argued that the spending increases were critical to Latvia's strategic priorities, including NATO integration (0.4 percent of GDP) and EU accession (0.2 percent of GDP). Staff agreed that higher spending for these priorities should be accommodated, but should fit within an appropriate overall expenditure ceiling if more resolve was shown in prioritizing spending and implementing the public sector reform measures under the program. The budget also includes expanded social spending, such as for higher teacher salaries (0.3 percent of GDP) and in the health sector—although spending in these areas is already high in relation to comparator countries. The staff also questioned whether the capacity existed to efficiently implement the sharp acceleration of the public investment program (capital spending would increase 40 percent, or about 1 percent of GDP). Finally, in light of the strong performance of the Social Fund in 2001, good growth in 2002 could generate a moderate Social Fund surplus and contribute to a smaller overall fiscal deficit; however, the authorities wanted to maintain the relatively cautious projection of a small deficit in the Social Fund.

34. **The need for better prioritization and enhanced efficiency of expenditures is reinforced by plans to reduce the tax burden.** The 2002 budget includes a reduction in the rate of corporate income tax from 25 percent to 22 percent (implying a revenue loss of ¼ percent of GDP), with further reductions leading to a 15 percent rate by 2004. Staff agreed that a lower tax burden was an appropriate medium-term goal, but argued for a more cautious approach to tax rate reductions and for a thorough review of tax exemptions, with a view to offsetting the revenue impact of rate reductions.[6] Rate reductions for social insurance contributions and the property tax were postponed, but may be taken up in the context of the

[6] The corporate tax rate reduction will not apply to enterprises benefiting from many of the exemptions, in effect reducing the attractiveness of the exemptions. The authorities have undertaken to review all current corporate income tax exemptions.

2003 budget.[7] However, the authorities are taking steps to improve revenue performance by curbing the scope for tax evasion. Parliament, in November, approved amendments to reduce allowances for duty-free imports for personal consumption, including of petroleum products, and to broaden the coverage of fuel-related excise taxes.

35. **The staff urged the authorities to persevere in their implementation of public sector reforms.** The authorities intend to step-up implementing their medium-term budget planning which will help prioritize spending. Building on the pilot comprehensive public administration review done earlier in 2001, they also will complete reviews of at least two more policy areas by July 2002, in time for the conclusions to be reflected in the 2003 budget.

36. **Despite the uncertainty in the external environment and in international capital markets, Latvia successfully issued its second Eurobond in November 2001.** The seven-year €200 million bond was issued at an interest rate of 5⅜ percent, about 150 basis points over a comparable German bond. The size of the bond goes beyond the needed external financing, reflecting the authorities' desire to establish a greater presence on international capital markets and help reduce liquidity pressures in domestic financial markets.

D. Exchange Rate and Monetary Policies and Financial Sector Reform

Discussions focused on:

- ***The maintenance of the SDR peg until EU accession***
- ***The monetary program for the remainder of 2001 and 2002***
- ***The reduced reliance on foreign exchange swaps***
- ***Enhancements to banking and financial sector supervision***

37. **The exchange rate peg to the SDR remains appropriate, having served Latvia well by helping to maintain price stability and encouraging disciplined macroeconomic policies**. Moreover, Latvia's real economy has demonstrated considerable flexibility, so that competitiveness has been sustained even in the face of considerable movements in nominal exchange rates. BoL officials reiterated their view that the peg sends a strong positive signal regarding the BoL's policy stance and use of the SDR as the anchor broadly reflects the currency composition of Latvia's trade. The staff supported the authorities' intention to retain the existing peg until shifting to a euro peg following accession to the EU.[8] The BoL wished to ensure an orderly and transparent transition during the re-pegging and intends to consult with the ECB. The staff and authorities agreed that the current level and projected path of international reserves were adequate, especially given the recent Eurobond issue (Box 5).

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[7] The staff's projections for social tax and property tax revenues in 2002 are somewhat above those of the authorities (Table 4), on the expectation that collections would grow roughly in line with nominal GDP.

[8] The authorities and staff expect no significant speculation to arise from the upcoming repegging of the Lithuanian litas from the US dollar to the Euro.

Box 5. External Short-Term Debt and the Level of Reserves

The most appropriate short-term debt indicator will depend on a country's circumstances; in Latvia the role and size of international banking activity is an important consideration. The most comprehensive measures of short-term debt, including foreign liabilities of the banking system, initially suggest that Latvia's short-term debt is high.[1] However, these liabilities are largely matched by high-quality, highly liquid foreign assets. Thus, more appropriate measures of short-term debt for Latvia that consider the nature of these liabilities suggest that short-term debt does not present any immediate concern.

By its broadest measure, economy-wide external short-term gross debt at end-June 2001 was US$2,960 million (40 percent of GDP). Total external gross debt was US$4,817million (66 percent of GDP). The ratio of BoL international reserves to short-term debt (R/STD) was 0.32. According to *Debt- and Reserve-Related Indicators of External Vulnerability* (SM/00/65), R/STD should ideally be above 1.0.

In the case of Latvia, however, this measure may give a misleading impression. Over two-thirds of Latvian short-term debt consists of non-resident deposits in commercial banks; these deposits are largely redeposited in foreign banks or placed in other secure liquid foreign assets in OECD countries chosen to closely match the currencies and maturities of the deposits;[2] in addition, the Latvian banking sector is reasonably strong and well-supervised (Box 3). When assessing vulnerability, it is reasonable therefore to exclude non-resident deposits from short-term debt, or to net the liabilities with their corresponding assets.

Excluding non-resident deposits, R/STD is at a more comfortable level of 1.0, broadly in line with the benchmark threshold. Alternatively, as mentioned in SM/00/65, reserve assets could be augmented with private assets when calculating the R/STD ratio (without excluding non-resident deposits). For Latvia, it seems reasonable to include commercial banks' liquid or short-term assets; the ratio would then be slightly over 1.0. If all other non-FDI assets are added to reserve assets, an option suggested in the report, the ratio becomes 1.3.

Short-term debt figures cited here include an estimate of (original) long-term maturities falling due in the coming year. For short-term debt on a maturity basis, the R/STD ratio exceeds 1.2 (excluding deposits).

[1] External debt is defined as the sum of all non-equity elements of liabilities in the International Investment Position (IIP). Short-term debt by remaining maturity includes monetary instruments, financial derivatives, short-term elements of other investments, and an estimate of other liabilities maturing within one year.
[2] Reflecting similar factors, the R/STD ratio in the United Kingdom, for example, was 0.02 at end-2000.

38. **The staff raised questions about the emergence of interest rate spreads relative to the anchor currency basket, and urged the authorities to monitor developments closely**. The lats had been trading near the more appreciated level under its (± 1 percent) band, despite outright foreign exchange purchases by the BoL, suggesting confidence in the currency and the peg. The authorities noted that the increased spread was concentrated at the short end of the market and reflected a thin market and a tight lats liquidity situation, resulting mainly from the government's large issues of medium-term bonds earlier in the year. In this context, staff emphasized the need to better coordinate government debt policy with the BoL's liquidity management.

39. **The 2002 monetary program is designed to support the exchange rate peg.** The BoL and staff reached understandings on indicative targets through June 2002 consistent with a prudent macroeconomic policy stance. The targets are based on a continued increase in money demand and the money multiplier, in line with the growing sophistication of the banking system.[9] Broad money would increase by 23 percent in 2002 and reserve money by 11 percent. Growth of private sector credit is projected to slow to 27 percent in 2002; the staff stressed the need for vigilant monitoring of loan portfolios (Box 6). The BoL intends to

Box 6: Credit Growth—A Cause for Concern?

In April 2001, several Directors expressed concern over the 37 percent growth in private sector credit in 2000. This rapid growth has continued and could reach 40 percent in 2001. While the credit expansion requires close monitoring, it also may benefit Latvia's financial development. Lending is developing off a very low base—credit as a share of GDP was about 20 percent at end-2000, compared to 26 percent in Estonia and 48 percent in the Czech Republic. Moreover, credit is being provided to sectors that had lacked access. An assessment of the sustainability of credit growth can include macroeconomic considerations and microeconomic factors.

Macroeconomic considerations. The BoL has maintained a fairly tight policy stance over the past year, as evidenced by occasional liquidity distress in the banking system, increasing money market rates, and low inflation. Rapid economic growth has contributed to credit demand; however, bank lending also fosters growth. Finally, at end-September 2001, credit to enterprises was primarily directed to fast-growing industries such as trade (25 percent), manufacturing (20 percent), and transport and communication (12 percent).

Microeconomic factors. Despite the surge in private sector credit, banks appear to operate on a sound footing. The nonperforming loan ratio has declined steadily, from 4.6 percent of total loans at end-2000 to 3.2 percent at end-September 2001 (Table 8 and Figure 6); the overall stock of non-performing loans fell from LVL 54 million to LVL 45 million during this period. The primary providers of credit are foreign-owned banks, which have strong financial backing and sound corporate governance, and experience and expertise in risk management and loan evaluation practices. While the liquidity ratio has fallen during 2001, this is consistent with the increasing share of loans in banks' total assets. As some foreign-owned banks have significant foreign credit lines not included in this ratio, the risks associated with this decline seem manageable at this point.

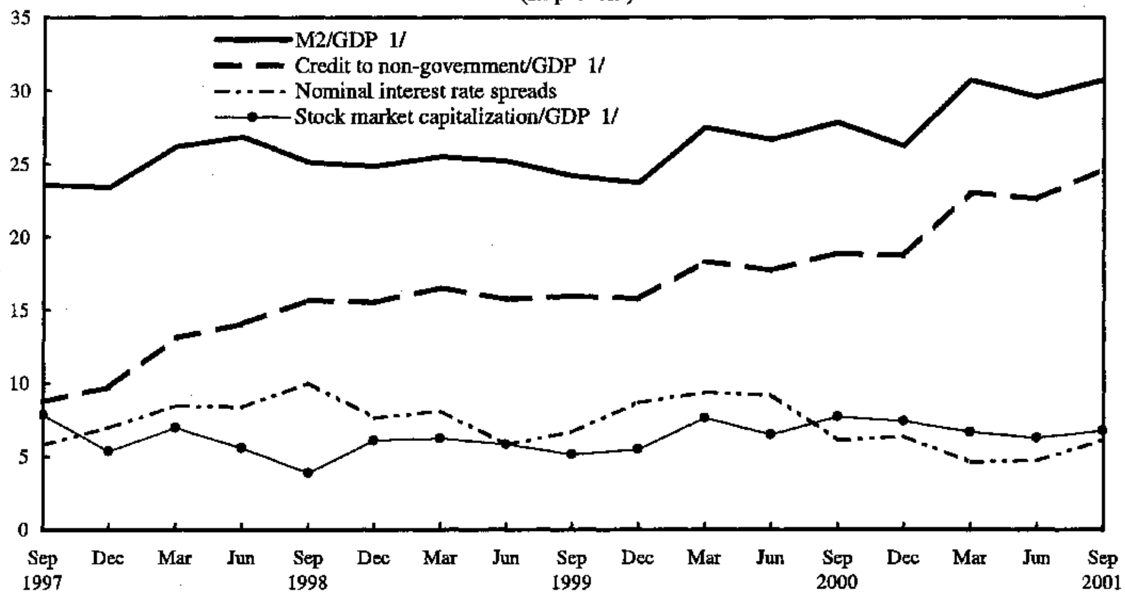
Stress tests conducted in the context of the FSAP confirmed the health of the banking system, based on end-December 2000 balance sheets and possible stresses resulting from interest rate fluctuations, exchange rate fluctuations, an increase in non-performing loans (such as could result from excessive growth of domestic credit), and a narrowing of interest rate margins associated with increased competition.

Despite this generally positive assessment, continued close monitoring is required and decisive steps will be needed should there be signs of a deterioration in loan quality. Thus, if the current rising trend in interest rates does not slow the credit expansion, further monetary tightening may be needed to: (i) send a stronger signal to banks; (ii) guard against the creation of overcapacity; and (iii) contain the credit expansion and thus counteract a potential future deterioration of loan portfolios. An official statement by the Governor clarified that the BoL would not increase its liquidity provision to banks, and banks seem to be well aware of this. The impact on loan portfolios of increasing banking competition also requires close monitoring in the medium term, including by ensuring that loan evaluation practices remain appropriate.

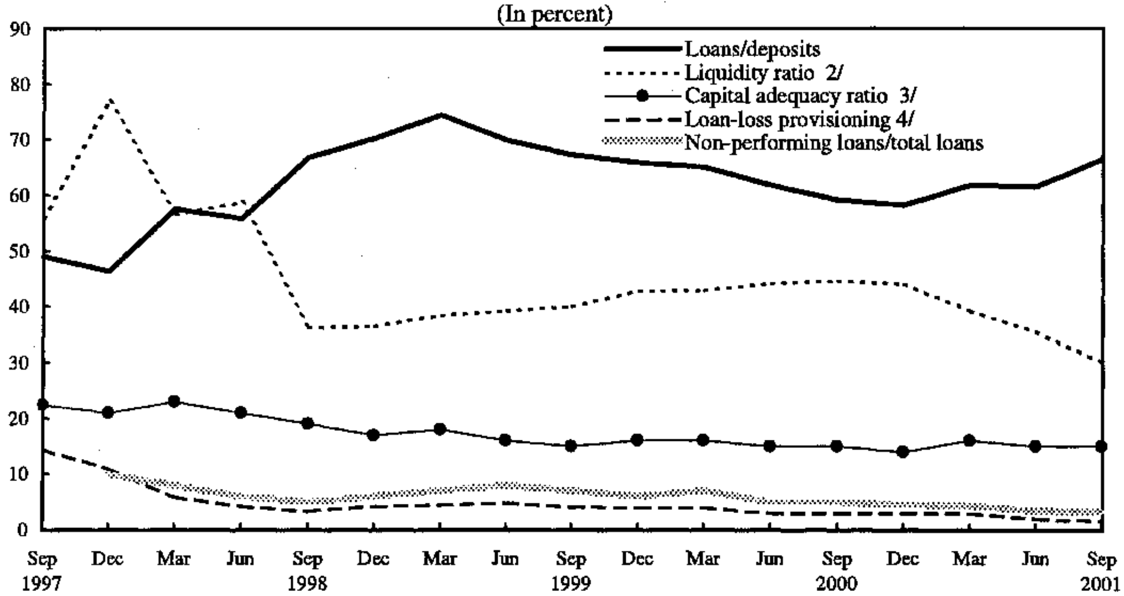
[9] Reserve requirements will be lowered from 6 to 5 percent from January 1, 2002. As the share of cash in vaults that banks may count toward their reserve requirement will also be reduced, from 40 to 30 percent, the liquidity injection will be a modest LVL 8 million.

Figure 6. Latvia: Financial Sector Developments, 1997-2001

Financial Sector Development Measures
(In percent)



Banking Sector Soundness Variables
(In percent)



Sources: Bank of Latvia, Riga Stock Exchange, and Fund staff estimates.

1/ Annualized GDP.

2/ The liquidity ratio is defined as (cash+claims on the central bank + claims on other credit institutions + fixed income government bonds - liabilities to the central bank - liabilities to other credit institutions) / deposits.

3/ For end-December, based on auditors' reports. Otherwise as reported by banks.

4/ In percent of total loans.

contain the expansion of its net domestic assets mainly through open market operations, indicating that it would henceforth use short-term foreign exchange swaps only to fine tune monetary conditions, with the outstanding stock to not normally exceed US$40 million.[10] Believing that long-term (two-year) foreign exchange swaps have successfully helped foster the market for longer-term domestic currency borrowing, the BoL has decided to discontinue them by end-2001.

40. **The staff welcomed the smooth transition to unified financial supervision under the FCMC.** In light of questions raised about the effective enforcement of Latvia's money-laundering provisions, the FCMC and the MLB assured staff that they were constantly improving cooperation, but believed that the capacity to follow through on the large number of reports of suspicious activity was limited. The staff stressed the need for continuous monitoring of inflows of non-resident deposits and for stepping up enforcement capabilities in this area, noting the importance of preserving the reputation of Latvia's banking system.[11]

41. **The staff strongly advised against the creation of a Financial Services Center in an existing free economic zone.** Notwithstanding Latvia's otherwise adequate regulatory regime, the supervisory demands arising from the likely complicated financial structures that could locate in such a Center could initially present challenges. With perceptions of money laundering activity persisting, there are concerns about the type of financial institutions that such a center might attract. Given the weight of considerations, the initiative seemed to lack strong support and most officials agreed that the Center would likely not be established.

E. Structural Policies and Data Issues

Discussions focused on:

- ***The government's intention to complete the privatization program in 2002***
- ***The importance of fostering competition in energy and telecommunications***
- ***Measures to improve the business climate***

42. **The World Bank is taking the lead on privatization issues and in most other structural areas.** Despite the upcoming elections and the setbacks in 2001, the authorities hope to reinvigorate large-scale privatization in 2002. They intend to adopt, by end-2001, an action plan that would culminate in the privatization of LASCO in 2002; they will also seek

[10] The BoL has reduced its stock of short-term swaps from US$101 million at end-2000 to US$58 million at end-October 2001.

[11] About half of these deposits continue to be received from the United States (reportedly from companies incorporated in Delaware), as was noted in EBS/00/109. However, given Latvia's traditional role as a major financial services center for Russia and other CIS countries, a major share of these deposits are believed to originate in that region.

to sell their minority share in Ventspils Nafta in the second half of 2002. The arbitration process resulting from the accelerated elimination of Lattelekom's monopoly rights in 2003 continues, with the divestiture of the state share in Lattelekom hinging on its conclusion. The state's remaining holdings in Latvijas Gaze and Krajbanka are to be sold by mid-2002.

43. **The staff stressed the importance of establishing an adequate regulatory framework for public utilities.** Latvia is establishing, by October 2002, separate legal entities for electricity generation, transmission, and distribution, and intends to complete the restructuring plan for Latvenergo by end-2002. The Public Utilities Commission is developing, by April 2002, a strategy paper and detailed work program for its regulation of the energy and telecommunications sectors over the medium term.

44. **The Latvian authorities continue to implement the *Action Plan to Improve the Business Environment*, in consultation with foreign investors.** A key step is expected to be the parliamentary approval of transitional provisions to allow the entry into force of the new Commercial Law, which was passed in April 2000. In other key areas, the Corruption Prevention Bureau (CPB) will be established by May 2002 under the Ministry of Justice to consolidate resources and responsibilities and end agency fragmentation. Another positive development in the fight against corruption has been the involvement of Transparency International in monitoring the LASCO privatization.

45. **The authorities have an excellent record in their dissemination and publication of data and other information** (Appendix III). The periodicity and timeliness of data are adequate. Latvia subscribes to the Special Data Dissemination Standard and has recently submitted the Data Template on International Reserves and Foreign Currency Liquidity. Table 9 provides indicators of financial obligations to the Fund.

IV. Staff Appraisal

46. **Latvia is reaping the benefits of sustained macroeconomic stabilization and structural reform, with strong growth and low inflation, one of the best performances among EU accession countries.** Improved fiscal control and a strong commitment to the exchange rate peg and the monetary policies that support it have fostered an environment conducive to investment, while microeconomic reforms have enhanced the efficient allocation of resources. The fiscal adjustment of around 1½ percentage points of GDP in 2001 is commendable, all the more so as it follows the fiscal loosening that occurred late in 2000. External vulnerability has diminished, as the current account deficit has declined significantly since 1999 and buoyant FDI inflows have continued. Market sentiment has remained favorable, as evidenced by the successful placement of Latvia's second Eurobond.

47. **Looking forward, the external imbalance remains the most significant risk to the Latvian economy.** While moderate current account deficits that reflect high investment can be expected at Latvia's advanced stage of transition, the magnitude and obduracy of Latvia's current account deficit need to be considered carefully when devising macroeconomic policies. Weakening external demand together with continued strong growth at home are at

present generating pressures on the current account. Under Latvia's exchange rate peg, fiscal policy is the main policy tool for counteracting such pressures, while facing new challenges in both the near term (such as the upcoming parliamentary elections) and over the medium-term (such as the strategic expenditure needs of EU- and NATO- accession and the importance of reducing the tax burden).

48. **A shift toward more expansionary fiscal policy, as represented in the 2002 budget, will exacerbate the risks and is inappropriate under Latvia's present circumstances, including its strong growth.** The staff believes that there is scope to accommodate high priority strategic expenditures within an appropriate overall deficit target of about 1½ percent of GDP.

49. **However, the authorities did not see scope for reducing expenditures in the 2002 budget, and attached strong importance to their tax reform plan.** While there was no convergence of views on an overall 2002 fiscal deficit target, staff welcomes the authorities' agreement to fiscal deficit targets for the first two quarters of 2002 that would be consistent with an annual deficit target of 1½ percent of GDP. However, staff remains concerned that expenditure pressures in the latter part of the year, including those arising from the October elections, will make it very difficult to restrain spending below the levels authorized by parliament. Against this background, particular efforts are needed to sustain the current strong revenue performance well into next year and to regain momentum in the area of the public sector reforms. In the same vein, staff urges against any revisions to the pension amendments now in parliament.

50. **Latvia's exchange rate regime and the level of the lats are appropriate.** The exchange rate peg to the SDR continues to serve Latvia well by fostering price stability and contributing to an environment conducive to investment and growth. Continued strong export growth and the ability of Latvian exporters to expand into new markets indicate that Latvia's competitiveness is adequate. The staff found that this view was generally echoed by the authorities and private sector representatives. The recent increase in the spread of Latvian interest rates over those of the anchor currency requires close monitoring. The staff supports the authorities' decision to stop their issuance of long-term foreign exchange swaps and to limit their use of short-term swaps, relying more extensively on open market instruments.

51. **The overall positive assessment of the Latvian financial sector under the FSAP bodes well for its sustained future development.** The successful launch of the FCMC will further enhance such prospects. While recognizing the present health of the banking system, in light of the continuing rapid expansion of private sector credit the staff urges vigilance in monitoring banks' loan portfolio quality. The BoL should stand ready to tighten monetary conditions if deemed necessary to counter a worsening in the quality of banks' loan portfolios. Staff welcomes the creation of a sensible anti-money laundering framework, but more emphasis needs to be placed on closely watching over the continuing large inflows of non-resident deposits and on strengthening the enforcement capabilities. The authorities' quick move to introduce anti-terror financing legislation after September 11 was fitting.

52. **Substantial progress has been made on structural reforms, and staff is confident that the prospect of rapid EU accession will sustain the reform momentum.** In particular, the efforts to enhance the business climate and create a competitive framework in the energy and telecommunications sectors could buttress growth and heighten Latvia's attractiveness to foreign investors. Staff calls on the authorities to persevere in their efforts to fight corruption and improve governance, and to show more resolve in divesting from LASCO and the few other remaining public enterprises to bring the privatization program to an end. In addition, allowing the Commercial Law to become effective should be considered a key priority.

53. **The staff welcomes Latvia's decision to publish this Article IV staff report.**

54. **Staff recommends that Latvia remain on a standard 12-month consultation cycle.**

Table 1. Latvia: Selected Economic and Financial Indicators, 1998–2002

	1998	1999	2000	2001 1/				2002
				Q1	Q2	EBS/01/44	Proj.	Proj.
National income								
Nominal GDP (millions of lats)	3,589	3,897	4,333	1,079	1,193	4,700	4,753	5,140
Nominal GDP (millions of U.S. dollars)	6,086	6,662	7,144	1,744	1,881	7,681	7,768	8,368
Real GDP (annual growth)	3.9	1.1	6.6	8.3	9.2	6.0	7.0	4.5
Registered unemployed (in '000, end of period)	111	109	93	97	94	...	...	...
Unemployment rate (end of period)	9.2	9.1	7.8	8.1	7.8	...	...	...
Prices and wages (annual change, unless otherwise specified)								
Consumer price index (period average)	4.7	2.4	2.6	1.1	2.4	2.3	2.5	3.0
Consumer price index (end-period)	2.8	3.2	1.8	1.4	3.1	3.0	3.2	3.0
Producer price index (end-period)	-1.9	-1.1	1.0	0.6	2.0	...	...	...
Real wage (period average)	6.2	3.3	3.3	4.3	2.9	...	...	...
Average monthly wage (in lats)	133	141	149	150	157	...	...	...
General government (in percent of GDP, unless otherwise specified)								
Revenue 2/	42.6	40.0	37.4	36.7	36.8	37.5	36.3	36.5
Expenditure	43.3	43.8	40.7	37.6	38.9	38.9	37.8	38.1
Net lending	0.1	0.2	0.0	0.0	-0.2	0.3	0.2	0.0
Fiscal balance 2/	-0.8	-3.9	-3.3	-0.9	-1.9	-1.7	-1.7	-1.5
Gross government debt (millions of lats) 3/	377	511	570	617	630	...	...	...
Gross debt as percentage of GDP	10.5	13.1	13.2	13.9	13.9	...	...	...
Foreign debt (millions of lats)	232	358	347	346	343	...	...	...
External sector								
Current acct. balance (incl. official transfers, percent of GDP)	-9.8	-9.8	-6.9	-4.2	-6.3	-6.3	-7.1	-7.0
External trade balance (percent of GDP) 4/	-18.6	-15.4	-14.8	-13.0	-13.7	-14.5	-14.8	-14.4
Exports value (annual growth)	9.4	-6.1	9.0	8.6	12.2	11.7	10.0	8.3
Imports value (annual growth)	17.0	-7.2	6.9	10.0	7.7	9.3	9.5	7.3
CPI-based real exchange rate index, weights for 15 most important trading partners (end-of-period, 1997 average=100)	115.8	125.4	125.6	122.3	124.3	...	...	...
International reserves (in months of imports of goods and nonfactor services, end-of-period)	2.9	2.9	2.6	2.4	2.5	2.9	3.1	2.9
Exchange rate (lats per $US; period average)	0.590	0.585	0.607	0.619	0.634	...	...	...
Exchange rate (lats per Euro; period average)	0.660	0.624	0.560	0.571	0.553	...	...	...
Money and credit (end-of-period, change in percent, unless otherwise specified)								
Reserve money	7.0	11.6	7.7	12.3	19.2	13.4	11.1	11.1
Domestic credit (non-government)	59.0	15.1	36.7	39.8	42.7	29.0	39.9	26.8
Broad money	6.0	8.0	27.9	24.2	24.0	27.0	24.0	23.2
Ratio of broad money to NFA of the BoL (level)	1.7	1.9	2.4	2.4	2.4	2.6	2.3	2.7
Riga Stock Exchange Price Index, RICI, (level)	186	171	176	158	159	...	...	...
Interest rates (in percent, per annum, end-of-period)								
Deposit 5/	7.0	6.0	4.9	5.5	5.6	...	...	...
Credit 5/	15.0	15.0	11.3	10.1	10.3	...	...	...
Three-month treasury bill auction rate	7.9	5.1	4.5	4.5	5.2	...	...	...

Sources: Latvian authorities and Fund staff estimates and projections.

1/ Growth rates and changes refer to corresponding period previous year..
2/ Privatization receipts are classified as a deficit financing component, i.e. they are excluded from revenues.
3/ Excluding government guaranteed debt
4/ Goods only.
5/ Average volume-weighted commercial bank interest rates on 3-6 month domestic currency transactions.

Table 2a. Latvia: Quantitative Performance Criteria and Indicative Targets Under the Stand-By Arrangement, 2001 1/

Variable and Periods	Adjusted Target		Outcome	
				(In millions of lats)
I. Ceilings on the general government fiscal deficit 2/				
From January 1, 2001 to:				
March 31, 2001: Indicative		20		10
June 30, 2001: Performance criterion		46		33
September 30, 2001: Performance criterion		62		47
December 31, 2001: Performance criterion		79		
II. Ceilings on net domestic assets of the Bank of Latvia 3/				
March 31, 2001: Indicative		1		-14
June 30, 2001: Performance criterion		12		12
September 30, 2001: Performance criterion		33		-12
December 31, 2001: Performance criterion		62		
				(In millions of US$)
III. Floor on convertible net international reserves of the Bank of Latvia 4/ 5/				
March 31, 2001: Indicative		831		906
June 30, 2001: Performance criterion		851		936
September 30, 2001: Performance criterion		890		962
December 31, 2001: Performance criterion		844		
IV. Ceilings on contracting and guaranteeing of medium-and long-term nonconcessional external debt 6/ 7/	Total	Of which: maturity of more than 1 and up to 5 years	Total	Of which: maturity of more than 1 and up to 5 years
Reference point: December 31, 2000				
March 31, 2001: Indicative	52	52	0	0
June 30, 2001: Performance criterion	242	52	0	0
September 30, 2001: Performance criterion	300	52	0	0
December 31, 2001: Performance criterion	320	72		
V. Ceilings on contracting or guaranteeing of external debt of up to and including one year 6/ 7/				
March 31, 2001: Indicative		0		0
June 30, 2001: Performance criterion		0		0
September 30, 2001: Performance criterion		0		0
December 31, 2001: Performance criterion		0		
VI. Indicative ceilings on reserve money 8/				
March 31, 2001:		572		541
June 30, 2001:		595		586
September 30, 2001:		640		577
December 31, 2001:		641		

Table 2a. Latvia: Quantitative Performance Criteria and Indicative Targets
Under the Stand-By Arrangement, 2001 1/

Variable and Periods		Adjusted Target	Outcome
			(In millions of lats)
VII.	Indicative ceilings on net domestic assets of the banking system 3/ 9/		
	March 31, 2001:	790	810
	June 30, 2001:	850	842
	September 30, 2001:	918	918
	December 31, 2001:	1,009	
VIII.	Zero ceiling on the non-accumulation of external arrears by the general government	Continuous	

1/ Definitions of the performance criteria and indicative targets are included in the Annexes to the Memorandum of Economic Policies.
2/ The ceilings on the general government fiscal deficit will be adjusted downward by the amount by which central government tax revenue exceeds the indicative targets mentioned in Annex I of the MEP.
3/ The ceilings will be adjusted upward (downward) for any shortfall (excess) from programmed levels of disbursements of foreign balance of payments assistance and for any decumulation (accumulation) of foreign exchange swaps compared to the stock of such swaps at end-December 2000. The ceilings will also be adjusted downward for any receipts from foreigners from privatization and the sale of UMTS and GSM licenses (see Annex II of MEP).
4/ The floors will be adjusted downward (upward) for any shortfall (excess) from programmed levels of disbursements of foreign balance of payments assistance and for any decumulation (accumulation) of foreign exchange swaps compared to the stock of such swaps at end-December 2000. The floors will also be adjusted upward for any receipts from foreigners from privatization and the sale of UMTS and GSM licenses (see Annex III of MEP).
5/ The program definition includes gross international reserves generated from foreign exchange swaps accumulated by end-December 2000 (see Annex III of MEP).
6/ Applies to the general government, the Bank of Latvia, or any other agencies acting on behalf of the government.
7/ The performance criteria on debt ceilings apply not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274 – (00/85), adopted August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received. Because of difficulties in ensuring effective monitoring of leasing and import financing by local entities, such transactions by local governments are not included under the external debt limits (see Annex IV of MEP).
8/ The program definition excludes time deposits of commercial banks held with the BoL (see Annex II of MEP).
9/ The program definition includes foreign equity of commercial banks, which is recorded in "other net assets" (see Annex II of MEP).

Table 2b. Latvia: Structural Benchmarks
Under the Stand-By Arrangement, 2001-2002

By end-June 2001:		
1.	Submit to Parliament amendments to the pension law, as described in paragraph 24 of the MEP.	Observed
2.	Complete the transfer of all accounts of budget financed institutions (BFI) directly financed by the budget from commercial banks to the Treasury, as described in paragraph 15 of the MEP.	Not observed
3.	Parliament to pass the amendments to the Excise Tax Law, as described in paragraph 23 of the MEP.	Observed
By end-September 2001:		
1.	The Cabinet of Ministers to adopt supporting regulations for the implementation of the Law on Public Agencies, as described in paragraph 16 of the MEP.	Not observed
2.	Submit to Parliament the 2002 budget documents providing the information described in paragraph 15 of the MEP.	Submitted on October 18, 2001
3.	Submit to Parliament the amendments to the Law on Credit Institutions, as described in paragraph 30 of the MEP.	Submitted on October 12, 2001
By end-March 2002:		
1.	The Bank of Latvia to discontinue two-year foreign exchange swaps, as described in paragraph 29 of the MEP.	

Table 3. Latvia-Balance of Payments, 1999-2006

	1999	2000	2001	2002	2003	2004	2005	2006
			Projections					
			(In millions of U.S. dollars)					
Current Account	-653.6	-493.4	-554.9	-585.3	-583.2	-606.0	-622.9	-604.7
excluding official transfers	-714.4	-528.9	-597.4	-665.3	-706.1	-752.3	-797.1	-803.9
Goods	-1,027.1	-1,058.1	-1,147.8	-1,208.0	-1,279.2	-1,351.5	-1,412.5	-1,470.6
Exports	1,889.1	2,058.3	2,263.4	2,452.1	2,707.2	3,006.2	3,359.2	3,760.4
Imports	-2,916.1	-3,116.5	-3,411.1	-3,660.1	-3,986.4	-4,357.7	-4,771.7	-5,231.0
Services	336.0	442.7	473.9	485.0	533.6	578.9	637.3	706.8
Transportation	521.7	559.5	572.2	585.2	628.0	665.5	710.3	762.7
Travel	-150.6	-117.3	-99.6	-105.0	-104.6	-104.4	-101.8	-98.3
Other	-35.2	0.5	1.4	4.8	10.3	17.7	28.8	42.4
Income	-55.4	24.4	12.8	-7.7	-27.9	-49.0	-93.3	-113.6
Current transfers	93.0	97.5	106.1	145.3	190.2	215.6	245.6	272.7
Official	60.9	35.5	42.5	80.0	122.9	146.3	174.2	199.2
Private	32.1	62.0	63.6	65.3	67.3	69.3	71.4	73.5
Capital and Financial Account	780.7	543.3	823.7	625.4	673.0	710.7	746.7	763.8
Capital Account	12.6	29.4	31.8	34.4	37.6	41.0	44.8	48.9
Financial Account	768.1	513.9	791.8	590.9	635.4	669.7	701.9	714.9
Direct Investment	330.6	398.0	441.6	472.7	493.8	520.4	551.1	563.4
Portfolio investment	273.5	-319.2	-55.3	-266.2	-266.4	-268.0	-272.8	-273.1
of which General government	210.6	34.5	178.7	0.0	0.0	0.0	0.0	0.0
Other Investment	164.1	435.1	405.5	384.4	408.0	417.3	423.6	424.7
of which General government	14.1	-7.5	60.8	102.5	35.1	60.7	116.6	107.6
Errors and omissions	37.9	-22.1	0.0	0.0	0.0	0.0	0.0	0.0
Overall Balance, Net reserve assets	165.0	27.8	268.7	40.1	89.7	104.7	123.8	159.1
Memorandum items:			(In percent of GDP, unless otherwise indicated)					
Current account balance	-9.8	-6.9	-7.1	-7.0	-6.4	-6.1	-5.8	-5.2
excluding official transfers	-10.7	-7.4	-7.7	-8.0	-7.8	-7.6	-7.4	-6.9
Trade balance	-15.4	-14.8	-14.8	-14.4	-14.1	-13.7	-13.2	-12.6
Merchandise exports	28.4	28.8	29.1	29.3	29.8	30.4	31.3	32.3
Merchandise imports	-43.8	-43.6	-43.9	-43.7	-43.8	-44.1	-44.5	-44.9
Services, income & transfers balance	5.6	7.9	7.6	7.4	7.7	7.5	7.4	7.4
Gross official reserves (millions of US$)	944.4	919.3	1,178.1	1,208.2	1,288.1	1,388.4	1,512.2	1,671.3
in months of GNFS imports	2.9	2.6	3.1	2.9	2.9	2.8	2.8	2.8
Value growth of merchandise exports (percent)	-6.1	9.0	10.0	8.3	10.4	11.0	11.7	11.9
Value growth of merchandise imports (percent)	-7.2	6.9	9.5	7.3	8.9	9.3	9.5	9.6
Terms of Trade, GNFS (percent)	1.8	-3.4	-0.1	-0.2	0.0	0.8	0.0	0.0
Net FDI / Current Account, percent	51	81	80	81	85	86	88	93
External public debt (millions of US$) 1/	708.1	705.6	936.3	1,025.9	1,047.4	1,099.5	1,211.4	1,308.9
in percent of GDP	10.6	9.9	12.1	12.3	11.5	11.1	11.3	11.2
Public debt service (in percent of exports) 1/	4.2	7.5	3.7	4.8	4.6	11.4	4.0	4.2
External debt 2/								
in millions of US$	3,820.7	4,488.7	5,169.9	5,703.6	6,232.9	6,806.9	7,507.1	8,209.2
in percent of GDP	57.4	62.8	66.6	68.2	68.5	68.9	69.9	70.4
of which short-term (in millions of US$)	2,315.6	2,789.0	3,161.3	3,402.7	3,864.6	3,965.7	4,310.5	4,614.4
gross official reserves / short-term debt	0.4	0.3	0.4	0.4	0.3	0.4	0.4	0.4
Net debt 2/								
total in millions of US$	764.7	1,026.1	1,186.1	1,398.2	1,567.3	1,729.3	1,895.8	2,010.8
total in percent of GDP	11.5	14.4	15.3	16.7	17.2	17.5	17.7	17.2
short-term in millions of US$	-126.1	36.4	95.8	228.3	561.2	490.1	568.4	556.2
short-term in percent of GDP	-1.9	0.5	1.2	2.7	6.2	5.0	5.3	4.8

Source: Data provided by Latvian authorities and staff estimates.

1/ Includes publicly guaranteed debt.

2/ In accordance with IMF advice, trust funds, which mostly involve transactions between non-residents, are temporarily excluded until a new survey, which will give more detailed information, is released in 2002

Table 4. Latvia: Consolidated General Government, 1999-2002
(in millions of lats, unless stated otherwise)

	1999	2000	2001					2002			
			Q1 to Q3		Q4	Annual		Draft	Staff	Indicative targets	
	Act.	Act.	Prog.	Act.	Prog.	Prog.	Est.	Budget	Proj.	Q1	Q2
Revenue 1/	1,561	1,620	1,288	1,258	472	1,760	1,725	1,848	1,871	447	466
Tax revenue	1,322	1,362	1,090	1,070	391	1,481	1,475	1,560	1,583	378	396
Direct taxes	786	801	647	637	231	878	873	915	931	223	236
Corporate income tax	92	74	75	74	23	98	98	94	96	25	29
Personal income tax	241	261	206	207	78	284	284	309	309	72	75
Social taxes 2/	453	466	365	356	131	496	491	511	525	126	131
Indirect taxes	534	560	443	426	160	603	596	639	646	154	158
Taxes on goods & services	487	516	414	391	151	566	551	598	598	143	147
VAT	316	338	274	262	95	369	364	397	397	97	98
Excises	155	164	133	117	52	185	172	184	184	43	46
Customs duty	16	14	8	11	4	12	15	16	16	3	4
Property taxes	47	44	29	35	9	38	45	41	49	11	11
Other (incl. taxes in transit)	2	0	0	6	0	0	6	6	6	1	1
Non-tax revenue	239	258	198	187	81	279	250	288	288	68	70
of which: EU grants	...	21	33	19	14	47	28	49	49	12	12
Expenditure	1,707	1,764	1,338	1,308	489	1,827	1,796	1,989	1,951	464	493
Current expenditure	1,530	1,591	1,211	1,190	454	1,665	1,646	1,766	1,751	423	441
Wages & salaries	386	397	300	305	117	417	421	460	460	111	113
of which: soc sec contributions	82	82	64	61	25	89	89	98	98	24	24
Goods & services	301	305	217	226	101	317	329	320	316	76	79
Interest	25	49	33	33	6	39	40	54	52	10	18
Subsidies & transfers	817	820	658	621	230	888	854	932	923	227	231
Transfers to households	616	604	451	440	159	610	591	617	612	150	154
Other	202	216	207	182	71	278	263	315	311	77	77
Other expenditure	0	20	3	5	0	3	3	0	0	0	0
Capital expenditure	177	173	127	118	36	163	150	223	200	41	52
Financial balance	-146	-144	-50	-50	-17	-67	-71	-141	-80	-17	-27
Net lending (+)	7	0	9	-3	3	12	8	-1	-1	0	0
Fiscal balance	-153	-143	-59	-47	-20	-79	-79	-140	-79	-17	-27
Financing	153	143	59	47	20	79	79	138	79	17	27
Privatization receipts	6	25	11	18	4	15	25	8	8	2	2
Domestic	36	129	19	33	15	35	-94	78	17	5	27
Banks	35	99	12	-38	9	20	-129	-8	13	2	23
BOL	-31	49	-19	-35	1	-18	-96	0	52	23	10
Commercial banks	66	50	31	-3	7	38	-33	-8	-39	-22	13
Other domestic	2	30	8	71	7	15	35	85	4	4	4
Foreign	111	-11	29	-4	1	29	148	53	53	10	-3
Memorandum items:					(in percent of GDP)						
Revenue	40.0	37.4	37.5	36.4	37.4	37.5	36.3	35.6	36.4	39.0	36.5
Direct taxes	20.2	18.5	18.8	18.5	18.3	18.7	18.4	17.6	18.1	19.5	18.5
Taxes on goods & services	12.5	11.9	12.1	11.3	12.0	12.0	11.6	11.5	11.6	12.5	11.5
Expenditure, *of which:*	43.8	40.7	38.9	37.8	38.7	38.9	37.8	38.4	38.0	40.5	38.6
Expenditure financed by EU grants	0.0	0.5	...	0.6	1.1	1.0	0.6	0.9	1.0	1.1	1.0
Wages & salaries (net of social taxes)	7.8	7.2	...	7.0	7.3	7.0	7.0	7.0	7.0	7.6	7.0
Transfers to households	15.8	13.9	...	12.4	12.6	13.0	12.4	11.9	11.9	13.1	12.1
Capital expenditure	4.5	4.0	...	3.2	2.8	3.5	3.2	4.3	3.9	3.6	4.1
Net lending	0.2	0.0	0.3	-0.1	0.2	0.3	0.2	0.0	0.0	0.0	0.0
Fiscal balance	-3.9	-3.3	-1.7	-1.4	-1.6	-1.7	-1.7	-2.7	-1.5	...	...
Excluding the cost of pension reform 3/	...	...	...	...	...	-1.6	-1.6	-2.3	-1.1	...	...
Social Budget											
Revenues (social taxes)	453	466	365	356	131	496	491	511	525	126	131
Transfers from basic budget	8	0	0	0	0	0	0	0	0	0	0
Transfers to individuals	500	486	379	356	130	509	487	512	507	125	126
Pensions	445	445	331	327	117	448	412	431	426	105	106
Balance	-47	-19	-15	0	1	-14	4	-1	18	1	5
In percent of GDP	-1.2	-0.4	-0.4	0.0	0.1	-0.3	0.1	0.0	0.4	0.1	0.4
Nominal GDP (millions of lats)	3,897	4,333	3,436	3,455	1,264	4,700	4,753	5,184	5,140	1,145	1,275
Central gov't. tax revenue (pgm. defn.)		...	...	...	...	...	1,226	...	1,313	316	331

Sources: Ministry of Finance; and Fund staff estimates.

1/ Revenues exclude receipts from privatization.

2/ Excluding social tax revenue being channeled to the second pension pillar (projected at LVL 5.9 million in 2001 and LVL 12.7 in 2002).

3/ After adjusting for social taxes channeled to the second pillar and the net cost of the pension amendments.

Table 5. Latvia: Reserve Money and Net Domestic Assets of the Bank of Latvia, 1999-2002
(in millions of lats)

	1999	2000	2001					2002		
	Dec	Dec	Mar	Jun	Sep	Dec Prog.	Dec Proj.	Mar Proj.	Jun Proj.	Dec Proj.
Reserve money	526.3	566.7	541.0	585.8	577.1	641.0	629.4	656.4	670.8	699.1
Currency in circulation	426.1	482.3	476.4	500.4	515.8	519.2	544.4	567.7	570.2	587.2
Bank deposits	100.2	84.4	64.6	85.4	61.3	121.8	85.0	88.6	100.6	111.9
Foreign currency deposits	...	...	...	...	...	...	...	...	...	...
Other	100.2	84.4	64.6	85.4	61.3	121.8	85.0	88.6	100.6	111.9
of which: Time deposits 1/	4.0	6.0	...	...	...	...	...	...	...	...
Net foreign assets 2/ 3/	523.4	542.0	558.9	578.9	593.9	615.7	700.6	703.7	708.3	719.0
Net International Reserves	523.1	542.1	559.0	579.0	594.0	615.7	700.7	703.7	708.3	719.1
Correspondent accounts	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net domestic assets	2.9	24.7	-17.9	6.8	-16.8	25.4	-71.2	-47.3	-37.5	-19.9
Domestic credit	68.0	70.1	42.7	64.3	48.7	70.8	-5.7	18.2	28.0	45.6
Banks	63.3	42.5	35.0	102.0	60.8	68.2	68.2	70.8	72.0	73.7
BoP assistance	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Refinance credits	63.2	42.4	34.9	101.9	60.6	68.1	68.1	70.7	71.9	73.6
Government, net	4.6	27.5	7.7	-37.7	-12.1	2.6	-74.0	-52.6	-44.0	-28.1
BoP assistance	50.1	23.8	23.0	21.7	19.6	16.5	18.1	16.3	14.7	11.6
Other government, net 4/	-45.5	3.7	-15.3	-59.4	-31.7	-13.9	-92.1	-68.9	-58.7	-39.7
Other items, net	-65.1	-45.4	-60.6	-57.5	-65.5	-45.4	-65.5	-65.5	-65.5	-65.5
Memorandum Items:										
Percentage change from previous quarter										
Reserve money	17.1	6.1	-4.5	8.3	-1.5	0.2	9.1	4.3	2.2	...
Domestic credit	25.2	53.6	-39.1	50.8	-24.4	21.6	-111.8	417.0	54.2	...
Percentage annual change										
Reserve money	11.6	7.7	...	...	...	13.1	11.1	...	...	11.1
Broad money	8.0	27.9	...	...	...	27.1	24.0	...	...	23.2
Credit to the nongovernment sector	15.3	36.7	...	...	...	28.5	39.9	...	...	26.8
Velocity	4.2	3.8	...	...	...	3.1	3.3	...	...	3.0
Money multiplier	1.894	2.250	2.456	2.411	2.531	2.528	2.513	2.518	2.622	2.787
Exchange rate (LVL/US$)	0.583	0.613	0.631	0.639	0.619	0.613	0.613	0.613	0.613	0.613
NFA total (US$mn)	897.7	884.3	885.8	906.0	959.5	1,004.3	1,143.0	1,148.0	1,155.5	1,173.0
Nonconvertible NFA (US$mn)	0.4	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Government financing (cumulative, excl. BOP assistance)	-52.8	49.2	-19.0	-63.1	-35.4	-17.6	-95.8	23.2	33.4	52.4
Change in NIR (US$mn)										
Quarterly	...	36.0	1.5	20.2	53.5	-18.6	183.4	5.0	7.5	5.0
Cumulative	...	-13.0	1.5	21.7	75.2	120.0	258.7	5.0	12.5	30.0
NFA at program exchange rate										
In millions of lats	...	542.0	555.4	574.0	589.4	...	...	...	...	...
In millions of US$	...	884.3	906.0	936.4	961.5	...	...	...	...	...
Stock of swaps (US$mn)	...	184.1	217.0	221.4	236.4	...	...	...	...	...
Of which: short-term swaps	...	100.5	90.7	71.2	65.4	...	...	...	...	...

Sources: Bank of Latvia; and staff estimates.

1/ As of January 1, 2001, commercial banks' and other financial institutions' time deposits with the Bank of Latvia are excluded from the reserve money definition.
2/ Valued at current exchange rates.
3/ As the Bank of Latvia has almost no medium- and long-term foreign currency liabilities, NFA largely equals NIR.
4/ Includes purchase of Treasury bills and change in government deposits.

Table 6. Latvia: Broad Money and Net Domestic Assets of the Banking System, 1999-2002
(in millions of lats)

	1999	2000	2001					2002		
	Dec	Dec	Mar	Jun	Sep	Dec Prog.	Dec Proj.	Mar Proj.	Jun Proj.	Dec Proj.
Broad money (M2X)	996.9	1,275.3	1,328.8	1,412.4	1,460.9	1,620.6	1,581.7	1,652.8	1,758.6	1,948.5
Currency held by public	377.4	427.7	426.1	443.4	458.1	462.1	484.6	505.3	507.5	522.6
Household deposits	121.1	193.9	203.5	225.2	246.3	262.2	242.8	270.3	299.3	347.1
Enterprise deposits	199.9	257.0	281.2	289.6	292.7	410.1	379.8	422.7	468.2	542.9
Residents' FC deposits 1/	298.5	396.8	418.0	454.2	463.8	486.2	474.5	454.5	483.6	535.8
Total deposits	619.4	847.7	902.7	969.0	1,002.8	1,158.5	1,097.1	1,147.5	1,251.2	1,425.8
Net foreign assets (total) 2/ 3/	363.7	538.3	519.4	570.8	542.7	611.9	649.9	653.0	657.5	668.3
Convertible net int'l reserves 1/ 2/	497.1	491.3	492.6	532.1	504.4	564.9	611.6	614.7	619.3	630.0
Nonconvertible reserves 1/ 3/	-133.4	47.0	26.8	38.7	38.3	47.0	38.3	38.3	38.3	38.3
Net domestic assets 3/	633.1	737.0	809.5	841.6	918.2	1,008.7	931.8	999.9	1,101.1	1,280.2
Domestic credit	745.0	1,062.5	1,118.1	1,189.1	1,276.8	1,334.2	1,290.4	1,358.6	1,459.8	1,638.9
Credit to the non-government sector	665.1	909.4	996.3	1,078.2	1,169.7	1,168.2	1,272.3	1,340.7	1,420.5	1,613.7
Households	94.3	158.9	171.8	191.6	210.8	213.5	219.4	231.0	248.2	278.6
Enterprises	570.8	750.6	824.6	886.7	958.9	954.7	1,052.9	1,109.8	1,172.3	1,335.1
Government, net	79.9	153.0	121.8	110.9	107.1	166.0	18.2	17.9	39.3	25.2
Restructuring Bonds	6.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other Credit to Government	73.8	153.0	121.8	110.9	107.1	166.0	18.2	17.9	39.3	25.2
Other items, net 3/	-111.9	-325.5	-308.6	-347.5	-358.7	-325.5	-358.7	-358.7	-358.7	-358.7
Memorandum Items:										
Percentage change from previous quarter										
Broad money(M2X)	5.2	6.0	4.2	6.3	3.4	5.1	8.3	4.5	6.4	...
Domestic credit	8.8	17.1	5.2	6.4	7.4	7.3	1.1	5.3	7.4	...
Credit to the non-government sector	6.4	11.3	9.6	8.2	8.5	7.7	8.8	5.4	6.0	...
Households	9.9	14.1	8.1	11.5	10.1	7.3	4.0	5.3	7.4	...
Enterprises	5.9	10.7	9.9	7.5	8.1	7.8	9.8	5.4	5.6	...
Credit to the government, net	33.8	70.3	-20.4	-8.9	-3.4	4.3	-83.1	-1.7	119.9	...
Exchange rate (LVL/US$)	0.583	0.613	0.631	0.639	0.619	0.613	0.613	0.613	0.613	0.613
Total NFA (US$mn) 2/										
Total	623.9	878.2	823.1	893.2	876.7	998.2	1,060.2	1,065.2	1,072.7	1,090.2
of which: commercial banks 3/	-273.8	-6.0	-62.7	-12.8	-82.8	-6.1	-82.8	-82.8	-82.8	-82.8
Government financing (cumulative, excl. BOP assistance)	...	99.4	-30.4	-40.0	-41.7	20.3	-129.2	1.5	24.5	13.5

Sources: Bank of Latvia; and Fund staff estimates.

1/ As of June 1997, residents' foreign currency deposits are deposits in all currencies except lats.
2/ In currencies of OECD countries, valued at the current exchange rates.
3/ Up to end-June 2000, NFA of commercial banks include equity in Latvian commercial banks that is owned by non-residents; thereafter, such equity is treated like domestic capital and captured in "other items, net".
As of end-October 2001, this equity amounts to LVL 154 million.

Table 7. Latvia: Medium Term Macroeconomic Framework, 1999-2006

	1999	2000	2001	2002	2003	2004	2005	2006
			Projections 1/					
				(In percent of GDP)				
I. Baseline scenario								
Foreign savings 2/	9.8	6.9	7.1	7.0	6.4	6.1	5.8	5.2
Gross national saving	17.2	20.2	20.5	20.7	21.5	22.7	23.6	24.7
Nongovernment	16.4	19.5	18.9	18.3	18.5	18.6	18.6	19.0
Government 3/	0.8	0.7	1.6	2.3	3.0	4.1	4.9	5.7
Gross investment	27.0	27.1	27.7	27.7	27.9	28.9	29.4	29.9
Nongovernment fixed capital formation	20.4	20.6	21.8	21.3	21.4	21.3	21.6	21.6
Government fixed capital formation 4/	4.7	4.0	3.3	3.9	4.0	5.0	5.3	5.7
Change in inventories	1.9	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Memorandum item:								
Nongovernment savings-investment balance	-5.9	-3.6	-5.5	-5.5	-5.5	-5.3	-5.5	-5.2
Government savings-investment balance	-3.9	-3.3	-1.7	-1.5	-0.9	-0.9	-0.3	0.0
Revenues	40.0	37.4	36.3	36.4	37.4	38.4	38.5	38.7
Expenditures and Net lending	44.0	40.7	37.9	37.9	38.3	39.2	38.9	38.7
Nominal GDP (in millions of lats)	3,897	4,333	4,753	5,140	5,612	6,127	6,690	7,304
Real GDP growth rate	1.1	6.6	7.0	4.5	6.0	6.0	6.0	6.0
Inflation (annual average rate)	2.4	2.6	2.5	3.0	3.0	3.0	3.0	3.0
II. Alternative scenario								
Foreign savings 2/	9.8	6.9	7.1	7.4	6.9	6.2	5.8	5.2
Gross national saving	17.2	20.2	20.5	19.8	20.5	22.1	23.1	24.1
Nongovernment	16.4	19.5	18.9	18.2	17.9	17.9	18.0	18.3
Government 3/	0.8	0.7	1.6	1.6	2.6	4.2	5.0	5.8
Gross investment	27.0	27.1	27.7	27.2	27.4	28.4	28.8	29.3
Nongovernment fixed capital formation	20.4	20.6	21.8	20.7	20.8	20.7	20.9	21.0
Government fixed capital formation 4/	4.7	4.0	3.3	3.9	4.0	5.1	5.4	5.8
Change in inventories	1.9	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Memorandum item:								
Nongovernment savings-investment balance	-5.9	-3.6	-5.5	-5.0	-5.5	-5.4	-5.4	-5.2
Government savings-investment balance	-3.9	-3.3	-1.7	-2.4	-1.4	-0.9	-0.3	0.0
Revenues	40.0	37.4	36.3	36.5	38.1	39.1	39.3	39.4
Expenditures and Net lending	44.0	40.7	37.9	38.9	39.1	40.0	39.6	39.4
Revenue shortfall in terms of baseline GDP	...	...	...	0.6	...	...	...	...
Expenditure increase in terms of baseline GDP	...	...	...	0.2	...	...	...	...
Nominal GDP (in millions of lats)	3,897	4,333	4,753	5,042	5,505	6,010	6,562	7,164
Real GDP growth rate	1.1	6.6	7.0	2.5	6.0	6.0	6.0	6.0
Inflation (annual average rate)	2.4	2.6	2.5	3.0	3.0	3.0	3.0	3.0

Sources: Latvian authorities; and Fund staff estimates.

1/ The figures for 2002-2006 reflect staff projections.
2/ External current account deficit.
3/ Government revenues do not include privatization receipts.
4/ Including net lending.

Table 8. Latvia: Indicators of External and Financial Vulnerability, 1999-2001

	1999	2000					2001				
	Year	Mar.	Jun.	Sep.	Dec.	Year	Mar.	Jun.	Sep.	Latest	Date
Financial indicators											
Public debt (domestic and foreign, in percent of GDP)	14.7	15.6	15.3	15.1	14.7	14.7	14.5	14.2	13.9	13.9	Q3/2001
Broad money (year-on-year change in percent)	8.0	16.3	17.1	27.0	27.9	27.9	24.2	24.2	21.4	20.9	10/31/01
Broad money in percent of gross official reserves	181.1	194.4	209.6	220.9	226.3	226.3	229.6	236.5	239.0	232.0	10/31/01
Private sector credit (year-on-year change in percent)	15.3	19.6	24.6	30.7	36.7	36.7	39.8	42.7	43.1	41.7	10/31/01
Banking indicators											
Capital Adequacy											
Capital adequacy—risk-weighted average	16.0	16.0	15.0	15.0	14.0	14.0	16.0	15.0	15.0	15.0	Q3/2001
Capital and reserves (in millions of lats)	193.0	192.0	203.0	217.0	228.0	228.0	236.0	264.0	266.0	266.0	Q3/2001
Liquidity											
Liquidity ratio 1/	42.9	43.0	44.3	44.8	44.2	44.2	39.4	35.7	30.1	30.1	Q3/2001
Total reserves/total deposits	18.9	14.8	15.5	14.9	16.3	16.3	13.5	14.7	14.5	14.5	Q3/2001
Excess reserves/total reserves	19.8	8.9	8.4	3.6	7.5	7.5	8.8	8.3	1.2	1.2	Q3/2001
Asset quality											
Nonperforming loans (in percent of total loans)	6.0	7.0	5.0	5.0	4.6	4.6	4.4	3.4	3.2	3.2	Q3/2001
Loan-loss provisioning/gross loans	4.0	4.0	3.0	3.0	3.0	3.0	3.0	2.0	1.7	1.7	Q3/2001
Profitability											
Return on equity 2/	11.0	21.0	22.0	20.0	19.0	19.0	15.0	17.0	16.0	16.0	Q3/2001
Return on assets	1.0	2.0	2.0	2.0	2.0	2.0	1.4	1.3	1.2	1.2	Q3/2001
Income from fees/total income	23.5	26.9	22.5	23.6	26.2	26.2	23.4	21.9	22.1	22.1	Q3/2001
Loans and deposits											
Loans/deposits	65.9	65.0	62.0	49.0	58.3	58.3	61.9	61.6	66.5	66.5	Q3/2001
Loans/total assets	43.4	42.0	41.3	40.0	40.3	40.3	42.8	40.8	44.7	44.7	Q3/2001
Credit to nongovernment/GDP 3/	15.8	18.0	17.5	18.8	19.6	19.6	23.5	22.5	...	22.5	Q2/2001
Nonresident deposits as a share of total deposits	46.9	46.6	47.3	49.1	51.3	51.3	48.2	51.4	48.5	48.5	Q3/2001
External indicators											
Current account balance in percent of GDP	-9.8	-4.5	-6.7	-6.2	-9.8	-6.9	-4.2	-6.1	...	-6.1	Q2/2001
Exports of GNFS (year-on-year change in percent)	-8.2	15.5	14.3	10.4	9.2	12.3	7.0	7.7	...	7.7	Q2/2001
Imports of GNFS (year-on-year change in percent)	-8.7	8.7	11.1	7.6	4.5	7.8	10.8	5.8	...	5.8	Q2/2001
Capital and financial account balance in percent of GDP	11.7	6.8	5.0	6.4	11.8	7.6	4.8	6.2	...	6.2	Q2/2001
Gross official reserves (in millions of U.S. dollars)	944	924	904	886	919	919	917	935	987	1,018	10/31/01
Gross official reserves/short-term debt	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3	...	0.3	Q2/2001
Gross official reserves/short-term debt less non-resident deposits	0.9	0.8	0.8	0.7	0.8	0.8	1.0	1.0	...	1.0	Q2/2001
Gross official reserves/reserve money	104.6	114.1	110.4	101.9	99.4	99.4	107.0	102.0	105.8	107.1	10/31/01
Gross official reserves in months of imports of GNFS	2.9	2.6	2.5	2.5	2.6	2.6	2.4	2.5	2.6	2.6	Q3/2001
Net foreign assets of financial sector (in millions of U.S. dollars)	624	701	782	974	878	878	823	893	877	903	10/31/01
Total external debt (in millions of U.S. dollars)	3,821	3,843	3,990	4,094	4,489	4,489	4,481	4,817	...	4,817	Q2/2001
in percent of GDP	57.4	57.0	58.0	58.6	62.8	62.8	61.9	65.2	...	65.2	Q2/2001
in percent of exports GNFS (over the last four quarters)	131.1	99.5	101.0	102.1	108.9	108.9	105.8	111.9	...	111.9	Q2/2001
of which:											
Public sector external debt (in millions of U.S. dollars)	708.1	706.4	706.9	680.9	705.6	705.6	693.1	685.2	717.8	717.8	Q3/2001
in percent of GDP	10.6	10.5	10.3	9.7	9.9	9.9	9.6	9.3	9.5	9.5	Q3/2001
Short-term external debt (in millions of U.S. dollars)	2,316	2,420	2,494	2,678	3,011	3,011	2,661	2,960	...	2,960	Q2/2001
in percent of GDP	34.8	35.9	36.2	38.3	42.1	39.0	36.8	40.0	...	40.0	Q2/2001
Short-term external net debt (in millions of U.S. dollars) 4/	-126	-59	-109	43	258	258	1	60	...	60	Q2/2001
in percent of GDP	-1.9	-0.9	-1.6	0.6	3.6	0.5	0.0	0.8	...	0.8	Q2/2001
including bonds and notes on asset side (millions of US$)	-544	-611	-704	-585	-489	-489	-581	-573	...	-573	Q2/2001
in percent of GDP	-8.2	-9.1	-10.2	-8.4	-6.8	-6.8	-8.0	-7.8	...	-7.8	Q2/2001
Real effective exchange rate (e.o.p., year-on-year change in percent, "+" = appreciation) 5/	8.3	5.2	4.3	4.9	0.1	0.1	-2.8	-1.0	...	-3.2	Aug-01
Bond market indicators											
Foreign currency long-term debt rating 6/	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB	BBB	11/1/01
Spread of benchmark bonds (percentage points) 7/	1.8	1.1	1.2	1.1	0.9	0.9	0.9	0.8	1.2	0.9	11/13/01
Memorandum items:											
Nominal exchange rate (end-of-period)											
Latvian lats/U.S. dollar	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	11/15/01
Latvian lats/euro	0.6	0.6	0.6	0.5	0.6	0.6	0.6	0.5	0.6	0.6	11/15/01

Sources: Bank of Latvia, Ministry of Finance, Department of Statistics, National Stock Exchange of Latvia, Bloomberg, Standard & Poor's, Baltic News Service, and Information Notice System.

1/ The liquidity ratio is defined as: (cash + claims on the central bank + claims on other credit institutions + fixed-income government bonds - liabilities to the central bank - liabilities to other credit institutions) / deposits.
2/ Return on equity is defined as the ratio of the value of bank-issued equity to profits.
3/ GDP is calculated using annualized quarterly data.
4/ Short-term assets include reserve assets.
5/ CPI-based REER against the 15 most important trading partners. Yearly number is end of period change.
6/ S&P
7/ End-of-period spread of 5-year Eurobond issued in May 1999 above the rate on German Euro denominated bond maturing July 15, 2004.

Table 9. Latvia: Indicators of Financial Obligations to the Fund, 2001-2006

	2001	2002	2003	2004	2005	2006
	Projections					
Debt service to the Fund (in millions of SDRs) 1/	2.1	8.7	8.9	13.7	17.1	7.7
Debt service to the Fund (in millions of USD)	2.7	11.3	11.5	17.7	21.9	9.8
Repurchases (in millions of SDRs)	1.9	7.6	7.6	12.7	16.5	7.6
Charges (in millions of SDRs)	0.2	1.1	1.3	1.0	0.6	0.1
In percent of exports of goods and non factor services	0.1	0.3	0.3	0.4	0.4	0.2
In percent of convertible currencies debt service	3.2	9.7	9.2	5.1	16.5	6.2
In percent of gross official reserves	0.2	0.9	0.9	1.3	1.4	0.6
Memorandum items:						
Fund credit outstanding 2/						
In millions of SDRs	28.6	44.4	36.8	24.1	7.6	0.0
In millions of U.S. dollars	37.4	57.8	47.7	31.1	9.8	0.0
In percent of quota	22.6	35.0	29.0	19.0	6.0	0.0
In percent of convertible currencies debt	0.7	1.0	0.8	0.5	0.1	0.0
In percent of GDP	0.5	0.7	0.5	0.3	0.1	0.0
U.S. dollar/SDR	1.3	1.3	1.3	1.3	1.3	1.3

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

1/ Data for 2001 relate to the remainder of the year; i.e. November 1, 2001 to December 31, 2001.

2/ Projections assume that all drawings are made under the stand-by arrangement. It is further assumed that the undrawn amounts that were scheduled for April 20, 2001 and August 31, 2001 (SDR 9.5 million) would be drawn on November 29, 2001. Since the review could not be completed at this time, it is further assumed that drawings that were scheduled for November 30, 2001, February 28, 2002, and May 31, 2002 will be drawn on May 31, 2002 (totaling SDR 14.1 million). Projections use the expectation schedule.

LATVIA: FUND RELATIONS
(As of November 30, 2001)

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

II. **General Resources Account:**	**SDR Million**	**Percent of Quota**
Quota	126.80	100.0
Fund holdings of currency	147.73	116.5
Reserve position in Fund	0.06	0.0

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Net cumulative Holdings	0.17	N.A.

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent of Quota**
Systemic Transformation	20.97	16.5

V. **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** (SDR million; based on existing use of resources and present holdings of SDRs):

	Overdue	Forthcoming					
	(11/30/01)	2001	2002	2003	2004	2005	2006
Principal	0	1.9	7.6	7.6	3.8	0.0	0.0
Charges/interest	0	0.0	0.5	0.3	0.1	0.0	0.0
Total	0	1.9	8.1	7.9	3.9	0.0	0.0

VII. Safeguards Assessment:

Under the Fund's safeguards assessment policy, the Bank of Latvia is subject to a full Stage One safeguards assessment with respect to the Stand By Arrangement approved on April 20, 2001, which is scheduled to expire on December 19, 2002. A Stage One safeguards assessment of the Bank of Latvia was completed in October 2001. The overall findings indicated that the BoL's safeguards appear generally adequate and a Stage Two (on-site) assessment was not considered necessary at this juncture. However, certain weaknesses were identified, most notably in the area of financial reporting and internal audit. In particular, staff recommended (i) the adoption by the BoL of a benchmark accounting framework or disclosure of the differences between BoL accounting standards and a benchmark accounting framework; (ii) reconciliation between foreign reserves on the BoL audited balance sheet and net foreign asset data reported to the IMF at December 31, 2001; and (iii) strengthening of the internal audit department by the adoption of a risk-based audit approach and a formal training program for internal audit staff.

VIII. Exchange Arrangements:

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

IX. Article IV Consultation:

Latvia is on the 12-month consultation cycle. The Executive Board concluded the 2000 Article IV Consultation on June 30, 2000. Directors commended the authorities for the generally sound macroeconomic policies, which had helped Latvia weather the impact of the Russian financial crisis. Directors emphasized that Latvia's growth prospects over the medium term were promising, provided that the authorities continue to pursue appropriate macroeconomic policies, improve further the efficiency of the public sector, and remove the remaining impediments to private sector activity. In particular, Directors stressed the importance of continued fiscal adjustment, and a balanced budget over the medium-term. This approach was seen as instrumental in bringing about a reduction in the persistently large external current account deficit, which, together with the decline in foreign direct investment in the wake of the Russian crisis, posed a potential risk to Latvia's external sustainability.

X. FSAP Participation and ROSCs:

A joint World Bank-International Monetary Fund mission conducted an assessment of Latvia's financial sector as part of the Financial Sector Assessment Program (FSAP) between February 14-28, 2001. An FSAP update was conducted between October 22-26, 2001, as part of the 2001 Article IV consultation. The Financial Sector Stability Assessment (FSSA) report will be circulated together with the 2001 Article IV staff report.

ROSC Modules

Standard/Code assessed	Issue date	Document number
Code of Good Practices on Fiscal Transparency	March 29, 2001	SM/01/98

XI. Technical Assistance:

TECHNICAL ASSISTANCE FROM THE FUND, 1999–2001

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

No future technical assistance missions have been agreed upon at this time.

XII. Resident Representative:

The fourth resident representative of the Fund in Latvia is Mr. Knöbl, who took up his post in October 1999.

XIII. Fourth Amendment:

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

World Bank Relations
(As of end-November, 2001)

1. Latvia became a member of the World Bank on August 11, 1992. The main emphasis of the Bank's current lending and economic sector work program is on improving public sector governance. In support of this strategy, the Bank has seven projects under implementation totaling US$152.4 million in commitments, of which US$95.8 million have been disbursed. In addition, it has an IDF grant under implementation totaling US$0.4 million. The total amount of original commitments and principal, including closed operations, is US$393.7 million, of which US$292.3 million has been disbursed. The current amount of outstanding obligations is US$244.8 million.

2. Since 1992, the Bank has financed a variety of loans in the following areas: agriculture, enterprise and financial restructuring, environment, heating and other municipal services, highway maintenance, and welfare reform. More recent loans include the State Revenue Service Modernization Project (January 1999, US$5 million), which supports strengthening the organization and management as well as the operations of the revenue administration; and the Education Improvement Project (August 1999, US$31 million), which aims to improve education by strengthening the management of both resource inputs and the learning process. Other projects under implementation are the Municipal Services Development Project, the Municipal Solid Waste Management Project in Riga, the Liepaja Region Solid Waste Project, and the Welfare Reform Project. Projects in energy and housing are also under preparation. More recently, the government has worked with the World Bank to undertake a Programmatic Structural Adjustment Operation. This three-year reform program, which focuses on improving governance, was discussed and the Bank's board approved the first loan under the program in March 2000, and US$40.4 million has been disbursed. Negotiations for the second PSAL were completed in October 2001, but board presentation has been postponed until Spring 2002, at the earliest, in particular due to disagreements on the macroeconomic framework.

3. The Bank is preparing a new Country Assistance Strategy (CAS) for discussion by the Bank's board early in 2002. The latest World Bank CAS was presented to the board in April 1998. Over the years, the Bank has prepared a series of policy notes that provide advice on various poverty related issues, macroeconomic issues, and structural reform issues such as local government expenditure and resource transfer; and on macroeconomic and financial sector vulnerability. In 2000, a Bank team conducted a second Public Expenditure Review (PER) to advise the Government on: (i) how to improve efficiency and effectiveness of its programs, and (ii) how to further rationalize its policy and budget decision-making processes. A PER report provided recommendations on public expenditure planning, programming, and management. In February 2001, a Financial Sector Assessment (FSA) of the Latvian financial system was carried out under the joint IMF/World Bank FSA Program. In addition, the Bank has provided technical assistance on tariff policy, customs administration, the design of a duty drawback scheme, and the preparation of the public investment program.

STATISTICAL APPENDIX

1. The authorities have a very open and well-articulated data dissemination and publication policy. Most economic and financial statistics are reported to the Fund on a regular and timely basis, and a large number of additional economic and financial aggregates is readily available on the websites of Latvian government institutions and agencies, as well as of the Bank of Latvia (BoL). The authorities are reporting data for the Fund's *International Financial Statistics, Government Finance Statistics Yearbook*, the *Direction of Trade Statistics,* and the *Balance of Payments Statistics Yearbook*. Latvia has subscribed to the Special Data Dissemination Standard (SDDS), meets the SDSS specifications, and its metadata are posted on the Fund's Dissemination Standards Bulletin Board on the Internet. There is increased cooperation on data issues between the Central Statistical Bureau (CSB), the BoL, the Ministry of Finance, and the customs authorities.

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

National accounts

3. The CSB compiles and publishes quarterly national accounts data from the production and expenditure approaches on a regular and timely basis, largely following the *1993 SNA* and *ESA-95*. However, there are significant discrepancies between the GDP estimates based on production and those based on expenditure. The underlying data for the production approach are primarily obtained through a comprehensive set of questionnaires that the CSB sends to businesses and individuals, supplemented by administrative data, labor force surveys, and information obtained from other agencies. The basic data are widely believed to understate economic activity, particularly in the private sector, and there is an ongoing effort to increase coverage. The official national accounts data published by the CSB incorporate an adjustment for under-recording, which the CSB currently estimates as 16 percent of total GDP. The data for the expenditure-based accounts are obtained from household budget surveys and other surveys from the State Treasury and ministries. Input/output tables are currently being prepared.

Prices

4. The CSB compiles a nationwide consumer price index. With Fund technical assistance, it has developed appropriate methodologies to deal with most of the technical problems resulting from the major structural shifts that have occurred in the economy. Reporting improved markedly during 1998, in part due to the implementation of a new household budget survey, based on World Bank technical assistance, enabling the CSB to compile indices for different types of households. Following advice from EUROSTAT, the weights in the CPI basket are now revised annually. The weights in the producer price index

are updated annually and the index covers almost three quarters of total industrial activity. The CBS also publishes export and import unit value and volume indices.

Government finance statistics

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

Monetary statistics

6. Monetary data are comprehensive, timely, and comply with international standards. Specifically, data on the balance sheets of the BoL, commercial banks, and other financial institutions, as well as the banking survey, are compiled with a very short time lag, i.e., within two weeks of the end of the reporting period. Fund staff is also weekly provided with the BoL balance sheet and data on foreign exchange transactions, including outright interventions and foreign currency swaps. The institutional coverage, classification, and sectorization of accounts comply with Fund standards. Interest rate data are compiled and published with equally short time lags. The BoL also reports comprehensive data on banking supervision and prudential regulations.

Balance of payments statistics

7. Since early 2000, the BoL has assumed the responsibility for compiling the balance of payments statistics from the CSB and has since 2001 begun publishing monthly series based on an international transactions reporting system (ITRS). This source is to be supplemented with the results of three other quarterly surveys that were launched in 2000: non-financial enterprises, foreign-direct investment and related income flows and transportation services. An annual survey of other services will be launched for 2002.

8. Current account transactions: Merchandise trade data, based for the most part on customs data, underestimate imports into and exports from Latvia's 140 or so Custom-bonded warehouses and the three free trade zones. The implementation by the customs department of transaction-price based valuation reduces previous problems relating to the valuation of goods. With regard to trade, proper procedures to assure that goods passing through customs warehouses are properly valued have not been completely implemented. Coverage of exports to Russia and CIS countries is incomplete. Exports of cars and shuttle trade items are particularly difficult to capture; improved survey techniques are recommended. Estimates of travel credits and debits have been improved through a revised survey.

9. Financial account operations: until the quarterly and annual surveys are fully implemented, enterprise surveys currently collect information on other services items and the income component. Enterprise surveys, supplemented by balance sheet data from banks, are

employed to estimate financial account flows. As additional sources, BoL has requested data from the Security and Exchange Commission and from the Privatization Agency on shares in state-owned companies sold to non-residents. Starting in 2000 BOL has also been using ITRS data for estimating new investment not captured by the main balance of payments survey.

Data dissemination standards

10. Latvia has subscribed to the Fund's Special Data Dissemination Standard since November 1996 and has been posting metadata on the Dissemination Standards Bulletin Board since December 1997. Latvia has been disseminating data on the reserves template since April 2000.

Survey of Reporting of Main Statistical Indicators
(As of end-November, 2001)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance 2/	Overall Government Balance	GDP/ GNP	Public External Debt and Debt Scheduling
Date of latest observation	29-Nov	23-Nov	23-Nov	23-Nov	31-Oct	31-Oct	Oct-01	Sep-01	Q2, 2001	31-Oct	Q2, 2001	30-Sep
Date received	30-Nov	28-Nov	28-Nov	28-Nov	20-Nov	20-Nov	10-Nov	19-Nov	28-Sep	20-Nov	20-Sep	31-Oct
Frequency of data	D	W	W	W	M	M	M	M	Q	M	Q	M
Frequency of reporting	D	W	W	W	M	M	M	M	Q	M	Q	M
Source of data	C	A 1/	A 1/	A 1/	A 1/	A 1/, C	C	C	C	A 1/	A, N	A
Mode of reporting	E	C,E	C,E	C,E	C,E	C,E	E	E	E	C	E	V
Confidentiality	C	C	C	B	C	C	C	C	C	C	C	C
Frequency of Publication	D	M	M	M	M	M	M	M	Q	M	Q	M

Sources: A--direct reporting by Central bank, Ministry of Finance, or other official agency; C--commercial service; N--official publication or press release.

1/ Through the resident representative office.

2/ Beginning in 2001, monthly Balance of Payments data are published within 30 business days after the end of the month. These data are regarded as preliminary estimates based on a smaller set of data sources.

Notes:
Frequency of data: D-daily, W-weekly, M-Monthly, Q-Quarterly.
Frequency of reporting: M-Monthly, Q-Quarterly, V-irregular in conjunction with staff visits.
Mode of reporting: C-cable or facsimile, E-electronic news reporting, V-staff visits, or O-other.
Confidentiality: (B) for use by the staff and the Executive Board, (C) for unrestricted use.

November 21, 2001

Johannes Mueller
IMF Mission Chief
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Mueller:

The Government and the Bank of Latvia have successfully implemented the policies under the program supported by the IMF, as outlined in our Memorandum of Economic Policies dated March 21, 2001. As a result, real GDP could grow by 7 percent this year, while inflation remains subdued and Latvia's vulnerability to external shocks has diminished. All performance criteria for end-June and end-September 2001 have been met, and we are committed to meeting the respective end-December 2001 targets as well. We have also implemented a wide array of structural reforms, mainly in the areas of public sector and financial sector reform.

We are committed to continuing our strong performance in 2002. The attached document describes the macroeconomic and structural policies that the Government and the Bank of Latvia intend to follow next year, with a particular emphasis on the period through June 2002. It reflects agreement reached with the IMF mission in several areas, such as monetary policy, public sector reform, tax administration, and financial sector reform.

The draft budget submitted to the Seima sets a deficit of LVL 128 million (including social insurance contributions diverted to the second pillar), or 2½ percent of GDP. We understand that under Latvia's present circumstances the IMF does not support a deficit of this size, and that the first review under the program supported by the stand-by arrangement cannot be completed at this time. Nevertheless, the government intends to meet quarterly fiscal deficit targets for the first two quarters of 2002 that are consistent with an annual deficit target of 1½ percent of GDP. The Bank of Latvia has also agreed to monetary targets for these quarters that are in line with a prudent macroeconomic policy stance.

We hope that, if achieved, a strong fiscal performance during the first quarter of 2002, including revenue collections in excess of the programmed amount, would serve as a basis for resuming the discussions to complete the first program review.

We look forward to continued close cooperation and policy dialogue with the IMF.

Sincerely,

//s//

Gundars Bērziņš
Minister of Finance
Ministry of Finance

//s//

Einars Repše
Governor
Bank of Latvia

Attachment

LATVIA: ECONOMIC POLICIES FOR 2002

A. Introduction

1. The Latvian economy has experienced high and robust growth in a low inflation environment over the last two years. Real GDP grew at 6½ percent in 2000 and 8¾ percent during the first half of 2001. Growth has been broad based and strongly supported by investment. At the same time, inflation has remained subdued, with the twelve-month inflation rate at 3½ percent in September 2001. Latvia's vulnerability to external shocks has diminished, as the external current account deficit has declined substantially, notwithstanding the appreciation of the lats vis-à-vis the euro. This was accompanied by strong FDI inflows, which helped finance the external current account deficit to a large extent, thereby keeping external debt indicators in check.

2. Expenditure restraint in the first nine months of 2001 helped contain the general government deficit to 1.4 percent of GDP, and all related performance criteria under the program were observed with a comfortable margin. The government has largely complied with the public sector reform measures under the program: First, it submitted to Parliament amendments to the excise tax law and the pension law. Second, most accounts of budget-financed institutions were brought inside the Treasury. And third, the 2002 budget law explanations included (i) annexes covering auxiliary information on contingent liabilities, tax expenditures and quasi fiscal-activities, (ii) a comprehensive presentation of forecasting assumptions, and (iii) detailed information on financing. However, the implementing regulations for the new law on public agencies have not yet been adopted, but we will strive to do so by mid-December 2001.

3. Monetary conditions during the first nine months of 2001 were sufficiently tight to support the Bank of Latvia's (BoL) exchange rate objective, and all monetary performance criteria to date under the program were observed. In addition, the BoL reduced the volume of new issues of both long-term and short-term foreign exchange swaps as envisaged under the program. Despite the continued strong growth of credit to the private sector, the banking system appears to operate on a firm footing.

4. We have submitted to Parliament the Law on Credit Institutions (LCI), which will bring our prudential framework in full compliance with the Basel Core Principles for Effective Banking Supervision (BCP). The newly established Financial and Capital Markets Commission (FCMC) made considerable progress in implementing the recommendations set forth in the joint IMF/World Bank Financial Sector Assessment Program (FSAP) report. This will ensure operational efficiency and full integration of supervisory functions, which is crucial to sustaining growth in Latvia's financial system.

5. Latvia has made steady progress in the area of structural reforms. While the privatization process has continued to face various impediments, significant steps have been taken in other areas. In particular, efforts focused on improving the business climate, enhancing competition in the energy and telecommunications sectors, and reinforcing utilities regulation, including through the enactment of supporting legislation for the

newly established Public Utilities Commission (PUC). Our liberal trade regime continues to be in line with EU requirements and WTO rules and agreements.

B. The Government's Program for 2002

Program Objectives and Macroeconomic Framework

6. Notwithstanding the strong economic activity to date and the successful implementation of the program, significant risks remain to our continued economic advancement. These mainly emanate from the still large external current account deficit and the current uncertainties surrounding the world economy. Our economic program for 2002 and over the medium term aims at limiting these risks through strong macroeconomic policies—including by moving toward a balanced budget over the medium term—and proceeding with our structural reform agenda so as to preserve FDI inflows and create an environment conducive to private sector activity. These efforts will be underpinned by maintaining our successful exchange rate peg to the SDR. We recognize the need to closely monitor external developments, and stand ready to further tighten policies as needed to maintain the sustainability of our external position and to support the exchange rate peg.

7. Our EU accession negotiations are progressing well, with more than half of the 31 chapters of the *acquis communautaire* closed to date. We expect that negotiations on all chapters will be completed by end-2002, setting the stage for sustained economic development and our integration into the EU.

8. While the slowdown in the world economy may lead to a moderation of growth in Latvia in the short run, we expect that, over the medium term, strong growth will materialize in a low inflation environment. Our main macroeconomic objectives for 2002 and beyond are as follows: (i) real GDP growth at 4½ percent in 2002 and 6 percent annually thereafter; (ii) inflation at about 3 percent per year; and (iii) containing the external current account deficit at about 7 percent of GDP in 2002, with a gradual improvement expected from 2003 onwards. We also anticipate a continuation of strong FDI flows so that at least two-thirds of the current account deficit will be financed through these flows, thereby keeping our external debt indicators at low levels.

Fiscal Policies

9. Our fiscal policy aims at achieving a balanced budget over the medium term. To this end, we are committed to containing this year's general government budget deficit to LVL 79 million, or 1¾ percent of GDP, despite the adoption by Parliament in June of a supplementary budget that would otherwise imply a rise in the deficit of 0.2 percent of GDP. To help ensure this outcome, we will not submit to Parliament a second supplementary budget.

10. Our 2002 budget sets a general government fiscal deficit of LVL 128 million, or 2½ percent of GDP. This higher deficit as compared to 2001 mainly reflects substantially higher expenditures in the areas of defense and security (related to NATO accession), pensions (as a result of pension amendments agreed with the World Bank), European

Union accession, teacher salaries, and health, as well as an acceleration of our public investment program. We recognize that under our present economic circumstances, and in light of the current uncertainty in the external environment, a more appropriate fiscal stance would suggest a deficit on the order of 1½ percent of GDP, broadly in line with our original intention under the stand-by arrangement. The quarterly pattern of revenues and expenditures next year will, in practice, allow us to keep the deficit in the first two quarters down to a level consistent with an annual deficit of 1½ percent of GDP. We therefore intend to limit our cumulative fiscal deficit to LVL 20 million at end-March and LVL 46 million at end-June. We intend to continue to strengthen revenue collection efforts, and we will strive for central government tax revenues of LVL 316 million by end-March and LVL 648 million by end-June.[1] We hope that this, together with expenditure restraint, will produce a strong fiscal performance through the first quarter of 2002 that could serve as the basis for a resumption of discussions and the possible completion of the first program review.

11. In view of the conceivably beneficial effects on the business climate, we will reduce the corporate income tax rate from 25 to 22 percent in 2002. This rate reduction will not apply to taxpayers benefiting from tax exemptions. We will review all current tax exemptions under the corporate income tax law, with a view to accelerating their full elimination which is currently planned for 2005. Additionally, we will not reduce the tax rate for social insurance contributions and the property tax.

12. We will continue to identify measures to raise revenue collections, reduce the scope for tax evasion, and improve tax compliance, particularly with regard to the difficult area of excise taxes. To this end, Parliament will adopt by end-December 2001 amendments to the Law on Taxes and Fees, the Law on Customs Tariffs, and the Law on the Excise Tax that would: (i) reduce the value of goods that can be imported duty-free using the exemption for personal use; (ii) limit the possibility for natural persons to import oil products for personal use to the standard capacity of the fuel tank of their vehicle; and (iii) broaden the coverage of the fuel-related excises. In addition, in 2002 we intend to revise the definitions of various types of alcohol under the Law on the Excise Tax on Alcoholic Beverages to harmonize them with EU definitions.

13. We will further raise the effectiveness and efficiency of our public sector. To this end, in July 2001 the Cabinet of Ministers adopted the *Public Administration Reform Strategy, 2001-2006*, which provides a set of development goals and guidelines for modernizing the public sector and which will help us to better coordinate individual reform initiatives. We have completed, ahead of schedule and based on a newly derived methodology, a comprehensive public administration review in the Secretariat for

[1] Following Annex I of our Memorandum of Economic Policies dated March 21, 2001, central government tax revenues are defined for this purpose as the sum of corporate income taxes, the value added tax, all excise taxes, customs duties, the personal income tax accruing to the central government special budget, central government taxes in transit, and social insurance contributions (excluding those diverted to the second pillar).

Regional Development, and the findings of this pilot review are helping us better coordinate our activities in this area. We will build on this pilot review by completing reviews for at least two more policy areas in time for the conclusions to be available during the 2003 budget process. We will determine the policy areas to be reviewed by end-December 2001 and submit the completed reviews to the Cabinet of Ministers by July 2002. The development of regulations for the phased implementation of a new civil service pay scale has moved more gradually than initially expected, because the tight fiscal situation limits the available options. We intend to adopt the regulations by end-December 2001 and to begin implementation of the new pay scale some time after mid-2002. The re-prioritization of spending is critical to meeting our medium-term fiscal objectives, and we will continue to implement the overall framework for medium-term budget planning approved by the Cabinet of Ministers in April 2001.

Exchange Rate, Monetary, and Financial Sector Policies

14. The exchange rate peg to the SDR has served Latvia well, and we intend to retain this peg until EU accession. The BoL will continue to follow an appropriately tight monetary policy to support the peg and keep inflation at low levels.

15. Our revised monetary program for 2002 is based on the assumption of a sustained increase in the demand for money and the money multiplier, in line with the rising sophistication of our banking system. We will contain the growth of reserve money to 11 percent in 2002, relying mainly on open market operations. Growth of credit to the private sector is expected to moderate to 27 percent in 2002, primarily reflecting market saturation and continued sound lending practices. Nonetheless, we will continuously monitor credit developments and stand ready to tighten monetary conditions to counteract any potential deterioration of banks' loan portfolios.

16. The long-term foreign exchange swaps have served their intended function of contributing to the broader availability of long-term credit in lats. We will therefore discontinue this instrument by end-December 2001. We will also strive to reduce our reliance on short-term swaps, only using this instrument for monetary fine-tuning. For this purpose, the outstanding stock of short-term swaps would normally not exceed LVL 25 million.

17. The FCMC commits itself to continuously harmonize all sector-specific legislation, regulations, and supervisory methods to reap the full benefits of unified financial sector supervision. By end-June 2002, the FCMC will explore the feasibility of introducing a rating system for the institutions to be supervised to enhance the effectiveness of its oversight activity. In addition, the FCMC will prepare on-site manuals for insurance and securities market supervision by end-2002. The FCMC will continuously enhance risk-based supervision and review the feasibility of introducing certain consumer protection measures for the financial sector.

18. We acknowledge that the IMF advises us against the implementation of the proposal to create a Financial Services Center in one of the existing free economic zones due to the potential fiscal implications of such undertaking. While our anti-money laundering legislation is in line with international practice, we recognize the need to

enhance its enforcement. To this end, we will vigorously pursue reports of suspicious activity identified by the Money Laundering Board (MLB).

Structural and Trade Policies

19. Completion of our structural reform agenda is key to durable growth and enhancing Latvia's attractiveness to foreign investors. We will continue to improve the business climate and pursue the implementation of our *Action Plan to Improve the Business Environment*. In particular, we expect Parliament to approve the transitional law to allow the new Commercial Law to become effective in January 2002. Moreover, we will (i) take steps to facilitate overland border crossing with Russia; (ii) draft and implement amendments to the *Procedure for Declaration of Goods*; and (iii) ensure that the simplified rules for obtaining construction permits are being applied across all municipalities. Finally, we will amend the *Law on the Natural Resource Tax* and its procedures in order to simplify the administration of this tax, as specified in the action plan.

20. One of our key objectives is to advance utilities regulation and enhance competition in the energy and telecommunications sectors over the medium term. To this end, the PUC will, by end-April 2002, develop its strategy paper and a detailed work program. Following the adoption by the Cabinet of Ministers of a detailed restructuring program for Latvenergo (which meets the requirements of EU Directive No. 92/96), we will establish by October 1, 2002 separate legal entities for generation, transmission, and distribution; in agreement with the World Bank, we have already established the Transmission System Operator (TSO) as a separate legal entity, enabling it to carry out its responsibilities independently. We intend to complete the restructuring program of Latvenergo by end-2002. We will also reduce the criteria for qualified customers to 20 GWH by July 1, 2002. Finally, the Telecom Law was enacted on November 1, 2001, which will pave the way to close the acquis chapter on telecommunications.

21. We are committed to reviving and completing the divestiture of our remaining state enterprises, in close cooperation with the World Bank. In particular, we will dispose of the remaining state shares in Latvijas Gaze and Krajbanka by mid-2002. We will adopt, by end-2001, guidelines for the privatization of the Latvian Shipping Company (LASCO) to allow for its sale to take place in 2002. Based on the recommendations of our financial advisors, we will strive to sell our minority share in Ventspils Nafta during the second half of 2002. The divestiture of the state share in Lattelekom still hinges on the conclusion of the arbitration process related to the WTO-mandated relinquishing of monopoly rights by 2003.

22. In our ongoing effort to fight corruption, we will create, by May 2002, a Corruption Prevention Bureau (CPB) under the Ministry of Justice, which will end the current agency fragmentation in this area. In defining the functions of this unit and providing sufficient resources to enable the fulfillment of its obligations, the government will follow the advice of the World Bank. To this end, a timetable will be adopted for establishing the bureau, including on the transfer of the SRS anticorruption unit into the bureau. We will also prepare and publish the terms of reference for, and expeditiously

appoint, the CPB head. Finally, a survey of public opinion on corruption will be piloted and implemented.

23. We are committed to maintaining our liberal trade regime and remain in line with EU requirements and WTO rules and agreements. The simple average MFN tariff has been reduced to below 5 percent and legislation that will eliminate the MFN rate of 0.5 percent, applied to some industrial goods, will become effective on January 1, 2002.

24. We believe that the policies described above will help ensure that Latvia enjoys sustainable economic growth over the medium-term and facilitate the process of acceding to the EU. We are prepared to implement any additional measures deemed necessary to meet these goals.

Statement by the IMF Staff Representative
January 18, 2002

Since issuance of the staff report (SM/01/366), additional information has become available on macroeconomic developments, fiscal and monetary performance, and structural issues. This information does not alter the thrust of the staff appraisal.

Economic growth has begun to slow, broadly in line with expectations. Real GDP growth in the third quarter was 6.3 percent, and economic activity indices point toward a further gradual moderation of growth during the fourth quarter. Inflation remained low: the end-of-period CPI increased by 3.2 percent in 2001.

The merchandise trade balance widened in the third quarter. This reflects the slowdown of export growth to about 5 percent, while the strong import growth, mainly of investment goods, was sustained at about 10 percent. In light of this development and recent indications that the Latvian Shipping Company (LASCO) made major capital purchases in the fourth quarter (equivalent to about 1½ percent of GDP), the 2001 current account deficit could exceed the staff projection by 2 percentage points of GDP or more. Foreign direct investment financed about three-fifths of the current account deficit in the first three quarters. The spread on Latvia's 2004 Eurobond has declined further and was under 60 basis points in early 2002.

The Latvian authorities met most policy targets for end-December 2001, but exceeded the performance criterion on the general government fiscal deficit. The performance criteria on the NIR and NDA of the Bank of Latvia and on external debt were all met comfortably. However, preliminary data (that still need to be verified) suggest that the fiscal deficit target was exceeded by LVL 8 million, as the Riga city budget outcome was worse than expected. This implies a fiscal deficit of 1.8 percent of GDP for the year as a whole.

The liquidity situation in the banking system eased somewhat in late December and early January. This has led to about a 1½ percentage point decline in the short-term money market interest rate spread against the SDR. Credit to the private sector grew by about 50 percent in 2001; however, abstracting from a large loan from a major bank to its leasing subsidiary in December, credit growth was 39½ percent, in line with expectations.

In the structural area, the new Commercial Law was brought into effect on January 1, 2002. The pension amendments adopted by Parliament in late December postponed to 2005 the abolition of early retirement and will steadily lift the ceiling on the pension payments that may be received by working pensioners, removing the ceiling in 2005; no estimates are yet available of the costs of the revised package. The Government has decided on the terms for the privatization of LASCO, envisaging the sale of 51 percent of the shares via the Riga Stock Exchange. In late December, Latvia closed an additional chapter in its EU accession negotiations, bringing the total to 23.

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IMF Concludes 2001 Article IV Consultation with the Republic of Latvia

On January 18, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Latvia.[1]

Background

Latvia has enjoyed a strong economic performance since the last Article IV consultation in June 2000. Real GDP growth was 6½ percent in 2000 and accelerated to 8¾ percent in the first half of 2001; growth has been led primarily by investment. Inflation has remained low at 3 percent in 2000 and 2001. The current account deficit fell to 7 percent of GDP in 2000, after reaching almost 10 percent of GDP in 1998–99, during the Russian crisis. However, further reduction of the current account deficit in 2001 was halted, due to the combination of continued strong growth in Latvia and a slowdown among Latvia's main trading partners. Nevertheless, robust export growth (9 percent in 2000) appears to have been sustained in 2001, as exporters have quickly reoriented toward other markets. Strong inflows of foreign direct investment have financed about three-fifths of the current account deficit, helping to keep external debt levels moderate. Market sentiment toward Latvia remains favorable, as evidenced by the relatively low yield spread on Latvia's first Eurobond and by the successful issue, in November 2001, of a second Eurobond.

This performance reflects on generally strong macroeconomic and structural policies, apart from a lapse in fiscal control in late 2000. After a moderate decline in 2000, the general government fiscal deficit is likely to have been reduced by about 1½ percentage points in 2001, to

[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.

1.7 percent of GDP. Fiscal consolidation has been accomplished mainly through expenditure restraint: the ratio of expenditures to GDP has been reduced by about 6 percent of GDP from the relatively high level reached in 1999 in the wake of the Russian crisis. The ratio of government revenue to GDP fell by about 4 percentage points from 1999 to 2001, reflecting a desire to reduce the tax burden, but also some weaknesses in tax collection.

The exchange rate peg of the lats to the SDR has contributed to price stability. Monetary policies have supported the exchange rate peg, while a relatively rapid expansion of credit to the private sector has helped facilitate investment. Latvia has continued to improve its financial sector framework, which includes the introduction of a unified financial sector supervision under the Financial and Capital Markets Commission in July 2001.

Latvia's generally liberal market economy and its continued pursuit of structural reforms in many areas have helped forge an environment conducive to investment and durable economic growth, which is also reflected in Latvia's prospect of joining the EU in 2004.

The main challenge to Latvia's economy is the persistent current account deficit. Past current account deficits have partly reflected the import content of the investment activity that has underpinned economic growth. Nonetheless, deficits of this magnitude, if sustained, pose a potential risk to Latvia's external sustainability.

The IMF Executive Board approved a 20-month Stand-By Arrangement (SBA) with Latvia in April 2001. The first review under the SBA was not completed at this time, over concerns about the 2002 budget, but may be taken up by the Executive Board at a later date.

Executive Board Assessment

Executive Directors noted that Latvia's economic performance in 2001 had been among the best of the EU accession candidate countries. Strong and broad-based economic growth had been driven by domestic demand, particularly investment, while inflation had remained low. At the same time, Directors expressed concerns about the magnitude and persistence of the external current account deficit and regretted that the first review under the current Stand-By Arrangement was delayed.

Directors were of the view that the economic performance in 2001 reflected Latvia's long-standing commitment to macroeconomic stability and the success of earlier structural reforms in creating a flexible and resilient market economy. In particular, Directors noted that the authorities had successfully implemented their 2001 economic program, including by adhering to macroeconomic policy targets.

Directors agreed that under Latvia's present circumstances the exchange rate peg to the SDR remained appropriate, but cautioned that it needed to be underpinned by the maintenance of sound fiscal and monetary policies. The peg should remain an anchor of Latvia's economic strategy in the period leading to European Union accession. Directors welcomed the Bank of Latvia's decision to discontinue the issuance of long-term foreign exchange swaps ahead of schedule and to limit their use of short-term foreign exchange swaps by relying more on open market operations.

Directors noted Latvia's strong medium-term growth prospects. To meet this potential, the authorities needed to continue pursuing disciplined macroeconomic policies, further improve public sector efficiency, and sustain the momentum of structural reforms. This would help ensure strong economic growth and low inflation in the medium term. For 2002, Directors expected that domestic demand would again underpin significant growth in the Latvian economy, albeit below the pace of 2001. However, the slowdown in the global economy was likely to place additional stress on Latvia's external current account, as had become evident in late 2001. Under the fixed exchange rate regime, fiscal policy remained the primary instrument of macroeconomic management.

Directors supported the government's intention to move toward a balanced budget over the medium term. However, they expressed reservations about the expansionary fiscal policy in the 2002 budget, which could exacerbate pressure on the external current account. Directors recognized the spending needs associated with EU and NATO accession—which are needed to upgrade the delivery of crucial public goods—and supported the authorities' desire to gradually reduce the tax burden on the economy. To make room for these important steps, however, Directors saw as crucial the improved prioritization and containment of public expenditure especially in election year 2002, continued efforts to enhance tax administration, and more determination in bringing public sector reforms to fruition, including at the municipal levels of government. In this context, Directors welcomed the authorities' adoption of fiscal targets for the first half of 2002 that were in line with a modest annual deficit; however, they noted that the budget adopted by Parliament would imply a substantial fiscal loosening in the second half of 2002. They encouraged the authorities to take steps to avoid this loosening of the fiscal stance, which as noted would likely add to pressures on the external current position.

Directors welcomed Latvia's participation in the joint IMF-World Bank Financial Sector Assessment Program, and noted that no major sources of vulnerability had been identified. They observed the smooth transition to unified financial sector supervision under the Financial and Capital Markets Commission. Directors recognized that Latvia had established an adequate money-laundering framework, but urged the authorities to strengthen enforcement capacity and to enhance their monitoring of the large inflows of non-resident deposits. They welcomed Latvia's quick actions to introduce anti-terrorism financing legislation after September 11. Some Directors expressed reservations over the possible introduction of a Financial Services Center in Latvia.

Directors expressed concern with the continued rapid expansion of private sector credit, particularly at very short terms, and urged the authorities to stand ready to tighten monetary conditions if deemed necessary to counter a worsening in the quality of banks' loan portfolios.

Directors welcomed advances in Latvia's agenda for structural reforms as the means to reduce unemployment and external vulnerability. They noted the continued improvements in the environment for investment, and particularly foreign investment. In this regard the process of EU accession was providing a useful impetus to structural and institutional reform, and Directors welcomed Latvia's progress in accession negotiations. Directors urged the authorities to persevere in their privatization of large-scale public enterprises and in their efforts to fight corruption and improve governance. They commended Latvia's maintenance of a very open international trade regime.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2001 Article IV Consultation with Latvia is also available.

Republic of Latvia: Selected Economic Indicators

	1996	1997	1998	1999	2000
			Changes in percent		
Real Economy					
Real GDP	3.3	8.6	3.9	1.1	6.6
Unemployment rate (end of period)	7.2	7.0	9.2	9.1	7.8
Consumer price index (period average)	17.6	8.0	4.7	2.4	2.6
			In percent of GDP		
Public Finance					
General government balance	-1.8	0.3	-0.8	-3.9	-3.3
Total government debt	14.4	12.0	10.5	13.1	13.2
External government debt	8.4	7.4	7.7	10.6	9.9
			End-period; changes in percent		
Money and credit					
Reserve money	25	30	7	12	8
Broad money	20	39	6	8	28
Domestic credit (non-government)	1	76	59	15	37
			In percent of GDP unless stated otherwise		
Balance of payments					
Trade balance	-15.5	-15.0	-18.6	-15.4	-14.8
Current account balance	-4.2	-5.1	-9.8	-9.8	-6.9
International reserves (in months of imports)	2.8	2.5	2.9	2.9	2.6
Exchange rate					
Exchange rate regime			Peg to the SDR		
Exchange rate (lats per US$; end-of period)	0.556	0.590	0.569	0.583	0.613
Real effective exchange rate (1997 = 100) 1/		100.0	115.8	125.4	125.6

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

1/ End-of-period.

Statement by Ólafur Ísleifsson, Executive Director for the Republic of Latvia
January 18, 2002

First, I would like to thank the staff for their substantial contribution to the economic debate and the policy-making in Latvia. My Latvian authorities emphasize the importance of a fruitful cooperation with the Fund in maintaining a sustainable development of the Latvian economy. The Latvian authorities appreciate the quality of the set of documents and welcome the publication of the staff report, the Financial System Stability Assessment and the study on medium term fiscal issues relating to the Baltic countries' EU and NATO accession.

Over the last two years, the Latvian economy has experienced a rapid growth accompanied by increased macroeconomic stability. Moreover, Latvia appears to have overcome the negative economic consequences of the Russian crisis. This suggests that the Latvian economy is fundamentally stable, making the authorities well posed to effectively cope with potential external shocks. With the high growth rate and the stable macroeconomic environment, Latvia appears to be one of the most successful economies in Central and Eastern Europe.

EU and NATO accession remain top priorities for the Latvian authorities. In its 2001 Regular Report on Latvia's Progress Towards Accession, the European Commission concluded that if Latvia continues its efforts in maintaining the pace of and completes its structural reforms, it should be able to cope with the competitive pressures within the Union in the near future. By end-2001, negotiations on all chapters of the *acquis* had been opened and 23 provisionally closed. The Government intends to close all chapters by end-2002 and expects Latvia to become a member of the European Union in 2004.

Recent economic developments and prospects

Latvia's economic growth over the last two years has been among the highest in Central and Eastern Europe facilitating gradual convergence of per capita income towards the EU levels. Growth has been fairly well-balanced, with the sharpest increase in the service sector, while manufacturing has been recovering from the decline in production in 1999.

The global slowdown of the world economy has had a limited impact on the growth of Latvia's economy as in the first three quarters of 2001 real GDP grew by an annualized rate of 7.9 %. Nevertheless, for an open economy, such as Latvia, short term economic performance will to a large extent depend on the speed of recovery in the outside world, in particular the EU, the sustainability of Russian economic growth and the economic performance of the Baltic neighbors.

The current account deficit still remains considerable, reaching 7.1% in the first three quarters of 2001. The current account deficit mirrors the country's high investment rate, which for the last three years has exceeded 27% of GDP. Latvia seems well posed to continue to attract FDI, and investment inflows appear to be more than sufficient to finance the current account deficit.

During the next few years, economic growth will be driven mainly by strong domestic demand. Private consumption, which grew notably in 2000 and in the first half of 2001, is likely to be sustained due to the relatively high growth in real income. Nevertheless, since the growth of real wages is lower than productivity growth, relative labor costs are falling. This development improves profitability, fosters international competitiveness, and creates favorable conditions for investment and growth. Public consumption is not expected to contribute significantly to GDP growth in the coming years due to the necessity of keeping public expenditures in check.

Investment growth is expected to remain high in the coming years. Apart from favorable economic growth prospects, investment growth should be stimulated by the gradual reduction of the corporate income tax rate from 25 % in 2001 to 15 % in 2004. Inflation is expected to remain low - at about 3% over the next years. High real growth has reduced unemployment and a stable downward trend in the officially registered unemployment rate has been observed since the end of 1999. By December 2001 the unemployment rate was at 7.6 %.

Fiscal policy

In the light of the fixed exchange rate regime my Latvian authorities recognize that fiscal policy is the main instrument of macroeconomic policy. In particular, fiscal policy has a significant role in countering the current account deficit. In the medium term the aim of the government is to reduce the fiscal deficit and balance the budget.

In the first three quarters of 2001, the fiscal stance has been in line with the MEP. The preliminary data for 2001 indicate a general government fiscal deficit of 1.8 % of GDP compared to 1.7 % of GDP envisaged in the program. The central government has made significant efforts, as evidenced by cutting in half the 2000 fiscal deficit of 2.7 % of GDP to 1.4% in 2001. However, financial discipline appears to be lacking at the municipal level. To address this problem the Latvian authorities are inspecting the financial control systems already in place with the intention to strengthen them if necessary.

The approved 2002 budget has a deficit of 2.5 % of GDP[1], including contributions to the funded pension scheme. While the Government acknowledges the need to tighten fiscal policy, the required expenditures to finance a range of activities related to Latvia's accession to the EU and NATO and the pre-election political environment prevented the authorities from being able to effectively revise the draft budget law. The main items related to EU accession are measures to improve environment protection. To facilitate the NATO accession defense expenditures are being increased to 1.75 % of GDP. The growth in budget expenditures in 2002 is also driven by increased commitments to allocate resources for investment, as the Government is determined to increase investment in projects that will bring infrastructure in compliance with the EU requirements and promote economic growth in the medium term.

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[1] The deficit is 2.7 % according to staff calculations.

The Latvian authorities intend to show moderation in the execution of the budget and believe that the prospects for achieving a lower deficit than budgeted are quite good. On the expenditure side, investment expenditures will likely fall short of the budgeted amount due to the specific implementation procedures of investment projects. On the revenue side, much attention will be paid to improve tax administration. My Latvian authorities therefore look forward to discuss the completion of the first review with the staff during the April mission.

Exchange rate and monetary policies

During 2001 monetary policy remained sufficiently tight to maintain the exchange rate objective and meet the monetary performance criteria agreed with the Fund under the SBA. The Bank of Latvia (BoL) was net purchaser of foreign exchange.

The BoL intends to keep the lat pegged to the SDR basket. The SDR composition broadly reflects the currency composition of Latvia's external trade. The authorities intend to re-peg the lat to the euro after Latvia's entrance to the EU.

The strong growth of credit to the non-government sector continued during 2001 with a 12-month growth rate of 39.6% in November 2001. This development reflects the deepening of the financial intermediation, rapid real economic growth and increasing confidence in the banking system and the economy. For the time being the credit expansion goes hand in hand with the improvement in the quality of the banks' credit portfolio and rapid growth of deposits and, therefore, does not appear to be a source for great concern. The Latvian authorities will continuously monitor developments in this area. They stand ready to adopt the necessary measures should a deterioration of credit quality be perceived.

To manage liquidity in the banking system and achieve external and internal stability of the lat, the BoL applies the same policy instruments as the European Central Bank. Given the recent growth in long-term lending, decreasing interest rates and successful issues of private sector long-term bonds in lats, from December 1, 2001 the BoL discontinued the issuance of two-year foreign exchange swaps, which were used to facilitate the broadening of the range of long-term financial instruments.

Structural reforms and financial sector policies

Significant progress in the pension reform has been achieved in 2001. On July 1, 2001, contributions to the second, fully funded, pillar began. It is believed that this pillar will promote savings and capital market development. The government intends to eliminate incentives for early retirement and to raise the retirement age further to 65 over the medium term.

The restructuring process of the Latvian banking sector is practically completed and over 95% of the banking industry is private-owned. Foreign investors are attracted by the high potential of the Latvian market and currently about two thirds of paid-up-share capital of the banking sector are owned by non-residents. On July 1, 2001, the Financial and Capital

Market Commission (FCMC) started to operate. This will facilitate the full integration of supervision of banking, insurance and capital markets.

The authorities have made a special effort to combat money laundering. As the staff emphasizes in the FSSA report, rules for prevention of money laundering are in line with international standards. A joint European Council and the OECD Financial Action Task Force (FATF) expert commission has found that Latvia has made significant progress in combating money laundering activities. There is still need for some improvements in enforcement, especially with respect to the speed of the legal process. My Latvian authorities are making efforts to improve enforcement. A new criminal law is being prepared. Enforcement of the legislation is overseen and coordinated by the Financial Intelligence Unit. In addition, a separate division in the Financial Police will be established within this month.

The authorities have acknowledged the importance of the cross border cooperation to combat money laundering. The Financial Intelligence Unit is a member of an international organization, the Egmont Group, and cooperates with all 58 member countries in the area of information exchange. Moreover, the Financial Intelligence Unit has signed cooperation agreements with analogous agencies in other European countries.

Following September 11 and the consequent international effort to combat terrorism worldwide, the Latvian government has committed to putting emphasis on prevention of terrorist financing through money laundering. The necessary legislative and administrative measures have been designed, and in October 2001 the Latvian government adopted the "Action Plan of the Government of Latvia for Combating Terrorism" that contains a far-reaching package of measures for both national and international cooperation, including the prohibiting and combating of terrorism financing.

Significant progress has been achieved in advancing utilities regulation and enhancing competition in the energy and telecommunication sectors, including the enactment of supporting legislation for the Public Utilities Commission (PUC), which started its operation on October 1, 2001. Contrary to the FCMC, which unified several regulators within a single sector, the multi-sector model of regulation adopted for the PUC had no prototypes in Western Europe. The PUC oversees energy, telecommunications, postal and railway sectors.

The restructuring program for the "Latvenergo" energy company will be completed by end-2002. Last November the Telecom Law was enacted. This will pave the way for closing the acquis chapter on telecommunications.

Privatization of small and medium enterprises, which was launched in 1991, has been successfully completed. On December 2001, guidelines for privatization of the Latvian Shipping Company (LASCO) were adopted, which will allow for its sale to take place in 2002. In 2002 the remaining state shares in Latvijas Gaze and Krajbanka will be sold, and the Government intends to sell its minority share in the "Ventspils Nafta" - oil company.

Financial Sector Assessment Program

The Latvian authorities have benefited from the Financial Sector Assessment Program, which was successfully completed in 2001 and provided a comprehensive analysis of the financial sector in Latvia. The Latvian authorities recognize that while the overall assessment of the Latvian finance sector was positive, improvements are necessary in some areas.

Some of the recommendations of the FSAP report have already been implemented or will be implemented shortly. However, a certain number of the recommendations require more time for implementation and are targeted as medium-term goals.