August 2005
IMF Country Report No. 05/282

Republic of Latvia: 2005 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for 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 2005 Article IV consultation with Republic of Latvia, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on April 26, 2005, with the officials of Republic of Latvia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 14, 2005. 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 July 27, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 27, 2005 discussion of the staff report that concluded the Article IV consultation.

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

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

Selected Issues Paper

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

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

Staff Report for the 2005 Article IV Consultation

Prepared by Staff Representatives for the
2005 Consultation with the Republic of Latvia

Approved by Alessandro Leipold and Carlos Muñiz

July 14, 2005

The 2005 Article IV consultation discussions were held in Riga during April 13–26, 2005. The team comprised Ms. van Elkan (head), and Messrs. Luna and Stavrev (all EUR). Ms. Zubkova (Advisor, OED) and Mr. Rosenberg (Regional Representative) attended several meetings. The mission met with Bank of Latvia (BoL) Governor Rimšēvičs, Finance Minister Spurdziņš, and senior officials, academics, and representatives of financial institutions, foreign investors, and NGOs.

Latvia acceded to the European Union (EU) on May 1, 2004 and entered ERM2 on April 29, 2005. A four-party center-right coalition government took office in December 2004. Notwithstanding the short tenure of governments, macroeconomic policy has been anchored to meet the preconditions for EU accession and euro adoption. The next general election is due in 2006. The authorities are aiming to adopt the euro at the beginning of 2008.

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

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

The authorities released the mission's concluding statement (http://www.imf.org/external/np/ms/2005/042505.htm) and have expressed their intention to publish the staff report.

Contents Page

Executive Summary

Background: Growth increased to 8¼ percent in 2004 on very strong consumption and investment, while inflation and the current account deficit jumped sharply—only partly related to temporary factors. Booming bank credit added to demand pressures and also increased macroprudential risks. Gross external debt reached 93 percent of GDP, although net debt is a more modest 30 percent. Nonresident deposits—an important funding source for banks—point to growing mismatch risks. Latvia joined ERM2 in April 2005 at the prevailing parity and plans to adopt the euro in 2008.

Outlook: Booming demand is set to continue, fuelled by ongoing credit expansion, real wage growth, and sharply higher net EU grants. Average inflation is expected to remain at 6¼ percent—well above the Maastricht limit—while the current account deficit should narrow on account of larger net EU grants.

Policy issues and discussions

Access to substantial EU funds poses a difficult tradeoff for fiscal policy. With the currency peg preventing further effective tightening of monetary policy, fiscal policy remains the primary demand management tool. While EU-financed investment would raise growth potential over the medium term, it adds to near-term cyclical pressures. With output slightly above potential, the mission stressed the need for a firmer fiscal stance than planned. This would also slow external debt accumulation and help prefinance pension reform costs.

Moderating credit growth was viewed as essential to containing inflationary pressures. While credit growth has been driven by availability of new financial instruments and lower real interest rates, it continues to contribute to demand pressures. The authorities are considering taxing multiple mortgage loans to moderate credit growth. Staff called for eliminating distortions in the tax system that were fuelling the mortgage boom, including generous treatment of capital gains on real estate.

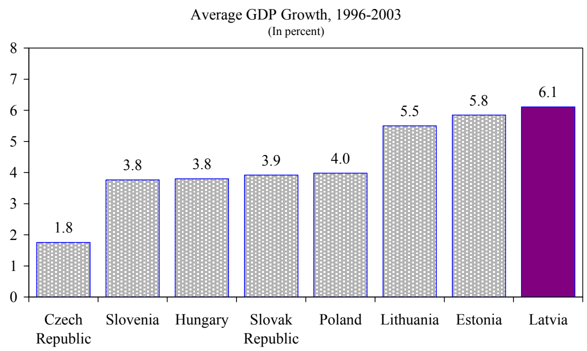
Maintaining competitiveness in ERM2 will depend on bringing down inflation and containing wage growth. The mission stressed the importance of demand management for dampening inflation and labor market flexibility to limit wage growth, although there was recognition on both sides that sustained productivity gains augured well for the maintenance of competitiveness going forward.

Vulnerabilities from the credit boom put a premium on strong supervision and prudential safeguards. Recent improvements in financial sector monitoring are welcome but the loosening of some prudential regulations may exacerbate risks. The mission highlighted the need for strengthened supervision of banks with significant nonresident deposits. Recent amendments to AML laws and the authorities' request for an AML/CFT ROSC are welcome.

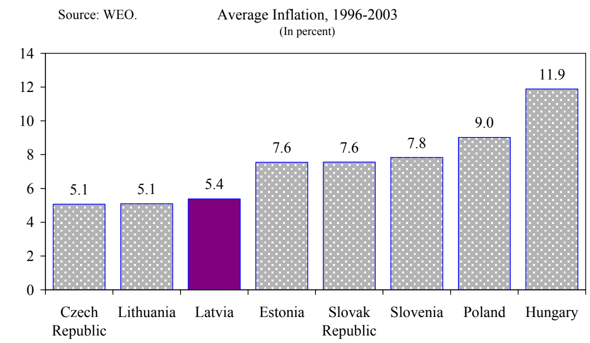
Sustaining vigorous growth remains contingent on expanding and efficiently allocating capital and employment. Reducing corruption, transparently allocating EU funds for infrastructure, encouraging greater labor force participation, and better matching skill acquisition with skills demanded in the labor market will help to avoid bottlenecks to medium-term growth.

I. Background

1. **During much of the past decade, Latvia's growth performance has outstripped other new EU member countries while broad macroeconomic stability has been maintained**. A sound policy framework and far-reaching structural reforms supported this performance, including a prudent fiscal policy that underpinned the exchange rate peg, and fundamental reforms of the business and wage-setting environments. These efforts promoted enhancements in factor productivity and investment—including substantial FDI—that have expanded productive capacity and narrowed the per capita income gap with Western Europe. However, at 40 percent of the EU-15 average (PPP basis) in 2004, per capita income still remains the lowest in the EU.



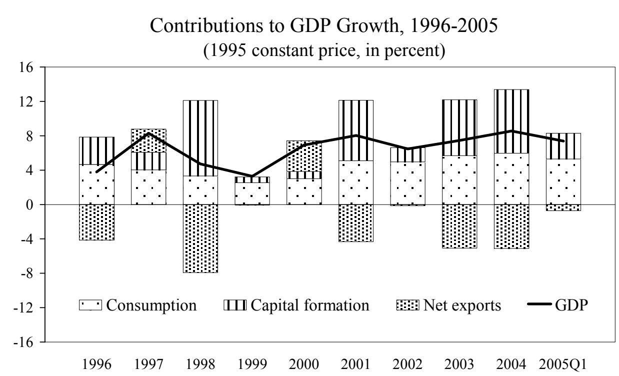
Source: WEO.



Source: WEO.

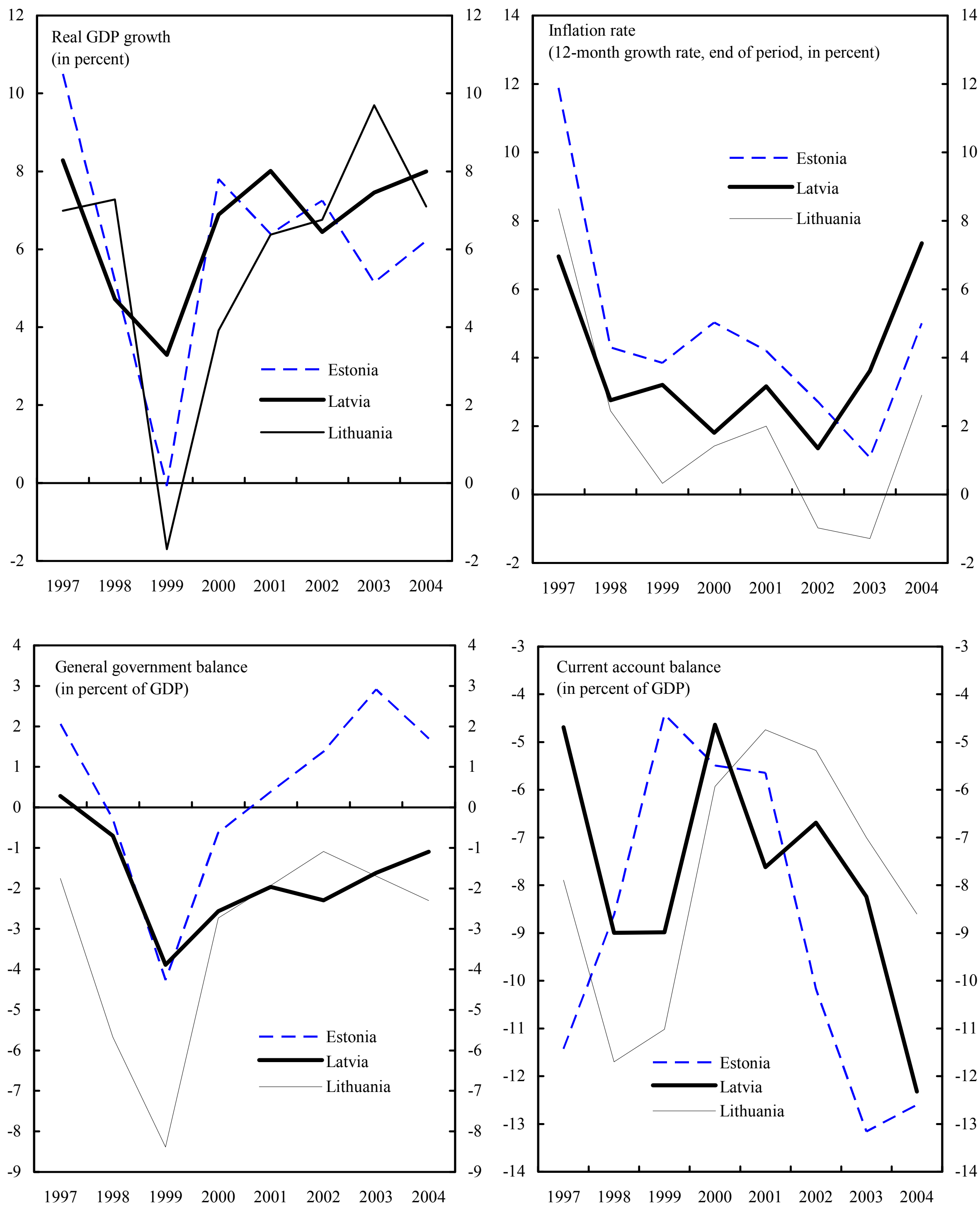
2. **Rapid economic growth under Latvia's open trade and capital account regime contributed to relatively large current account deficits and rising external debt** (Figure 1). Despite strong growth of exports, current account deficits averaged 7¼ percent of GDP during 1996–2003, consistent with Latvia's low initial income and high growth potential. FDI has covered about half the cumulative deficit, but with privatization slowing, nonresident deposits (NRDs) and borrowing from parent banks have played an increasing financing role (Figure 2). As a result, total gross external debt has risen sharply to 93 percent of GDP in 2004, even though net external debt remains a more modest 30 percent of GDP (Figure 3).

3. **Domestic demand picked up sharply in 2004, pushing economic growth well above the 1996-2003 average**. A strong increase in investment and consumption—driven by expectations of sustained income convergence and declining real interest rates—pushed GDP growth up to 8½ percent, from 7½ percent



Sources: Eurostat and Fund staff estimates.

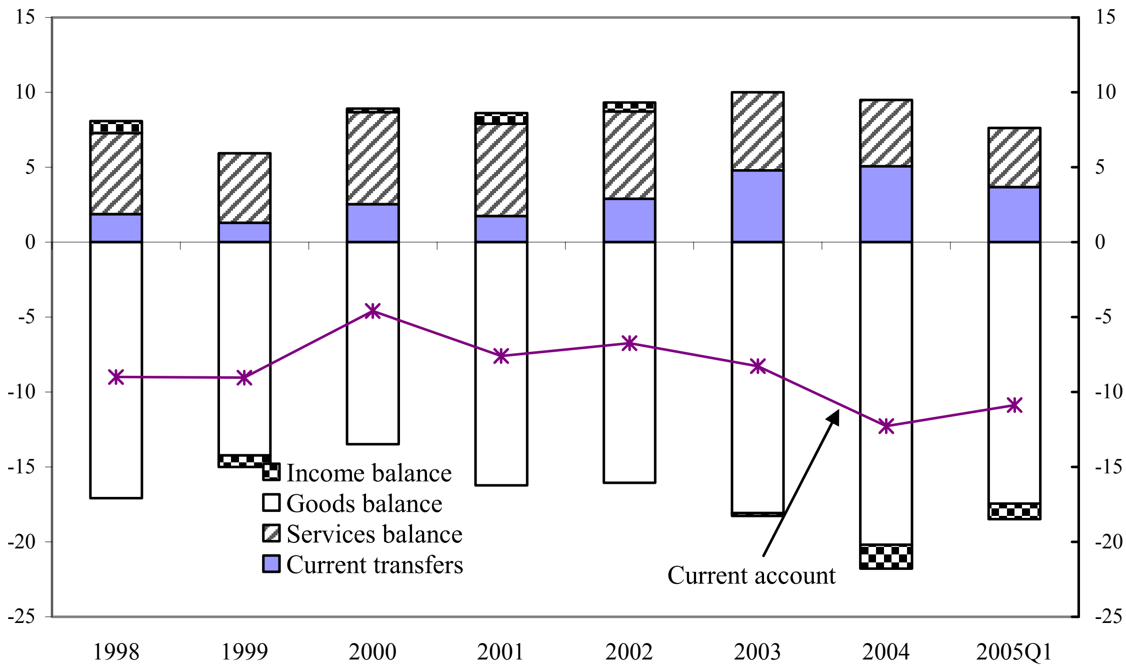
Figure 1. The Baltics: Macroeconomic Performance, 1997-2004



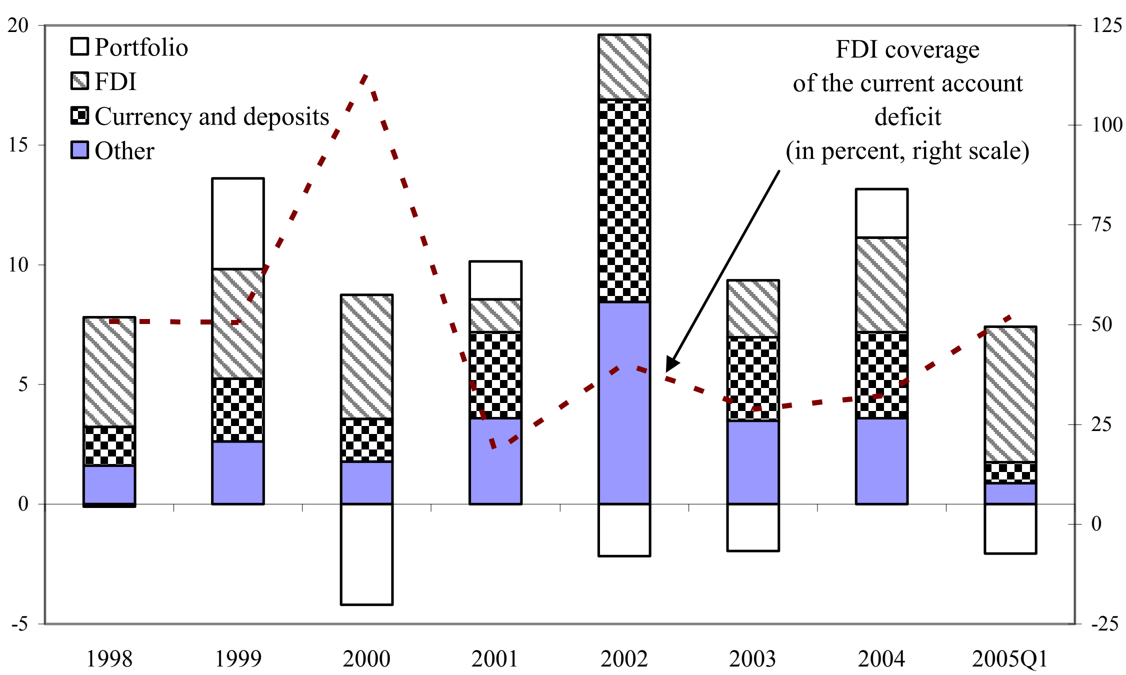
Sources: Country authorities and Fund staff estimates.

Figure 2. Latvia: External Sector, 1998-2005
(In percent of GDP)

Current Account



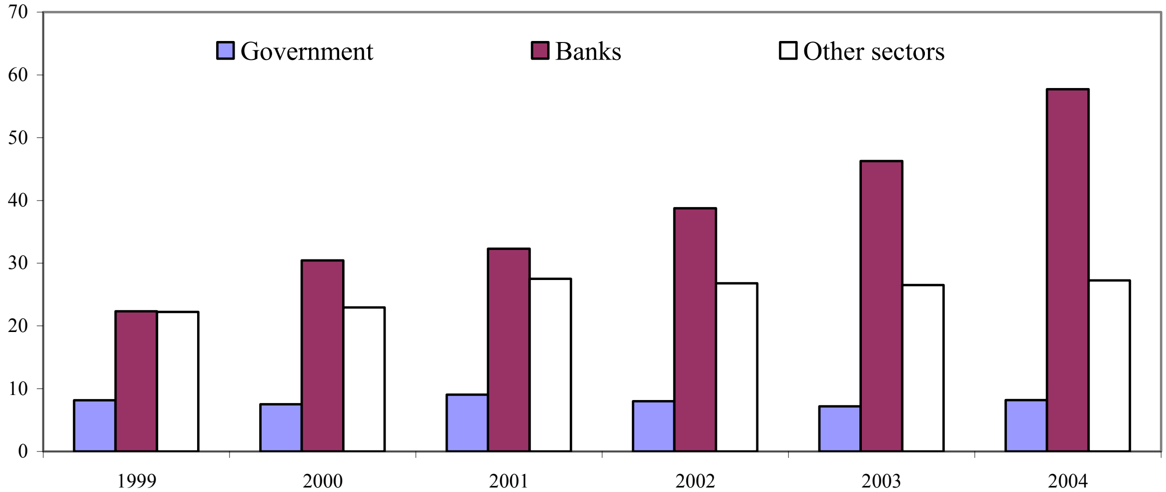
Financial Account



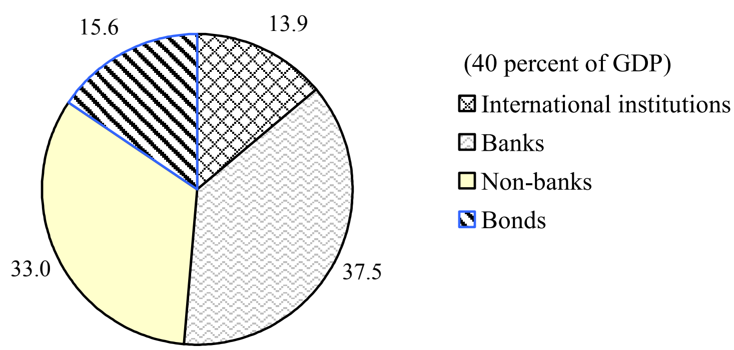
Sources: Country authorities; and Fund staff estimates.

Figure 3. Latvia: Gross External Debt by Borrower and Long-term Debt by Creditor, 1999-2004

Gross External Debt by Borrower
(In percent of GDP)



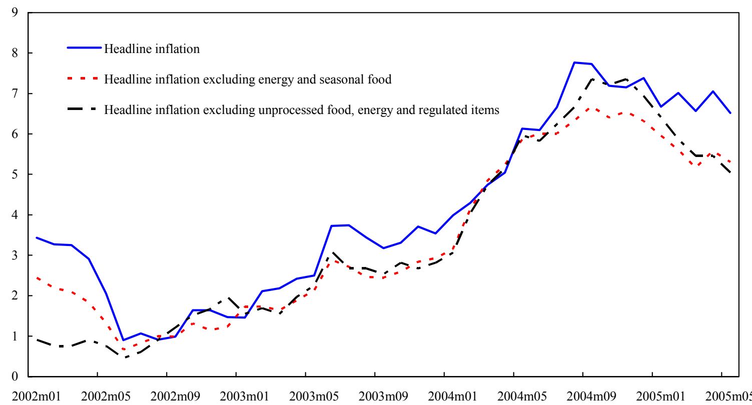
Long-term Debt by Creditor, end 2004
(In percent of total)



Source: Bank of Latvia.

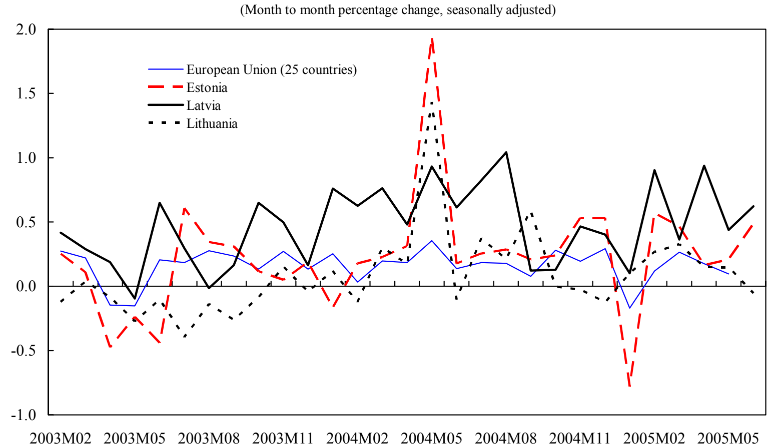
in 2003 (Table 1). The external sector remained a net drag on growth even as export volume growth increased. Private sector credit—particularly to households—continued to expand rapidly, growing by more than 35 percent for the fifth consecutive year to reach 57 percent of GDP, second highest among new EU members (Figure 4). Unemployment declined steadily to below 10 percent in Q1 2005—of which long-term unemployment is less than half—even as economy-wide wages continued to rise well above inflation.

Latvia: Headline Inflation, 2002-05
(12-month growth rate)



Sources: Bank of Latvia and Eurostat.

Headline Inflation, 2003-05
(Month to month percentage change, seasonally adjusted)

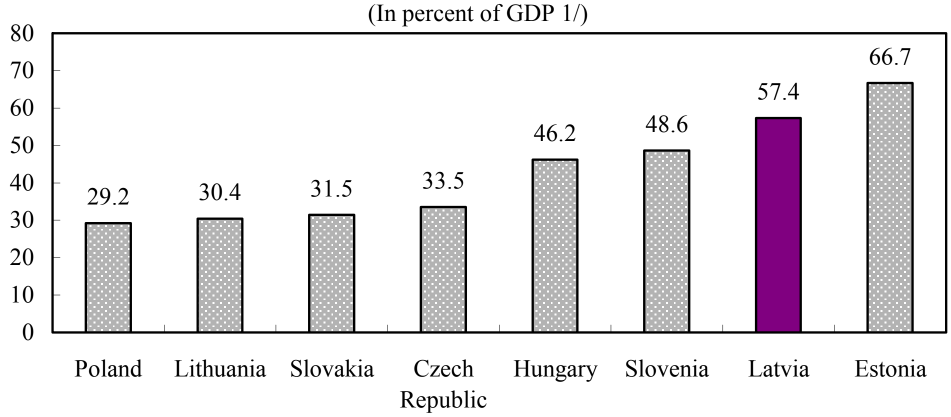


Sources: Eurostat and Fund staff calculations.

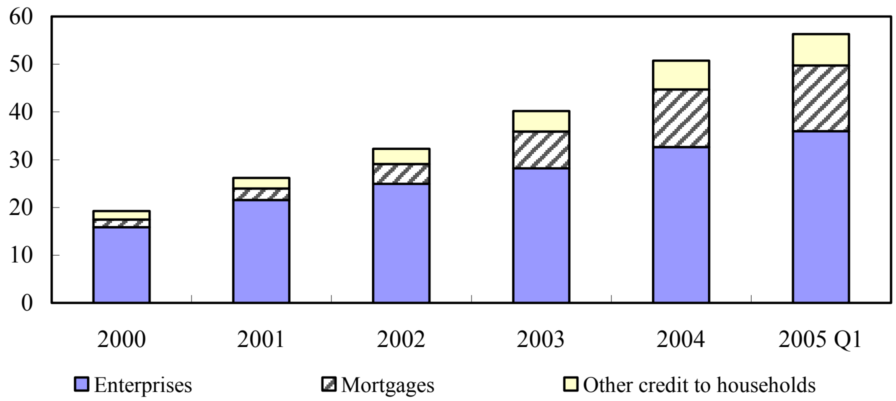
4. **Emerging imbalances have been evident in a pickup in underlying inflation and a widening of the current account deficit**. Headline inflation surged in 2004 to 6¼ percent (year-average basis), and the current account deficit swelled to 12.3 percent of GDP (Table 2). While one-off factors related to EU accession and supply shocks contributed, underlying measures of inflation and the current account deficit also deteriorated (Box 1). Excluding unprocessed food, energy, and regulated items, core inflation peaked in late 2004 and, while moderating to 5 percent by mid-2005, Latvia's monthly price increases remain among the highest in the group of new member (NM) states. With supply shocks having only a moderate direct impact, the still-high level of core inflation can be attributed to rising inflationary expectations and second-round demand effects, including retailers that used the opportunity of EU accession to raise prices in conditions of strong demand. Excluding large one-off investment imports of about 1½ percent of GDP and some pre-accession stock building, the underlying current account deficit widened by about 2 percentage points of GDP in 2004, reflecting strong import demand and rising income payments on FDI.

Figure 4. Latvia: Credit Developments, 2000-05

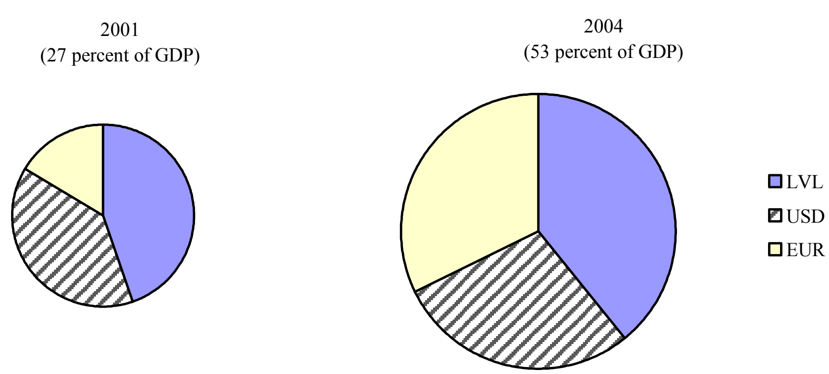
Credit to Private Sector Residents in New EU Member Countries, Q1 2005
(In percent of GDP 1/)



Credit to Private Sector Residents
(In percent of GDP)



Currency Composition of Loans to Residents



Source: Bank of Latvia; Eurostat and Fund staff calculations.
1/ GDP is of 2004.

Box 1. Impact of One-Off Factors in 2004: A Moderate Effect

One-off factors in 2004 accounted for only part of the increase in inflation and the current account deficit. As in several other NM states, EU accession brought increases in indirect taxes and changes in customs duties, leading to higher prices and some pre-accession hoarding of goods during the early part of the year. However, in Latvia, the direct contribution of these effects is thought to have been small. According to the Bank of Latvia, changes in indirect taxes (both increases and reductions) and administratively regulated prices added 1 percentage point to inflation around mid-year. A pre-accession buildup in stocks boosted imports by about 1¼ percent of GDP early in the year, but these are likely to have been largely drawn down during the second half, with only a small net impact on imports for the year as a whole. Food price equalization within the enlarged EU may also have contributed to rising inflation. However, Latvia's food prices are already relatively high compared with several other NM states, and not out of line with the range of food-price levels observed among EU-15 countries. Moreover, the contribution to inflation of higher world energy prices and the need to gradually raise Latvia's gas and electricity prices to world levels was muted on account of energy's relatively low weight in the CPI basket.

Cost of Living Comparison in NM8 Capital Cities--
Food and non-alcoholic beverages, July 2004
(Brussels = 100)

Bratislava, Slovakia	69
Budapest, Hungary	73
Ljubljana, Slovenia	88
Prague, Czech Republic	62
Riga, Latvia	67
Tallinn, Estonia	72
Vilnius, Lithuania	63
Warsaw, Poland	53

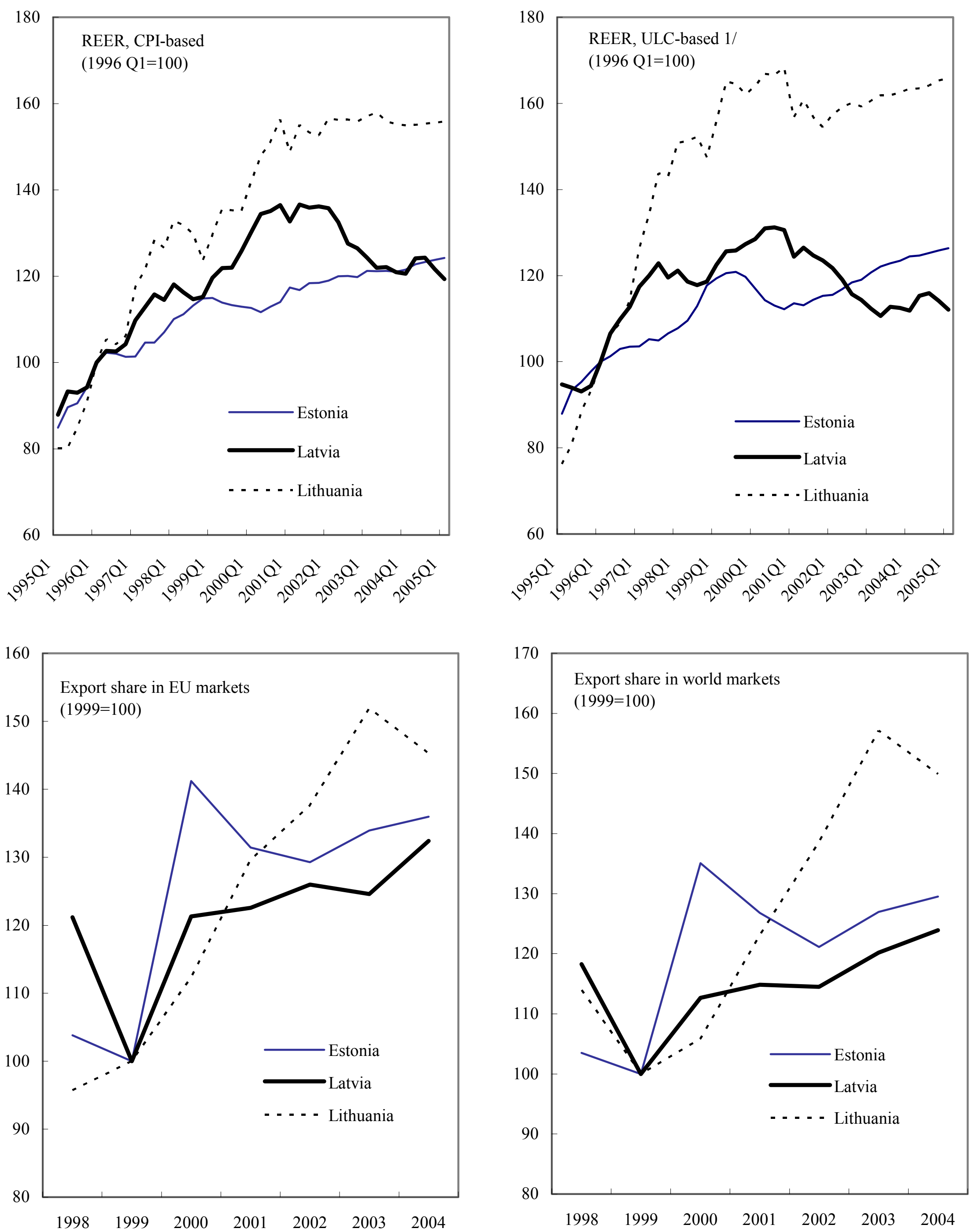
Source: Eurostat.

5. **Notwithstanding the surge in imports in 2004—partly attributable to the fast pace of domestic demand—external competitiveness appears adequate**. The labor cost-based real exchange rate—broadly unchanged in 2004 relative to 2003—improved significantly compared with earlier years as rapid productivity growth and a modest depreciation of the SDR-linked currency compensated for strong growth in nominal wages (Figure 5). Exports grew robustly in volume terms and, together with a favorable terms of trade, further increased Latvia's export share in EU and world markets. Latvia joined ERM2 on April 29, 2005 at the prevailing exchange rate parity, having repegged from the SDR to the euro in January.

6. **Booming bank credit added to demand pressures**. With bank profits strong, easy access to foreign financing, nonperforming loans low and well provisioned, and capital adequacy—though moderating in recent years—still considerably higher than the newly lowered minimum requirement,[1] banks faced few constraints in expanding their balance

[1] The minimum statutory capital adequacy ratio (CAR) was reduced in late 2004 from 10 percent to 8 percent—the rate in most EU countries—to provide similar conditions for domestic banks and foreign branches.

Figure 5. The Baltics: Real Effective Exchange Rates and Export Penetration, 1995-2004



Sources: Country authorities; Eurostat; Direction of Trade; and International Financial Statistics.

1/ Economy wide.

sheets (Table 3 and Appendix II). With mortgages the most dynamic segment of the credit market, banks have become increasingly exposed to credit risk from possible house price fluctuations and from a slowdown in economic growth to which bank lending is an important contributor. Since most mortgages are denominated in foreign currency (euros and U.S. dollars), indebted households are exposed to movements in the exchange rate. Nonresident deposits (NRDs)—an important funding source at many banks (including several of the largest banks)—represent more than half of total deposits, raising concerns about the growing shortfall of banks' liquid foreign assets relative to short-term foreign liabilities, as well as possible links with money laundering.

7. **Despite two supplementary budgets, strong revenue overperformance enabled a better-than-budgeted fiscal outturn in 2004**. With conservative revenue forecasts, higher-than-expected GDP growth, and lower spending than approved in the supplementary budgets, the general government deficit on a cash basis was contained to 1.1 percent of GDP,[2] one percentage point below target and ½ percentage point below the 2003 outturn, consistent with Executive Directors' recommendations during the 2004 Article IV consultation (Table 4 and Box 2). Adjusting for cyclical effects on revenue and excluding net EU grants, the fiscal stance is estimated to have been contractionary in 2004 (Box 3).

Box 2. Article IV Policy Recommendations and Implementation

Latvia has generally heeded the Fund's advice on macroeconomic and structural policies, as evidenced by a series of stand-by arrangements, the most recent of which expired at end-2002. However, recent years have seen an easing of fiscal control toward year-end on account of a surge in spending, slowing progress toward the authorities' medium-term goal of budget balance. Monetary policy has generally supported the exchange rate peg, and in preparation for euro adoption, liquidity management has increasingly relied on open market operations.

In the financial area, supervision has been streamlined with the establishment of a unified financial sector supervisor, and the authorities recently approved a package of legislation aimed at eliminating deficiencies in the AML/CFT framework.

In concluding the last Article IV consultation, Directors praised Latvia's continued strong economic performance (http://www.imf.org/external/pubs/ft/scr/2004/cr04260.pdf). However, they saw as ongoing risks the large current account deficit and rapid credit growth which—though consistent with Latvia's stage of development—called for a prudent fiscal path and vigilant bank supervision. They also advised that potential overheating risks should be warded off in a timely manner. This advice remains relevant in view of recent macroeconomic developments.

[2] On an ESA95 basis, the deficit was 0.8 percent of GDP. The difference between the cash and ESA concepts reflects the one-time effect of the increase in the VAT collection lag following EU accession.

Box 3. Estimating the Fiscal Stance in Latvia

In addition to standard adjustments for cyclical conditions and differences between cash and accrual accounting, estimating the demand effect of fiscal policy requires accounting for EU transfers. EU-financed government spending leaves the fiscal balance unchanged but adds to demand pressures, the timing of which may not fully coincide with the receipt of EU funds owing to advance and *ex post* payments which are recorded upon arrival of the funds in the national budget presentation. On the other hand, contributions to the EU raise the measured deficit, but do not generate domestic demand. The Latvian budget format ("extended" government) includes in revenues and expenditures EU grants to private sector final beneficiaries (estimated by the mission at 40 percent of EU grants for 2005), even though these are not part of government activity. On the basis of these considerations, the appropriate concept for assessing the fiscal stance is the change in the structural accrual balance excluding net EU grants and transfers to the private sector where the government is the paying authority.

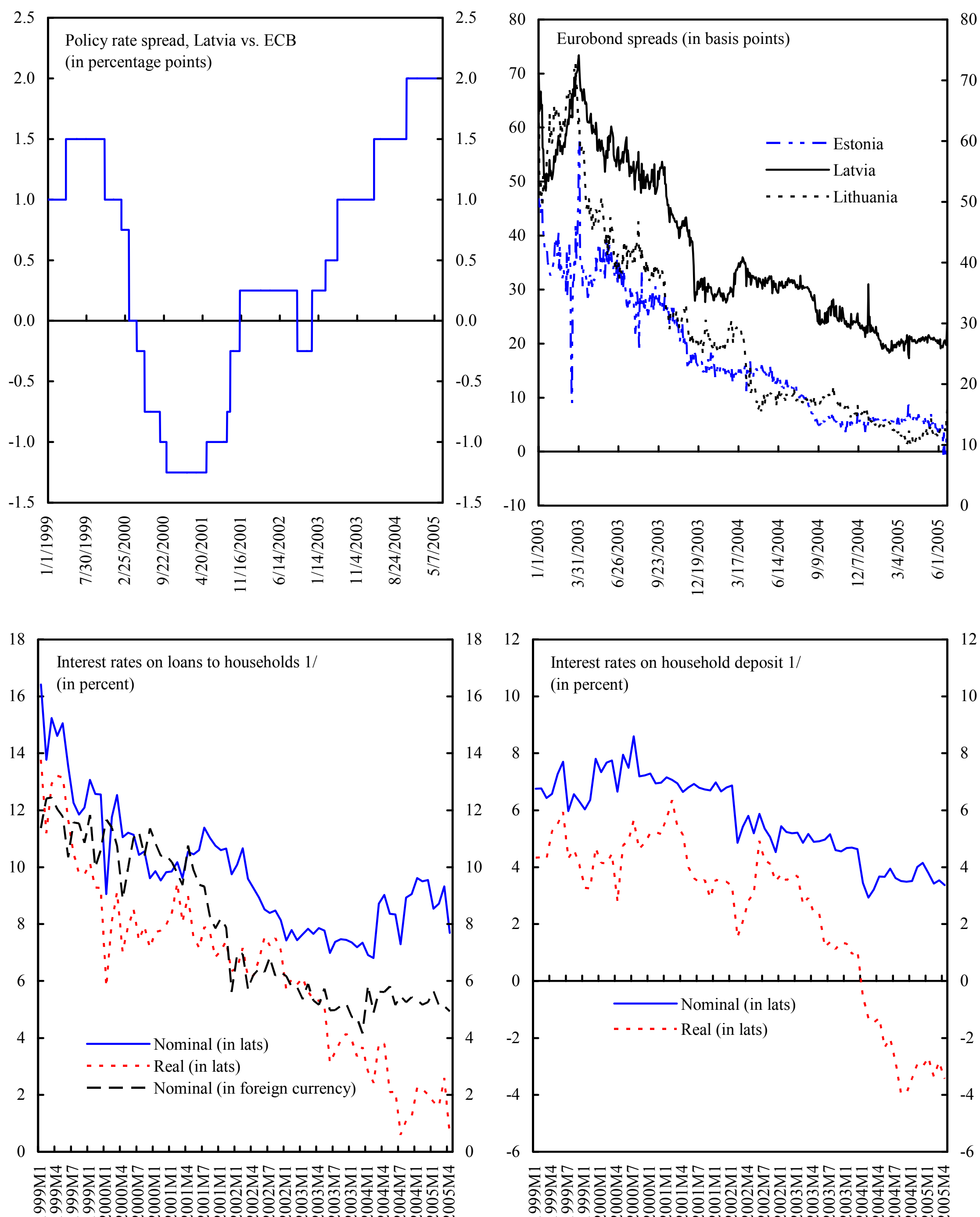
Latvia: Demand Effects of Fiscal Policy, 2004
(In percent of GDP)

	2003		2004	
	Extended Gov. 1/	General Gov. 2/	Extended Gov. 1/	General Gov. 2/
Revenues excluding EU grants	32.6	32.6	32.3	32.3
Expenditures and net lending excluding payments to the EU	35.0	34.6	34.6	33.7
Headline balance excluding net EU grants	-2.4	-2.0	-2.3	-1.4
Cyclical and accrual adjustments	0.1	0.1	0.3	0.3
Cyclical effects	0.1	0.1	-0.1	-0.1
Collection lag from change in VAT procedures 3/	0.0	0.0	0.4	0.4
Structural "accrual" general government balance	-2.3	-1.9	-2.0	-1.1
Demand effects of fiscal policy				-0.8
Memorandum items:				
Headline balance	-1.6	-1.6	-1.1	-1.1
EU grants 4/	0.8	0.4	2.1	1.2
Payments to the EU	0.0	0.0	0.9	0.9

Sources: Ministry of Finance; and Fund staff calculations.
1/ Includes economy-wide EU grants in revenue and expenditure.
2/ Includes in revenue and expenditure only EU grants for which the government is the final beneficiary. *GFSM2001* concept of government.
3/ EU VAT procedures increase collection lag on imports by one month.
4/ For extended government concept, includes economy-wide EU receipts. For general government concept, includes only those grants for which government is the final beneficiary.

8. **Within the limits of the narrow band exchange-rate peg, the BoL tightened its policy instruments over the past year**. A one percentage point increase in the refinancing rate and a tightening of mandatory reserve requirements—including by broadening the base

Figure 6. Latvia: Monetary and Financial Indicators



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

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

to include banks' short-term foreign liabilities—helped lift nominal interest rates on lats-denominated bank loans (Figure 6). However, the pickup in inflation was even stronger, and real borrowing costs declined, while real deposit rates turned sharply negative. Maintaining the ±1 percent band, the lats was repegged to the euro at the beginning of 2005 and Latvia entered ERM2 at end-April 2005. The authorities are aiming to adopt the euro at the beginning of 2008, which would require satisfying the Maastricht criteria sometime during 2007.

II. Report on the Discussions

9. **The discussions focused on policies to maintain macroeconomic and financial stability while preserving external competitiveness**. The challenge for the near term was seen as dampening overheating pressures in order to qualify for euro adoption without an undue delay that could generate its own risks.[3] Over the medium term, the goal is to sustain real income convergence by reducing risks of a boom-bust cycle triggered by eroding competitiveness and a heavy private-sector debt overhang. The discussions also explored the contribution of the financial sector to prevailing macroeconomic conditions, and the extent of vulnerabilities generated by the ongoing credit boom, the size of NRDs, and deficiencies in the AML/CFT framework.

10. **While recognizing the importance of fiscal policy as the primary lever to moderate demand, the authorities stressed that access to substantial EU funds posed a difficult tradeoff**. Given the constraints of the narrow-band currency peg, the authorities saw clear limits to their ability to influence private domestic demand through further tightening of monetary policy. While there was agreement that reining-in fiscal policy was the main available tool to contain overheating pressures, the authorities and the mission had different perspectives on how to resolve the tradeoff between the medium-term capacity-enhancing benefits of EU-financed spending (including on infrastructure), and the short-term benefits—for macroeconomic stability—of a firmer fiscal stance. This partly also reflected different assessments of the extent of spare capacity and thus prospects for disinflation.

A. Economic Outlook and Medium-Term Risks

11. **While the authorities saw strong growth continuing in 2005, they expected inflation and the current account deficit to moderate as temporary supply shocks dissipated.** They forecast economic growth at 7½ percent for this year, but estimated that this would leave output below potential until 2006. One-off supply side factors—rather than overheating pressures—were seen by the authorities as primarily responsible for the higher

[3] Latvia's participation in ERM2 was conditioned on achieving a sustainable reduction in inflation, including through a strengthening of the fiscal stance.

inflation and current account deficit last year. They saw spare capacity in industry (a utilization rate of about 70 percent—though rising) and the recent jump in the investment-to-GDP ratio (with positive effects on growth potential) as consistent with a still-negative output gap. For 2005, the authorities expect the current account deficit to narrow to 10 percent of GDP and inflation to moderate to 5–5½ percent (year-average basis). However, they were concerned about risks of second-round effects from further increases in energy prices scheduled for 2005, which could delay euro adoption.

12. **The mission considered the economy to be somewhat more cyclically advanced, with output marginally above potential since late 2004**. The ongoing credit boom and stronger real wage growth were expected to underpin private domestic demand this year, while a sharp increase in spending financed by net EU grants (by 2.4 percentage points to 3.6 percent of GDP) would also boost public spending. Staff thus projected GDP growth of 7¾ percent for 2005, slightly above the authorities' forecast and above staff's estimate of short-term growth potential (about 6½ percent). Moreover, actual growth may be exceeding the reported rate owing to very dynamic activity in the grey economy, especially construction. On the cyclical position of the economy, the mission noted that activity was unevenly distributed across economic sectors and geographic regions—with services accounting for nearly four-fifths of the economy and the Riga region generating the bulk of GDP—a pattern reinforced by the recent composition of growth. It pointed to evidence of capacity constraints in construction (the sector most affected by mortgage-financed housing and EU-financed infrastructure spending), where shortages of qualified workers have pushed up wages; and to the very rapid expansion in retail sales that has raised core inflation. While investment would enhance future growth potential, in the short term staff saw the pace of activity as set to further widen the positive output gap.

13. **Against this background, the mission saw the risks weighted toward higher core inflation and a wider underlying current account deficit this year**. While headline inflation (on a 12-month basis) would remain on a downward track through mid-year reflecting the high base in early 2004, demand pressures would likely turn this trend around in the second half, with the mission projecting year-end inflation at 6¼ percent. While staff saw the current account deficit narrowing to about 10½ percent of GDP this year on the basis of

Latvia: Underlying Current Account, 2003-05
(In percent of GDP)

	2003	2004	2005 Staff Projection
Headline current account balance	-8.2	-12.3	-10.5
Net EU current transfers	0.7	0.8	0.9
One-off imports 1/	...	2.0	...
Underlying current account balance	-9.0	-11.1	-11.4

Source: Fund Staff calculations.

1/ Includes imports of ships, turbines (together 1.4 percent of GDP), and some pre-accession stock building not unwound by year-end. Staff estimate.

higher net current transfers from the EU[4] and the absence of bulky one-off investments that pushed up imports in 2004, adjusting for these one offs, the deficit would be slightly higher in underlying terms than in 2004 due to strong domestic demand and higher energy prices.

14. **High external imbalances and rising foreign debt—the main risks for the medium term—could weigh on market sentiment, particularly if euro adoption is substantially delayed**. With relatively modest official reserve coverage of short-term external financing needs (Table 5), Latvia remains reliant on capital inflows. Under the baseline, staff is projecting external debt climbing by 14 percentage points of GDP over the next six years, reaching 108 percent by 2010. This reflects the impact on the current account deficit of strong domestic demand and faster inflation and productivity-adjusted wage growth relative to trading partners—with the deficit only partly financed by FDI—and the need to maintain adequate reserve coverage for imports (Tables 6–7). This baseline highlights the need for demand restraint to improve the saving-investment balance and slow debt accumulation. Fiscal consolidation would need to contribute significantly to the required adjustment, complemented by higher net private saving from measures to moderate credit growth (see below). The BoL regarded net debt (projected by the mission to reach 50 percent of GDP in 2010) as a more relevant indicator of vulnerability and noted that lending by parent banks to Latvian subsidiaries—which is likely to be continuously rolled over—accounted for 12 percentage points of gross debt. They also considered that external sector risks would greatly diminish once Latvia adopted the euro. The mission cautioned, however, that unless macroeconomic policies were geared to containing demand and inflation, market sentiment could be adversely affected, heightening external risks in the short term.

B. Fiscal Policy

15. **The mission expressed concern about the procyclical fiscal stance that is in prospect this year**. The 2005 budget targets a significant increase in spending—estimated at more than 11 percent in real terms—covered mostly by EU grants. Although the headline deficit is budgeted to widen by ½ percent of GDP, controlling for net EU grants and cyclical effects, the demand and stimulus is likely to be on the order of 3⅓ percent of GDP.

16. **The authorities agreed that the budget implied a procyclical stance, but explained that fiscal policy was likely to be considerably tighter than initially planned**. They expected strong tax collections in the first quarter to continue through the year,[5] while

[4] EU transfers are recorded in the current and capital accounts of the balance of payments. Payments to the EU are reported in the current account. The deficit in the current and capital accounts is expected to narrow by 3 percentage points to 7¼ percent of GDP in 2005.

[5] During January–April 2005, tax collection was running nearly 1 percentage point of GDP above the previous year.

the budget's assumptions on EU-financed spending were viewed as too ambitious, with likely execution at three-quarters of this level owing to slower-than-expected procurement and implementation bottlenecks. While a supplementary budget was currently under preparation authorizing additional spending to cover *inter alia* unforeseen storm and security costs, the authorities expected to keep the headline deficit under 1 percent of GDP.

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

	2004	2005			
	Actual	Budget		Baseline	Staff Target
	General Gov. 1/	Extended Gov. 2/	General Gov. 1/	General Gov. 1/	General Gov. 1/
Revenues excluding EU grants	32.3	30.4	30.4	32.6	32.6
Expenditures and net lending excluding payments to EU	33.7	37.2	34.8	35.2	33.7
Headline balance excluding net EU grants	-1.4	-6.7	-4.3	-2.6	-1.1
Cyclical and accrual adjustments	0.3	-0.1	-0.1	-0.1	0.0
Cyclical effects	-0.1	-0.1	-0.1	-0.1	0.0
Collection lag from change in VAT procedures 3/	0.4	0.0	0.0	0.0	0.0
Structural "accrual" general government balance	-1.1	-6.9	-4.5	-2.7	-1.1
Demand effects of fiscal policy	-0.8		3.3	1.6	0.0
Memorandum items:					
Headline balance	-1.1	-1.6	-1.6	-0.8	...
EU grants 4/	1.2	6.0	3.6	2.7	...
Payments to the EU 5/	0.9	0.9	0.9	0.9	0.9

Sources: Ministry of Finance; and Fund staff calculation.
1/ Includes in revenue and expenditure only EU grants for which the government is the final beneficiary. GFSM2001 concept of government. For 2005, assumes government is final beneficiary of 60 percent of EU grants.
2/ Includes economy-wide EU grants in revenue and expenditure.
3/ EU VAT procedures increase collection lag on imports by one month.
4/ For extended government concept, includes economy-wide EU receipts. For general government concept, includes only those grants for which government is the final beneficiary.
5/ For 2004, includes partial prepayment for 2005.

17. **Even with the headline deficit projected by the authorities, the mission saw risks in the resulting procyclical fiscal stance this year.** The mission estimated that the likely fiscal outturn for 2005, albeit considerably better-than-budgeted, implied a demand stimulus of about 1½ percent of GDP, and advised that a more appropriate target given the present cyclical position of the economy was to aim for broad fiscal neutrality. Such an objective would balance the need to reduce demand pressures with the benefits for the economy's supply potential of EU-financed investment. The mission estimated that a target of fiscal neutrality could be realized by holding expenditure and net lending relative to GDP (excluding payments to the EU) unchanged from the previous year, which would still allow real spending to increase by nearly 8 percent. Beyond the issue of the fiscal stance this year, the mission advised against the practice of authorizing large additional spending in the event of revenue overruns—as in the previous two years—given the risk that this could institutionalize procyclicality in public finances.

18. **The authorities considered staff's recommended fiscal stance for 2005 to be politically infeasible, and plan for rather gradual adjustment over the next several years**. In their next update of the Convergence Program, the authorities intend to revise down their medium-term fiscal targets on account of the stronger outturn for 2005, and to trim the fiscal deficit thereafter by 0.1 percentage points of GDP per year. Against this, ongoing second-pillar pension reform—by diverting contributions from government revenue—will increase the deficit by 1½ percent of GDP when fully phased in 2010. The mission saw benefit in faster medium-term adjustment to help prefinance pension reform costs and reduce external sector risks, and recommended improving the fiscal balance (including second-pillar contributions) by 1½ percent of GDP during 2004–10, supported by better tax compliance and some expenditure restraint. Phasing the adjustment—but with front loading during 2005-07—would also alleviate prevailing overheating pressures while accommodating the spending of time-bound EU grants that would enhance potential growth (Table 6). The authorities noted that because the revised Stability and Growth Pact provides only temporary

partial relief for pension reform costs, they were considering scaling back the second pillar reform. Staff pointed out that while reducing the size of the second pillar would avert an increase in the fiscal deficit, it would not appreciably affect aggregate saving or the external imbalance.

19. **The authorities saw complying with requirements for drawing EU funds and EU-related fiscal forecasting as having improved the medium-term perspective of the budget**. They noted that the medium-term deficit path in the Convergence Program is obtained from separate forecasts of revenues (linked to macroeconomic projections) and expenditures (based on estimates of recurrent costs and costs of planned and ongoing investments). Beginning with the 2005 cycle and as required by the EU, medium-term strategies prepared by several line ministries guide the selection of EU-financed investment projects, while a government working group was looking at the possibility of introducing two-year budgets. The mission welcomed these improvements, but noted that the credibility of fiscal targets would be enhanced if explicit forecasts of future EU disbursements—a key parameter for budget preparation—were made known.

C. Inflation, Credit Growth, and ERM2/Euro Adoption Issues

20. **There was general agreement on the need to moderate credit growth in order to contain inflationary pressures**. Latvia's credit boom has contributed to overly strong domestic demand and rising external debt (Box 4). In view of the narrow exchange rate band, the BoL saw little scope for further effective tightening of monetary policy, since widening the interest rate differential against the euro, for example, would likely induce a further shift toward foreign-currency borrowing, rather than moderating domestic credit. The authorities were therefore considering other measures to slow credit, including taxing multiple mortgage loans by individuals in order to stem speculative real estate purchases. The mission stressed the need to address distortions in the tax system that could be fuelling the mortgage boom, including generous capital gains tax exemptions and the practice of basing land registration fees on low cadastral values or assessors' valuations—rather than transaction prices. It therefore recommended restricting the scope of the capital gains tax exemption to an individual's primary residence, instead of all real estate owned by individuals, as at present.

21. **The mission supported Latvia's prospective move into ERM2, provided policies were in place to safeguard competitiveness**. Solid export volume growth, a rising export share in world markets, a favorable ULC-based real exchange rate, and a sharp rise (1¾ percentage points) in 2004 in self-financed reinvested earnings underpin the merit of the decision to adopt the prevailing euro-lats peg as the ERM2 central parity. The authorities underscored the importance of the exchange rate regime—including the narrow band—in securing and maintaining macroeconomic stability for more than a decade, prompting their decision to unilaterally preserve the narrow band within the standard ±15 percent ERM2 margins. The mission cautioned that excessive inflation could compromise medium-term competitiveness, and stressed the need to preserve existing labor market flexibility while

bringing domestic demand under control. The authorities saw the decentralized wage-setting system and ongoing productivity improvements as helping to support competitiveness going forward. The mission cautioned that sustained high wage growth in the nontradable sector would add to wage pressures in the tradable sector that could erode competitiveness unless productivity growth increased commensurately.

Box 4. Macroeconomic Effects of Latvia's Credit Boom

Latvia's credit boom likely results from the availability of new credit instruments and lower real interest rates—consistent with an easing of liquidity constraints from deepening financial integration. However, since the credit expansion stimulates domestic demand, it can also contribute to overheating. Rapid credit growth is not new to Latvia but, until recently, demand effects appeared to have been contained by high domestic saving and deposit accumulation. Since 2004, however, external bank borrowing has been the main funding source for credit.

A background paper uses an econometric estimation and simulates a theoretical model to analyze the macroeconomic effects of domestic credit.[1/] Results suggest that: (i) private sector credit raises domestic demand, inflation, and the current account deficit in the short to medium run; (ii) the financing source matters—foreign financing generates higher inflation and growth and a larger current account deficit than does domestic deposit-financed credit; and (iii) the sectoral allocation also matters, with household credit growth raising inflation and worsening the current account, while corporate credit has the opposite effect, presumably by expanding productive capacity.

[1] For further details, see "Macroeconomic Implications of Domestic Credit in Latvia" by E. Stavrev, in the upcoming Selected Issues paper for 2005.

D. Financial Sector Issues

22. **With little evidence that a slowdown in credit growth was underway, the mission urged vigilance in monitoring associated macroprudential risks**. Still low loan penetration of households (only 10 percent have a mortgage and 25 percent some form of credit) and renewed borrowing by corporates for EU-related projects were expected to fuel bank lending in 2005–06. Banking representatives saw the BoL's stress tests—which indicate considerable resilience to macroeconomic shocks—as supporting their favorable assessment of risks. Supervisors and the mission were somewhat more cautious in view of banks' aggressive drive for market share. The mission also cautioned that the current strong financial soundness indicators (FSIs) could quickly weaken if the economy were to slow sharply or the real-estate market undergo a correction.

23. **The mission welcomed the recent improvements in monitoring and stress testing which have strengthened the quality of macroprudential surveillance.** Following on from the major changes in financial sector supervision since the 2001 FSAP (including establishing a single independent supervisory agency; Appendix III), further progress has recently been made, including refining risk scenarios used in stress tests and collecting loan-performance data by type of borrower and credit instrument. The recent broadening of the coverage of the credit register for bad debts should also improve the basis for banks' lending decisions.

24. **However, the mission expressed concern that several key prudential regulations had recently been relaxed**. While recognizing the strong competitive pressures from foreign banks, the mission noted that the reduction in the minimum CAR was an unwelcome change during a credit boom, with two banks having reduced their capital cushions below the previous threshold. The mission also considered that the removal of limits on banks' open positions in euros had been premature. Supervisors saw repegging to the euro as having reduced the riskiness of the euro relative to other foreign currencies. They noted that they had recently advised banks to inform households of the risks of foreign currency loans, and welcomed the ongoing shift from dollar- to euro-denominated mortgages. The mission agreed that the relative riskiness of euro-denominated liabilities had declined, but considered it prudent to keep in place limits on net euro positions until euro adoption to discourage building-up large open positions in the interim (Box 5). It also called for supervisors to ensure that smaller loan-to-value norms are applied in all situations of currency mismatch between borrowers' income and debt to reflect the greater riskiness of these loans.

25. **From a macroprudential perspective, the mission saw merit in proactive supervision of banks with substantial NRD liabilities**. NRDs have high average turnover and could respond differently to shocks than other liabilities. The recent outflow of NRDs (concentrated primarily in two small banks identified as potentially involved in money laundering) underlines this difference. The authorities perceived systemic risks from NRD banks to be very modest owing to their relatively small share of domestic credit (11 percent of GDP) and limited interbank linkages. They also pointed to the resilience of NRDs to the Russia crisis and did not consider the run on Uruguay's NRDs during the Argentina crisis as a relevant parallel for Lativa. The mission nonetheless noted that several large banks have substantial domestic and NRD bases, creating the potential for a run on one type of deposit to spill over to another within a bank, and considered that the Uruguayan episode highlighted risks of liquidity and currency mismatches between banks' short-term NRDs and counterpart assets. The mission also considered that FSIs based on aggregate data were not very informative owing to large differences in liquidity and profitability across groups of banks, and welcomed the separate compilation of FSIs for banks with and without significant NRDs (Table 8).

26. **The authorities reported on progress to strengthen AML legislation and enforcement and requested an AML/CFT ROSC.** They confirmed that 13 banks had been

Box 5. Balance Sheet Approach to Macroprudential Vulnerabilities in Latvia

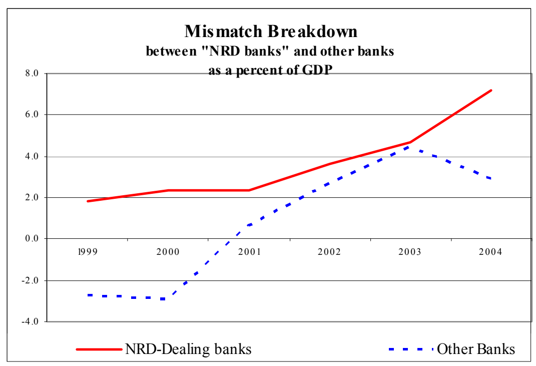
Using balance sheet data, a background paper assesses the extent of Latvia's macroeconomic vulnerability to liquidity and exchange rate risks.[1/] The analysis suggests that: (i) the public sector is moderately exposed to exchange rate fluctuations; (ii) banks are broadly hedged against exchange rate risk but are exposed to considerable liquidity risk; (iii) corporates are prone to substantial exchange rate fluctuations (though some may be naturally hedged), while households as a group have limited currency exposure owing to broadly matching levels of foreign currency-denominated liabilities and assets; and (iv) for the economy as a whole, foreign currency exposure is more contained (about 22 percent of GDP) than for the nonbank private sector alone.

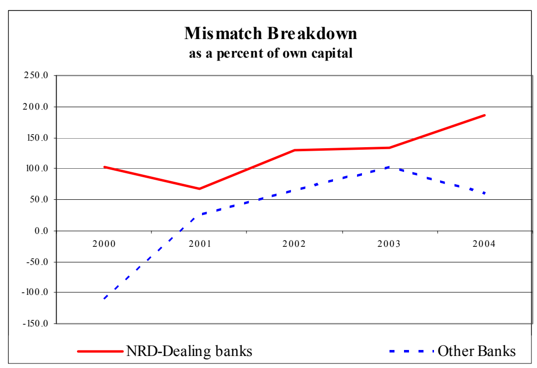
Balance-Sheet Mismatches, 2004
(In percent of GDP)

	Maturity 1/ Total	Maturity 1/ Foreign Currency	Foreign Currency 2/
Government and Bank of Latvia	2.1	0.8	8.2
Banks	-24.9	-16.4	1.7
Private sector	23.9	4.2	-30.1
Enterprises	5.0	-2.8	-25.6
Households	18.9	7.0	-4.5
Memorandum items (in percent of GDP):			
Households FX assets			7.3
Households FX liabilities			11.7
Enterprises FX assets			11.3
Enterprises FX liabilities			36.9

Sources: Bank of Latvia; and Fund staff calculations.
1/ Liquid assets minus short term liabilities.
2/ Foreign-exchange denominated assets minus liabilities (all maturities).

A large part of banks' short-term liabilities reflects NRDs. The mismatch between banks' short-term foreign liabilities and liquid foreign assets rose rapidly to 10 percent of GDP in 2004, of which 3 percentage points was due to short-term lending by parent banks and 7 percentage points due primarily to NRDs (equivalent to 200 percent of capital of NRD-intensive banks). Widespread withdrawal of NRDs could affect the economy through two channels: by creating liquidity shortfalls at NRD-intensive banks; and by drying-up an important source of current account financing.





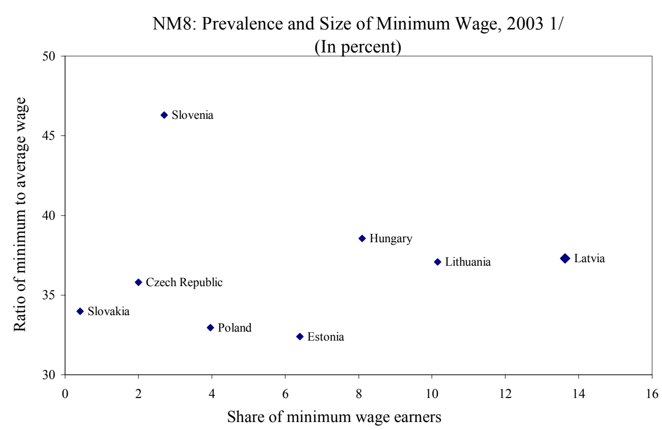
[1] For further details, see "A Balance Sheet Approach to Macroprudential Vulnerabilities in Latvia" prepared by F. Luna in in the upcoming Selected Issues paper for 2005.

placed under AML watch, thousands of bank accounts had been closed due to lack of client cooperation with customer due diligence requirements, and some 16,000 unusual- or suspicious-transaction reports had been filed in 2004 alone. Nonetheless, at the time of the mission, significant deficiencies remained, including: (i) legislation that did not define "beneficial owner" or stipulate the obligation to identify the beneficial owner; and (ii) an inadequately funded, staffed, and equipped law enforcement arm that was impeding timely investigations. To remedy legislative shortcomings, the authorities were preparing amendments to the Credit Institutions Law and the criminal code, which were approved following the mission. To determine whether this new legislation and its implementation complies with international best practice, the authorities requested an AML/CFT assessment for early 2006. The mission welcomed these developments and urged that any remaining weaknesses identified in the assessment be quickly addressed.

E. Structural and Other Issues

27. **The authorities saw the current structure of the economy as a potential bottleneck to medium-term growth potential**. They viewed as unsustainable the recent growth bias toward potentially-unproductive services and were also concerned that most EU structural funds had so far been allocated to Riga and the central region, while high-unemployment areas had seen little benefit. The authorities were therefore seeking to ensure a more regionally-balanced allocation of future EU grants. The mission supported this approach as also helping to alleviate overheating pressures and emphasized the importance of transparent and open project selection and tendering procedures in realizing the full growth potential of EU funds. It also urged continued efforts to strengthen AML/CFT protections and reduce corruption in order to maintain Latvia's attractiveness to foreign investors.

28. **Although unemployment is declining, the authorities were concerned that the structural component remains substantial despite rapid economic growth**. Long-term unemployment is concentrated among high-school drop-outs, low-skilled workers made redundant by structural change, and older workers reflecting the gradual increase in the official retirement age. The authorities credited active labor market measures with the gradual reduction in long-term unemployment. However, the mission viewed outdated training and work experience as obstacles to further reductions, and recommended reforms targeted to graduating workers with in-demand skills, including by giving a consultative role to the business community in the setting of education curricula.



Sources: Eurostat; and Fund staff calculations.
1/ Poland data is of 2002.

29. **The authorities viewed a higher minimum wage as supporting labor force participation while reducing the grey economy, but the mission cautioned about possible adverse**

effects on employment. The authorities suspected that the large share of minimum-wage workers reflected a sizable "grey" economy in which official wages are supplemented by cash payments. The mission acknowledged that raising the minimum wage could promote labor force participation and increase tax collections by legitimizing the grey economy, but cautioned that it could also discourage demand for low-skilled workers. This concern was reinforced by the relatively high ratio of minimum-to-average wages in Latvia. A better solution for increasing participation, the mission argued, was to narrow the tax wedge for low-wage workers by lowering their social security contributions.

30. **From accession, Latvia's trade policy is governed by the common policy of the EU**. Latvia terminated all bilateral preferential trade agreements and adopted the EU's common customs tariff and preferential agreements. The elimination at the beginning of 2005 of WTO quotas on textile imports was seen as detrimental to Latvia's textile exports to the EU, which represented some 80 percent of Latvia's domestic production.

III. Staff Appraisal

31. **Latvia faces the challenge of sustaining rapid income convergence with advanced European countries while maintaining macroeconomic stability**. Latvia's strong track record on macroeconomic performance, underpinned by deep-seated structural reforms and generally prudent fiscal and monetary policies, was crowned by EU accession and ERM2 entry. But with growth expected to remain above trend and emerging imbalances apparent in rising core inflation and a widening underlying current account deficit, action is needed to contain domestic demand by avoiding the stimulus in prospect for 2005. Doing so will also support Latvia's euro adoption goal and help preserve external competitiveness while preventing a large debt overhang that could weigh on market sentiment and slow income convergence.

32. **Given overheating concerns, macroeconomic policies should, at a minimum, avoid adding to demand pressures**. Under the pegged exchange rate and fully liberalized capital flows, further tightening domestic monetary policy instruments would likely be ineffective or counterproductive. Therefore, ensuring macroeconomic stability falls primarily to fiscal policy. Moderating the recent pace of credit growth would complement fiscal adjustment and limit the buildup in external debt.

33. **A broadly neutral fiscal stance would balance the supply-enhancing potential of EU-financed investment with the need to contain short-term demand effects of public spending**. This target is consistent with a general government deficit excluding net EU grants of 1.1 percent of GDP in 2005, only marginally smaller than the deficit on the same basis in the previous year. The revenue over performance in train should make this target achievable, provided the authorities contain the expenditure-to-GDP ratio (excluding payments to the EU) to the level in 2004. In this regard, the planned supplementary budget risks opening the door to additional spending demands that would make fiscal policy more procyclical, unless offset by savings elsewhere. More generally, the practice of authorizing spending of revenue

overruns during the year should be avoided as it tends to institutionalize procyclicality in public finances.

34. **Fiscal policy should also aim at lowering the buildup in external debt and prefinancing the cost of pension reform within a comprehensive multi-year budgeting framework**. Owing to the paucity of other instruments, fiscal policy should assume a sizable share of the needed external adjustment, notwithstanding low public debt and relatively low fiscal deficits. A more frontloaded medium-term fiscal adjustment than envisaged by the authorities would not only decrease dependence on foreign savings but also help cover the fiscal cost of pension reform—even if it is decided not to implement the reform in full. In addition, a smaller deficit would provide a buffer for meeting the Maastricht and SGP fiscal ceilings if the economy were to slow considerably. Recent improvements in medium-term budgeting are welcome, but to enhance the credibility of fiscal targets, the authorities could usefully make known their forecasts of EU grants that underlie the fiscal projections.

35. **Moderating the pace of credit is essential to support fiscal policy in containing inflationary pressures**. With little or no scope for independent monetary policy, other measures are needed to slow credit growth, especially mortgage credit. As a first step, distortions in the tax system that could be fuelling the mortgage boom should be eliminated, including by limiting the capital gains tax exemption only to an individual's primary residence. The authorities should also explore further their proposal for a tax on mortgage borrowing while recognizing that the effectiveness of such a measure would likely diminish over time as ways are found to circumvent the tax.

36. **Rapid credit growth puts a premium on strong supervision and prudential safeguards**. Recent improvements in monitoring and stress testing are welcome and further refining credit-risk scenarios will better alert the authorities to potential vulnerabilities. However, the easing of prudential regulations for credit and exchange rate risk amid a sustained credit boom is unwelcome. Close scrutiny of banks' currency exposures and credit standards should continue, while supervisors should ensure that banks appropriately tailor loan conditions to reflect the added risk of lending in a currency other than the borrowers' income, and continue to alert borrowers to risks entailed in unhedged foreign currency borrowing.

37. **Macroprudential vulnerabilities associated with nonresident deposits and the different profile of banks that specialize in these deposits call for enhanced supervision**. The growing mismatch between short-term foreign liabilities and liquid foreign assets is a concern in view of the high turnover of NRDs. The recent outflows from a few small banks due to money laundering concerns attest to the vulnerability associated with NRDs, as well as to the importance of addressing the underlying concerns. Several large banks with substantial domestic and NRD bases warrant rigorous monitoring owing to the risk that withdrawals of one type of deposit could adversely impact the confidence of other depositors. The authorities are also encouraged to regularly compile macroprudential data separately for banks with and without substantial exposure to NRDs.

38. **Strengthening the legislative and enforcement aspects of the AML/CFT framework remains a priority**. The recent amendments to AML legislation and the request for an independent evaluation in the form of an AML/CFT ROSC are welcome steps. Combating money laundering should be seen as an ongoing process, with development and timely implementation of an action plan for remedying remaining weaknesses a key goal that would serve to avert the reputational risk to Latvia's financial sector.

39. **Sustaining vigorous growth over the medium term is contingent on continuing to expand and efficiently allocate capital while raising employment**. Concerted efforts to reduce corruption and transparently allocate EU funds for infrastructure will support medium-term growth by ensuring the efficient use of scarce resources. Narrowing the tax wedge for low-wage earners through a reduction in their social security contributions would help to raise labor force participation and improve job creation relative to increasing the legislated minimum wage. Revamping the education system by tailoring curricula to graduate workers with in-demand skills would help boost the effective supply of labor.

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

Table 1. Latvia: Selected Economic Indicators, 2001-06

					Staff Projections	
	2001	2002	2003	2004	2005	2006
	(Annual percent change, unless otherwise stated)					
Output, prices, and employment						
Real GDP	8.0	6.4	7.5	8.5	7.8	6.8
Consumption	5.5	6.2	7.2	7.2	6.1	5.6
Gross fixed capital formation	11.4	13.0	7.8	20.6	15.0	9.0
Saving (in percent of GDP)	19.8	20.3	21.3	21.1	23.8	23.9
Private saving (in percent of GDP)	18.2	18.8	19.4	18.8	20.0	20.0
Investment (in percent of GDP)	26.9	26.8	28.8	32.3	31.1	30.9
Private investment (in percent of GDP)	24.6	24.6	27.1	30.9	28.0	28.9
Consumer price index (average; in percent)	2.5	1.9	2.9	6.2	6.3	5.1
(End-of-period; in percent)	3.2	1.4	3.6	7.2	6.2	5.0
Unemployment rate. LFS definition (in percent) 1/	13.1	12.4	10.6	10.4	9.9	...
Real wage 1/	3.9	6.4	8.2	3.1	10.1	...
	(In percent of GDP)					
Consolidated government						
Extended Government 2/						
Revenue	32.8	32.9	33.3	34.4	37.1	37.2
Expenditure and net lending	34.8	35.2	35.0	35.5	37.9	37.9
Fiscal balance	-2.0	-2.3	-1.6	-1.1	-0.8	-0.7
General Government 3/						
Revenues excluding EU grants	...	...	...	32.3	32.6	...
Expenditures and NL excluding payments to EU	...	...	...	33.7	35.2	...
Fiscal balance excluding net EU grants	...	...	...	-1.4	-2.6	...
Gross government debt 4/	13.8	13.3	13.4	13.2	13.5	13.5
Money and credit	(Annual percent change, unless otherwise stated)					
Broad money (millions of lats)	1540	1863	2257	2868	3539	...
Broad money (M2X)	20.8	20.9	21.1	27.1	23.4	...
Lats broad money	21.3	24.2	23.5	23.4	22.7	...
Credit to nongovernment	50.4	36.5	37.3	40.0	37.5	...
FX deposits (U.S. dollar millions)	743.6	906.7	1,147.8	1573.4	...	...
FX deposits (percent of M2X)	30.8	28.9	27.5	29.6	...	...
Interest rates (annualized)						
BoL basic rate	3.0	3.0	3.0	4.0	...	...
Money market (one month)	5.5	2.9	3.3	4.1	...	...
Balance of payments	(In millions of USD, unless otherwise stated)					
Gross official reserves	1,218	1,327	1,535	2,268	2,579	2,879
(In months of prospective imports of GNFS)	3.5	3.2	2.9	3.2	3.3	3.3
Current account balance	-626	-621	-917	-1,681	-1,652	-1,655
(In percent of GDP)	-7.6	-6.7	-8.2	-12.3	-10.5	-9.4
Trade balance	-1,335	-1,479	-2,003	-2,751	-3,062	-3,270
Exports GNFS	3,424	3,789	4,685	5,965	6,963	7,858
Imports GNFS	-4,251	-4,731	-6,112	-8,111	-9,391	-10,455
Gross external debt (in percent of GDP)	68.9	73.6	80.0	93.2	98.4	100.1
Net external debt (in percent of GDP)	18.2	20.6	23.5	29.9	35.2	38.5
Exchange rates						
Lats per U.S. dollar	0.638	0.594	0.541	0.516	...	...
(yoy percent change, + means appreciation)	-4.1	6.9	8.9	4.6	...	...
REER (end-of period; CPI based, 2000=100)	101.6	95.7	92.5	93.2	...	...
(yoy percent change, + means appreciation)	1.6	-5.8	-3.3	0.8	...	...

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

1/ Refers to first quarter actual data.

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

3/ Includes in revenue and expenditure only EU grants for which the government is the final beneficiary.
GFSM2001 concept of general government. For 2005, assumes government is final beneficiary of 60 percent of EU grants.

4/ Excluding government guaranteed debt.

Table 2. Latvia: Balance of Payments, 2001–06

	2001	2002	2003	2004	Staff Projections 2005	2006
	(In millions of U.S. dollars)					
Current account	-626	-621	-917	-1681	-1652	-1655
Excluding official transfers	-652	-658	-999	-1894	-2104	-2010
Goods	-1335	-1479	-2003	-2751	-3062	-3270
Exports	2243	2545	3171	4182	4940	5670
Imports	-3578	-4024	-5174	-6933	-8002	-8940
Services	509	537	577	605	634	673
Credits	1182	1244	1514	1783	2023	2187
Debits	-672	-707	-938	-1178	-1389	-1515
Income	58	54	-21	-220	-162	39
Current transfers	143	266	531	686	939	903
Official	26	37	83	213	453	355
Private	117	229	448	473	486	548
Capital Account	41	21	76	144	512	421
Current and capital account	-584	-601	-840	-1537	-1140	-1234
Financial account	887	677	886	1966	1532	1534
Direct investment	113	250	264	539	622	740
Portfolio investment	130	-199	-216	267	134	148
Other investment	644	626	838	1160	776	646
Trade credits, loans, and other	348	-152	452	...	...	...
Deposits	296	778	386	...	...	...
Errors and omissions	2	-74	23	-26	0	0
Overall balance, net reserve assets	305	2	69	403	392	300
	(In percent of GDP, unless otherwise indicated)					
Memorandum items:						
Current account balance	-7.6	-6.7	-8.2	-12.3	-10.5	-9.4
Trade balance	-10.1	-10.1	-12.8	-15.8	-15.4	-14.7
Merchandise exports	27.3	27.6	28.6	30.7	31.4	32.2
Merchandise imports	-43.5	-43.6	-46.6	-50.9	-50.9	-50.7
Services, income & transfers balance	8.6	9.3	9.8	7.9	9.0	9.2
Gross official reserves (millions of US$)	1,218	1,327	1,535	2,268	2,579	2,879
in months of GNFS imports	3.5	3.2	2.9	3.2	3.3	3.3
Value growth of merchandise exports (percent)	7.9	13.5	24.6	31.9	18.1	14.8
Value growth of merchandise imports (percent)	14.6	12.5	28.6	34.0	15.4	11.7
Terms of Trade, GNFS (percent)	0.1	-0.2	3.0	1.5	-1.3	0.1
Net FDI/Current Account (percent)	18	40	29	32	38	45
Net FDI/GDP (percent)	1.4	2.7	2.4	4.0	4.0	4.2
Gross external debt	68.9	73.6	80.0	93.2	98.4	100.1
Gross external debt excluding NR deposits	40.2	41.2	42.6	52.0	51.5	51.5

Sources: Latvian authorities; and Fund staff estimates.

Table 3. Latvia: Selected Vulnerability Indicators, 2000–05

	2000	2001	2002	2003	2004 1/	2005 1/	Latest Observation
Key economic and market indicators							
Real GDP growth (in percent)	6.9	8.0	6.4	7.5	8.5	...	*Dec-04*
CPI inflation (period average, in percent)	2.6	2.5	1.9	2.9	6.3	...	*Dec-04*
Short-term (ST) interbank rate (in percent) RIGIBOR (1 month, eop)	5.1	6.3	3.5	4.1	4.1	2.8	*May-05*
EMBI secondary market spread (bps, end of period)	...	...	...	...	...	...	*date*
Exchange rate NC/US$ (end of period)	0.61	0.64	0.59	0.54	0.52	0.56	*May-05*
Exchange rate NC/US$ (period average)	0.61	0.63	0.62	0.57	0.54	...	*Dec-04*
External sector							
Exchange rate regime	lats pegged: to SDR (+- 1 percent band)					EUR (+-1 percent band)	
Current account balance (percent of GDP)	-6.4	-8.9	-6.5	-8.6	-12.3	...	*Dec-04*
Net FDI inflows (percent of GDP)	5.2	1.4	2.7	2.4	4.0	...	*Dec-04*
Exports (percentage change of US$ value, GNFS)	12.3	4.1	12.5	22.7	32.1	...	*Dec-04*
Real effective exchange rate (2000 = 100) (eop)	98.9	97.0	91.6	87.4	90.7	...	*Nov-04*
Gross international reserves (GIR) in US$ billion	0.92	1.22	1.33	1.53	2.27	2.32	*Apr-05*
GIR in percent of ST debt at remaining maturity (RM) excluding non-resident deposits	96.5	114.4	106.1	88.6	108.1	...	*Dec-04*
GIR in percent of ST debt at RM including banks' non-resident FX deposits.	33.1	36.6	29.4	24.1	27.3	...	*Dec-04*
Net international reserves (NIR) in US$ billion	0.88	1.19	1.20	1.45	2.2	2.3	*Apr-05*
Total gross external debt (ED) in percent of GDP	61.0	68.9	73.6	80.0	93.2	...	*Dec-04*
Of which: ST external debt (original maturity, in percent of total ED)	59.6	59.7	63.9	68.1	62.5	...	*Dec-04*
ED of domestic private sector (in percent of total ED)	76.7	71.6	74.0	77.6	80.1	...	*Dec-04*
Total gross external debt in percent of exports of GNFS	144.8	165.5	179.2	189.2	212.8	...	*Dec-04*
Gross external financing requirement (in US$ billion) 2/	2.0	2.1	2.7	3.6	4.7	...	*Dec-04*
Public sector (PS) 3/							
Overall balance (percent of GDP)	-3.0	-2.0	-2.4	-1.6	-1.1	...	*Dec-04*
Primary balance (percent of GDP)	-1.6	-1.0	-1.5	-0.8	-0.3	...	*Dec-04*
Debt-stabilizing primary balance (percent of GDP) 4/	-1.0	-0.4	-0.4	-0.4	-0.1	...	*Dec-04*
Gross PS financing requirement (in percent of GDP) 5/	6.5	4.3	3.6	2.8	3.4	...	*Dec-04*
Public sector gross debt (in percent of GDP)	12.2	13.8	13.3	13.4	13.2	...	*Dec-04*
Financial sector (FS) 6/							
Capital adequacy ratio (in percent)	14.0	14.2	13.1	11.7	11.7	...	*Dec-04*
NPLs in percent of total loans	4.6	2.8	2.0	1.4	1.1	...	*Dec-04*
Provisions in percent of NPLs	74.1	80.4	95.5	89.4	99.1	...	*Dec-04*
Return on average assets (in percent)	2.0	1.5	1.5	1.4	1.7	...	*Dec-04*
Return on equity (in percent)	18.6	19.0	16.4	16.7	21.4	...	*Dec-04*
FX deposits held by residents (in percent of total deposits)	46.8	45.0	40.8	69.6	70.9	...	*Dec-04*
FX loans to residents (in percent of total loans)	51.3	56.3	53.7	60.6	65.9	...	*Dec-04*
Credit to private sector (percent change)	36.7	50.4	36.5	37.3	46.0	...	*Dec-04*
Memorandum item:							
Nominal GDP in billions of U.S. dollars	7.7	8.2	9.2	11.1	13.6	...	

Sources: Latvian authorities; and Fund staff calculations.

1/ Latest observations as indicated in the last column.
2/ Current account deficit plus amortization of external debt.
3/ Public sector covers general government.
4/ Based on averages for the last five years for the relevant variables (i.e., growth, interest rates).
5/ Overall balance plus debt amortization.
6/ ST debt and maturing medium- and long-term debt, domestic and external, excluding external debt to official creditors.
7/ Debt in foreign currency or linked to the exchange rate, domestic and external, excluding external debt on concessional terms.
8/ ST debt and maturing medium- and long-term debt at variable interest rates, domestic and external.
6/ Financial sector includes commercial banks.

Table 4. Latvia: Consolidated General Government, 2001-05

(In millions of lats, unless stated otherwise)

	2001	2002	2003	2004	Budget 2005
Revenue	1697	1874	2107	2530	3066
Tax revenues	1452	1598	1783	2025	2250
Corporate income tax	98	110	94	128	149
Income tax and social security contributions	765	848	929	1077	1165
Taxes on goods and services	527	576	690	746	862
Other taxes	62	65	69	75	74
Non tax revenues	113	131	150	199	173
Self-earned revenue	91	101	112	129	134
Grants	10	12	8	10	3
Other level government payments	2	4	5	7	0
Foreign financial assistance	28	28	50	160	506
Expenditure	1801	2022	2213	2639	3221
Non-capital expenditure	1619	1806	1989	2391	2792
Current expenditure	735	829	945	1119	1281
Wages and salaries	345	394	457	531	557
Interest payments	50	47	51	57	69
Subsidies and grants	835	930	993	1215	1442
Other non-capital expenditure	0	0	0	0	0
Capital expenditure	182	216	223	248	429
Investment	116	127	110	108	258
Net lending	-3	-17	-3	-30	-20
Fiscal surplus(+)/ deficit(-)	-102	-130	-102	-79	-135
		(In percent of GDP)			
Revenue	32.8	32.9	33.3	34.4	36.5
Tax revenues	28.1	28.1	28.2	27.5	26.8
Corporate income tax	1.9	1.9	1.5	1.7	1.8
Income tax and social security contributions	14.8	14.9	14.7	14.6	13.9
Taxes on goods and services	10.2	10.1	10.9	10.1	10.2
Other taxes	1.2	1.1	1.1	1.0	0.9
Non tax revenues	2.2	2.3	2.4	2.7	2.1
Self-earned revenue	1.8	1.8	1.8	1.7	1.6
Grants	0.2	0.2	0.1	0.1	0.0
Other level government payments	0.0	0.1	0.1	0.1	0.0
Foreign financial assistance	0.6	0.5	0.8	2.2	6.0
Expenditure	34.8	35.5	35.0	35.9	38.3
Non-capital expenditure	31.3	31.7	31.5	32.5	33.2
Current expenditure	14.2	14.6	14.9	15.2	15.2
Wages and salaries	6.7	6.9	7.2	7.2	6.6
Interest payments	1.0	0.8	0.8	0.8	0.8
Subsidies and grants	16.1	16.3	15.7	16.5	17.1
Other non-capital expenditure	0.0	0.0	0.0	0.0	0.0
Capital expenditure	3.5	3.8	3.5	3.4	5.1
Investment	2.2	2.2	1.7	1.5	3.1
Net lending	-0.1	-0.3	0.0	-0.4	-0.2
Fiscal surplus(+)/ deficit(-)	-2.0	-2.3	-1.6	-1.1	-1.6
Memorandum items:					
Primary balance	-1.0	-1.5	-0.8	-0.3	-0.8
Government debt	712.9	756.1	846.3	975.0	...
as a percentage of GDP	13.8	13.3	13.4	13.2	...

Sources: Ministry of Finance; and Fund staff estimates.

Table 5. Latvia: Vulnerability Indicators for Emerging Market Economies, 2004

	Exchange Rate Regime	Saving	Investment	Current Account Balance	External Debt: Gross	External Debt: Of which Nonresident Deposits	External Debt: Net	Official Reserve Coverage of: Imports (in months)	Official Reserve Coverage of: Gross External Requirement 1/	Official Reserve Coverage of: Short-term Debt at Remaining Maturity	Official Reserve Coverage of: Short-term Debt at Remaining Maturity and Foreign Currency Deposits of Residents
		(In percent of GDP)							(In percent)		
Baltics											
Estonia	Currency board in ERM2	19	29	-13.8	76	-	25	2.6	73	61	40
Latvia 2/	Euro peg with ±1 percent band in ERM2 3/	19	30	-12.3	85	41	26	3.3	36	29	23
Lithuania	Currency board in ERM2	15	21	-9.5	43	9	29	3.5	41	48	32
Central European Countries											
Czech Republic	Managed float	23	27	-5.1	36	-	-	4.6	74	159	110
Hungary	Euro peg with ±15 percent band	17	23	-9.1	63	-	-	2.8	77	176	-
Poland	Independent float	18	19	-1.6	49	-	-	4.6	99	170	107
Slovak Republic	Managed float	24	26	-3.1	45	-	-	5.5	95	120	110
Other Emerging Markets											
Chile	Independent float	23	20	2.5	47	-	-	6.5	74	113	82
Malaysia 4/	Dollar peg	35	20	13.4	43	-	-	6.8	-5557	462	443
Mexico	Independent float	20	21	-1.1	25	-	-	5.2	143	157	129
Thailand	Managed float	31	25	4.4	30	-	-	5.6	72	234	214

Sources: WEO; IFS; and Fund staff estimates.

1/ Current account deficit plus amortization of external debt.

2/ Official reserves and banks' liquid foreign currency-denominated assets cover about 75 percent of short-term debt at remaining maturity and foreign currency deposits.

3/ Since end-April 2005.

4/ The large negative value reflects Malaysia's negative gross external financing requirement (owing to a large current account surplus) and very high level of reserves.

Table 6. Latvia: Macroeconomic Framework, 2000-10
Baseline and Phased-Adjustment Scenarios
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
						Staff Projections					
Baseline scenario											
Investment	23.4	26.9	26.8	28.8	32.3	31.1	30.9	31.0	31.2	31.3	31.4
Private	19.7	23.4	23.0	25.3	29.0	26.4	26.3	26.5	26.5	26.7	26.9
Public	3.8	3.5	3.8	3.5	3.4	4.7	4.6	4.5	4.7	4.6	4.6
Domestic saving	19.3	19.8	20.3	21.3	21.1	23.8	23.9	24.4	24.7	25.0	25.0
Private	18.1	18.2	18.8	19.4	18.8	20.0	20.0	20.4	20.5	20.9	20.7
Public	1.2	1.6	1.5	1.9	2.3	3.8	3.8	4.0	4.2	4.2	4.3
Foreign saving 1/	4.2	7.1	6.5	7.5	11.3	7.3	7.0	6.6	6.5	6.3	6.5
Memorandum items:											
Fiscal balance 2/	-2.6	-2.0	-2.3	-1.6	-0.8	-0.8	-0.7	-0.6	-0.5	-0.4	-0.3
Net foreign direct investment	5.2	1.4	2.7	2.4	4.0	4.0	4.2	3.8	3.7	3.6	3.7
External debt											
Gross	61.0	68.9	73.6	80.0	93.2	98.4	100.1	102.3	104.8	106.5	107.6
Net 3/	12.4	18.2	20.6	23.5	29.9	35.2	38.5	41.7	44.8	47.3	49.4
GDP real growth (year-on-year in percent)	6.9	8.0	6.4	7.5	8.5	7.8	6.8	6.0	6.0	6.0	6.0
CPI inflation (average, year-on-year in percent)	2.6	2.5	1.9	2.9	6.3	6.3	5.1	4.2	3.3	2.9	2.7
Phased-adjustment scenario											
Investment	23.4	26.9	26.8	28.8	32.3	31.2	30.8	30.8	30.8	30.6	30.3
Private	19.7	23.4	23.0	25.3	29.0	26.5	26.2	26.2	26.0	26.0	25.7
Public	3.8	3.5	3.8	3.5	3.4	4.7	4.6	4.5	4.7	4.6	4.6
Domestic saving	19.3	19.8	20.3	21.3	21.1	23.9	24.1	24.7	25.0	25.3	25.8
Private	18.1	18.2	18.8	19.4	18.8	19.7	19.6	19.9	19.9	20.1	20.4
Public	1.2	1.6	1.5	1.9	2.3	4.2	4.5	4.8	5.1	5.2	5.4
Foreign saving 1/	4.2	7.1	6.5	7.5	11.3	7.3	6.7	6.0	5.8	5.3	4.5
Memorandum items:											
Fiscal balance 2/	-2.6	-2.0	-2.3	-1.6	-0.8	-0.5	-0.1	0.2	0.4	0.6	0.8
Net foreign direct investment	5.2	1.4	2.7	2.4	4.0	4.0	4.2	3.8	3.8	3.6	3.7
External debt											
Gross	61.0	68.9	73.6	80.0	93.2	98.6	100.2	101.3	101.6	100.4	98.3
Net 3/	12.4	18.2	20.6	23.5	29.9	35.3	38.4	40.7	42.4	43.1	42.8
GDP real growth (year-on-year in percent)	6.9	8.0	6.4	7.5	8.5	7.5	6.2	5.8	6.0	6.5	6.5
CPI inflation (average, year-on-year in percent)	2.6	2.5	1.9	2.9	6.3	6.0	4.5	3.0	2.7	2.5	2.5

Sources: Latvian authorities; and Fund staff estimates.

1/ Defined as the sum of the current account deficit and the capital account deficit.
2/ Includes 2nd pillar contributions. Accrual basis.
3/ Includes gross official reserves and banks' liquid foreign-currency assets.

Table 7. Latvia: External Sustainability Framework, 1999-2010

(In percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004	Projections 2005	2006	2007	2008	2009	2010
External gross-debt	68.9	73.6	80.0	93.2	98.4	100.1	102.3	104.8	106.5	107.6
External net-debt (includes gross official reserves)	18.2	20.6	23.5	29.9	35.2	38.5	41.7	44.8	47.3	49.4
Change in external gross debt	7.8	4.7	6.4	13.2	5.2	1.7	2.2	2.5	1.7	1.1
Identified external debt-creating flows (4+8+11)	0.8	-3.1	-7.8	-7.5	-6.5	-6.0	-5.1	-4.5	-4.9	-4.9
Current account deficit, excluding interest payments	5.7	4.4	5.8	10.0	8.6	7.5	6.6	6.5	6.1	6.3
Deficit in balance of goods and services	10.2	9.7	12.1	15.1	15.5	14.7	14.0	13.0	12.1	11.5
Exports	42.3	39.5	40.0	41.8	44.3	44.6	45.5	46.8	48.0	49.2
Imports	52.5	49.2	52.2	56.9	59.8	59.3	59.5	59.8	60.0	60.8
Net non-debt creating capital inflows (negative) 1/	-2.9	-2.7	-3.6	-4.6	-4.8	-5.0	-4.6	-4.6	-4.5	-4.5
Net foreign direct investment, equity	2.8	2.7	1.9	3.0	3.2	3.5	3.1	3.1	3.0	3.2
Net portfolio investment,equity	0.1	0.0	1.8	1.6	1.6	1.5	1.5	1.5	1.5	1.4
Automatic debt dynamics 2/	-2.0	-4.8	-10.0	-12.9	-10.4	-8.4	-7.1	-6.3	-6.5	-6.6
Denominator: $1+g+\rho+g\rho$	1.1	1.1	1.2	1.2	1.2	1.1	1.1	1.1	1.1	1.1
Contribution from nominal interest rate	1.8	2.5	2.3	2.1	2.1	2.2	2.2	2.3	2.3	2.3
Contribution from real GDP growth	-4.6	-4.0	-4.6	-5.5	-6.3	-6.0	-5.4	-5.6	-5.8	-5.9
Contribution from price and exchange rate changes 3/	0.8	-3.3	-7.8	-9.4	-6.2	-4.7	-3.9	-3.0	-3.1	-3.1
Residual, incl. change in gross foreign assets and exchange-rate valuation effects(2-3) 4/	7.0	7.9	14.3	20.7	11.8	7.6	7.3	7.0	6.6	6.0
Gross external debt-to-exports ratio (in percent)	162.9	186.5	199.9	222.8	222.0	224.5	224.6	223.8	222.1	218.6
Net external debt-to-exports ratio (in percent)	43.1	52.1	58.8	71.5	79.5	86.4	91.7	95.7	98.6	100.3
Gross external financing need (in billions of US dollars) 5/	4.1	4.4	6.2	8.9	10.8	12.8	14.6	16.7	18.8	21.1
in percent of GDP	50.4	46.3	53.0	62.6	69.1	72.8	75.3	78.8	81.3	83.6
Key Macroeconomic and External Assumptions										
Real GDP growth (in percent)	8.0	6.4	7.4	8.5	7.8	6.8	6.0	6.0	6.0	6.0
GDP deflator in US dollars (change in percent)	-1.4	5.1	11.8	13.4	7.1	5.0	4.0	3.0	3.0	3.0
Nominal external interest rate (in percent)	3.1	4.0	3.8	3.3	2.6	2.5	2.5	2.4	2.4	2.4
Growth of exports (GNFS in US dollar terms, in percent)	4.7	10.4	23.7	27.5	16.7	12.8	12.6	12.2	11.9	12.0
Growth of imports (GNFS in US dollar terms, in percent)	9.4	10.9	29.3	33.0	15.8	11.3	10.7	9.6	9.6	10.5

II. Stress Tests for External Gross Debt

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
1. GDP growth, interest rate, deflator, non-interest curr.acc., and non-debt inflows are at historical average in 2005-2010		73.6	80.0	93.1	99.1	100.4	101.3	101.7	101.8	101.2
2. Nominal interest rate is at historical average plus 4 percentage points in 2005 and 2006		73.6	80.0	93.1	102.3	108.1	109.8	111.8	113.1	113.8
3. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006		73.6	80.0	93.1	100.2	103.0	105.0	107.3	108.9	109.9
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006		73.6	80.0	93.1	111.4	125.7	126.1	127.1	127.5	127.2
5. Non-interest current-account deficit is at historical average plus two standard deviations in 2005 and 2006		73.6	80.0	93.1	96.3	97.2	99.6	102.3	104.2	105.4
6. One time 15 percent nominal depreciation in 2005		73.6	80.0	93.1	113.9	114.3	115.6	117.2	118.2	118.6

III. Stress Tests for External Net Debt

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
1. GDP growth, interest rate, deflator, non-interest curr. acc., and non-debt inflows are at historical average in 2003-2008		20.6	27.0	40.1	46.1	47.4	48.3	48.7	48.8	48.2
2. Nominal interest rate is at historical average plus three percentage points in 2004 and 2005		20.6	27.0	40.1	49.2	55.1	56.7	58.8	60.1	60.8
3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005		20.6	27.0	40.1	47.2	50.0	52.0	54.3	55.9	56.9
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2004 and 2005		20.6	27.0	40.1	58.3	72.6	73.0	74.1	74.4	74.2
5. Non-interest current account is at historical average minus two standard deviations in 2004 and 2005		20.6	27.0	40.1	43.2	44.2	46.6	49.3	51.2	52.4
6. One time 15 percent nominal depreciation in 2004		20.6	27.0	40.1	60.9	61.3	62.5	64.2	65.2	65.5

Historical Statistics for Key Variables (past 3 years) 6/	Historical Average	Standard Deviation
Current account deficit, excluding interest payments	5.7	1.5
Net non-debt creating capital inflows	2.8	0.6
Nominal interest rate (in percent)	3.3	0.5
Real GDP growth (in percent)	6.0	2.2
GDP deflator in US dollars (change in percent)	1.9	3.5

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

2/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (in

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

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

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

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

Table 8. Latvia: Selected Banking Indicators by Type of Bank, 2002–04
(In percent; unless otherwise stated)

	Banks Dealing with NRDs 1/		Other Banks	
	2002	2004	2002	2004
Own capital/Total own capital of the banking system	40.4	44.0	59.6	56.1
Assets/Total assets of the banking system.	50.5	48.7	49.5	51.3
Net foreign assets, mln lats	-126.7	-238.8	-299.0	-1031.5
Total reserves/total deposits.	24.5	20.9	5.9	4.2
Loans (banks and non-banks; residents only) / total assets	23.9	24.9	68.1	76.7
Loans (banks and non-banks; total)/total assets	68.7	76.9	77.6	83.8
Credit to nongovernment (banks and non-banks; residents only)/GDP	8.3	12.5	24.6	40.3
Credit to nongovernment (non-banks; residents only)/GDP	7.3	10.9	23.0	38.7
Liquidity test 2/	56.9	56.8	-2.2	-36.7
Capital adequacy ratio 3/	12.9	12.6	13.2	11.1
Nonperforming loans/total loans	3.2	1.5	1.4	1.0
Loan-loss provisioning/total loans	2.3	1.7	1.2	0.9
Return on equity 4/	13.8	21.0	19.4	21.9
Return on assets	1.1	1.7	2.0	1.8
Net commissions from operations with non-residents/total profits	91.3	64.4	5.0	3.5
Profits from Forex Transactions/total profits	50.3	44.0	28.3	22.1

Source: Latvian authorities.

1/ Banks for which non-resident deposits account for more than 20 percent of their liabilities.

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

3/ End-December values based on nonaudited financial statements.

4/ Return on equity is defined as the ratio of profits to the value of bank-issued equity.

Latvia: Fund Relations
(As of May 31, 2005)

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	126.76	99.97
Reserve position in Fund	0.06	0.04

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

IV. **Outstanding Purchases and Loans:** None

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:** None

VII. **Exchange Arrangements:**

The currency of Latvia is the lats, which was introduced in March 1993 to replace the Latvian ruble. The exchange rate was pegged to the SDR from February 1994 to December 2004, within a ±1 percent band. On January 1, 2005, the lats was repegged to the euro and on April 29, 2005, Latvia entered ERM2, maintaining the previous band width. Latvia's exchange system is free of restrictions on the making of payments and transfers for current international transactions. Latvia maintains bilateral payments agreements with Azerbaijan and Kazakhstan (reported as "inoperative"), and has notified the Fund under Decision No. 144-(52/51) that it has introduced measures to freeze accounts of members of Al-Qaeda, the Taliban and other terrorist groups in accordance with UN Security Council Resolutions Nos. 1267 (1999), 1333 (2000) and 1390 (2002).

VIII. **Article IV Consultation:**

Latvia is on the 12-month consultation cycle.

The 2004 Article IV staff report was issued on July 16, 2004 (IMF Country Report No. 04/260). The last Article IV Board discussion took place on August 4, 2004. The Public Information Notice No. 04/85 was released on August 6, 2004.

IX. FSAP Participation and ROSCs:

A joint World Bank-International Monetary Fund mission conducted an assessment of Latvia's financial sector as part of the Financial Sector Assessment Program (FSAP) during February 14–28, 2001. The Financial Sector Stability Assessment (FSSA) report (IMF Country Report No. 02/67) was discussed at the Board on January 18, 2002, together with the 2001 Article IV staff report (IMF Country Report No. 02/10).

ROSC Modules

Standard/Code assessed	Issue date	Document number
Code of Good Practices on Fiscal Transparency	March 29, 2001	www.imf.org
Code of Good Practices on Transparency in Monetary and Financial Policies	January 2, 2002	IMF Country Report No. 02/67
Basel Core Principles for Effective Banking Supervision	January 2, 2002	IMF Country Report No. 02/67
CPSS Core Principles for Systemically Important Payment Systems	January 2, 2002	IMF Country Report No. 02/67
IOSCO Objectives and Principles of Securities Regulation	January 2, 2002	IMF Country Report No. 02/67
IAIS Core Principles	January 2, 2002	IMF Country Report No. 02/67
OECD Corporate Governance Principles	January 2, 2002	IMF Country Report No. 02/67
Data Module	June 23, 2004	IMF Country Report No. 04/185

X. Technical Assistance:

Technical Assistance from the Fund, 1999–2002

DEPT	Project	Action	Timing	Counterpart
MAE	Banking Supervision	Mission	October 1999	Bank of Latvia
STA	Balance of Payments	Long-term Expert	October 1999 to October 2000	Bank of Latvia/Central Statistical Bureau

TECHNICAL ASSISTANCE FROM THE FUND, 1999–2002

MAE	Banking Supervision	Short-term Expert	April 2000	Bank of Latvia
MAE	Banking Supervision	Short-term Expert	June 2000	Bank of Latvia
FAD	Expenditure Policy	Mission	June 2000	Ministry of Finance
FAD	Tax Policy	Mission	July 2002	Ministry of Finance
STA	Monetary and Financial Statistics	Mission	July 2003	Bank of Latvia
FAD	Budget Reforms	Mission	January 2004	Ministry of Finance

XI. **Resident Representative:**

The resident representative office was closed in December 2004.

XII. **Fourth Amendment:**

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

Latvia: Financial Soundness Indicators and Financial System Structure, end-2004

(in percent; unless otherwise stated)

Financial Soundness Indicators	
Deposit-taking institutions (Banks)	
Regulatory capital to risk-weighted assets	11.7
Regulatory Tier 1 capital to risk-weighted assets	10.4
NPL net of provisions to capital	0.1
NPL to total gross loans	1.1
Sectoral distribution of loans to total loans (in percent of total loans)	
Central government	0.0
Local government	1.5
Financial institutions	8.5
Public enterprises	2.0
Private enterprises	44.4
Private persons	29.9
Non-profit institutions servicing private persons	0.4
Non-residents	13.2
ROA	1.7
ROE	21.4
Interest margin to gross income	36.6
Noninterest expenses to gross income	55.1
Liquid assets to total assets	33.7
Liquid assets to short-term liabilities	68.7
Net open position in foreign exchange to capital	5.4
Corporate Sector	
Total debt to equity	127
ROE	15.9
Earnings to interest and principal expenses	332
Corporate net foreign exchange exposure to equity	N/A
Number of applications for protection from creditors	958
Deposit-taking institutions (Banks)	
Capital to assets	8.0
Geographical distribution of loans to total loans, in million lats	
LR residents	3797.8
EU-15	74.1
USA	94.4
CIS	51.4
EU-10	264.7
Other non-residents	95.2
Gross asset position in financial derivatives to capital	0.9
Gross liability position in financial derivatives to capital	2.3
Large exposures to capital	178
Trading income to total income	9.0
Personnel expenses to noninterest expenses	24.5
Spread between reference lending and deposit rates (percentage points)	3.54
Spread between highest and lowest interbank rate (percentage points)	0.19
Customer deposits to total (non-interbank) loans	116.4
Foreign currency-denominated loans to total loans	65.8

Foreign currency-denominated liabilities to total liabilities	70.9
Net open position in equities to capital	19.6
Market liquidity	
Average bid-ask spread in the securities market	0.84
Average daily turnover ratio in the securities market	0.27
Other financial corporations	
Assets to total financial system assets	5.6
Assets to GDP	10.4
Households	
Household debt to GDP	18.7
Household debt service and principal payments to income	0.9
Real estate markets	
Real estate prices	107
Residential real estate loans to total loans	20.3
Commercial real estate loans to total loans	11.5
Financial System Structure	
Number	
Banks	22
Private commercial	13
State-owned	1
Foreign-owned subsidiaries	8
Branches of foreign banks	1
Securities companies:	
Investment management companies	10
Investment funds	15
Investment plans	19
Investment brokerage firms	6
Life insurance companies	5
General insurance companies	12
Other credit institutions (credit unions)	32
Pension funds	5
Pension plans	12
Concentration 1/	
Banks	8
Securities companies	
Investment management companies	5
Investment funds	5
Investment plans (incl. State Treasure)	3
Investment brokerage firms	3
Life insurance companies	3
General insurance companies	6
Pension funds	3
Pension plans	2
Assets (in millions of lats)	
Banks	7,452
Private commercial	3,722

State-owned	317
Foreign-owned subsidiaries	3,413
Branches of foreign banks	399
Securities companies	
Investment management companies	2
Investment funds	36
Investment plans (incl. State Treasury)	48
Investment brokerage firms	5
Life insurance companies	30
General insurance companies	126
Other credit institutions (credit unions)	5
Pension funds	1
Pension plans	26
Deposits in millions of lats	
Banks	4,973
Private commercial	2,934
State-owned	163
Foreign-owned subsidiaries	1,877
Branches of foreign banks	121

Sources: Bank of Latvia; and FCMC.

1/ Number of largest institutions that collectively comprise 75 percent of total assets.

Latvia: Follow-up on Key Recommendations of the 2001 FSAP

RECOMMENDATIONS	ACTIONS TAKEN (as reported by the authorities)
Priority policies	
FCMC establishment: Communications with staff and commercial banks should be strengthened, and procedures should be introduced for the smooth transition of deposit insurance to the Financial and Capital Market Commission (FCMC). The authorities should more clearly define the role and responsibilities of the deposit insurance agency within the FCMC, and ensure that there is no conflict of interest between the responsibilities of the deposit insurance fund and the larger goals of the supervisory agency. Initiate a change management program (hire human relations experts, form joint teams, etc.). Prepare for the internal organization of the FCMC by formulating internal procedural rules, sign off procedures and job descriptions. Strengthen independence and accountability through legal amendments to the law governing the FCMC, and harmonize legislation and supervisory methods.	Internal policies and procedures have been formulated. ISO 9001:2000 granted on 7 May 2003, confirmed annually. Organisational structure is established along functional lines. Legislation and supervisory methods are harmonized across sectors.
Strengthen accountability and appoint members of the Consultative Council (preferably full-time professionals not connected to a particular financial institution) and determine its operating mechanisms. Define short- and long-term objectives of the FCMC.	Pursuant to the Law on the Financial and Capital Market Commission, the Consultative Council is formed on a parity basis from representatives of the FCMC and professional associations of financial and capital market participants. Strategy was adopted by the FCMC Board. Annual action plans are approved by the Board and reviewed quarterly.
Insurance: Details on Policyholder Protection Plans for insurance policy holders should be disclosed to the public before the plan goes into effect on 1 July 2001.	Respective amendments to the Law on Insurance Companies and Supervision Thereof are implemented.
SMC: The Securities Market Commission (SMC) should be exempted from the new civil service conversion law.	Non-applicable.
Policies for the short to medium term	
FCMC establishment: Implement the change management program (appoint a PR firm, harmonize salaries, etc.). Implement internal organizational measures (form an International Affairs Division, nominate lead specialist staff) and formulate a strategic plan. Sign Memoranda of Understanding between FCMC, and both the BoL and MoF.	The change management program was successfully implemented. MoU was signed with the BoL and is reviewed regularly. Cooperation between BoL, FCMC and MoF is prescribed by legislation. A Memorandum of Understanding on co-operation in financial crisis situations between the banking supervisory authorities, the central banks and the Finance Ministries of the European Union is under preparation.

RECOMMENDATIONS	ACTIONS TAKEN (as reported by the authorities)
Legal framework: Indemnity should be provided for supervisory staff acting in good faith in the normal discharge of their functions and powers. Adopt legislation to transform court bailiffs into an independent legal profession. Train and appoint additional judges, and improve the infrastructure and security of court buildings.	Indemnity is provided to supervisory staff acting in good faith (Law on Credit Institutions, Art. 111 (5), Law on Insurance Companies and Supervision Thereof, Art. 110^2, Financial Instruments Market Law, Art 5)
Monetary policy: As planned, the BoL should reduce—with the aim of eventually eliminating—its long-term swap facility, given its effect on the level of usable reserves and given recent growth in long-term financial instruments.	In 2002, the Bank of Latvia eliminated the long-term swap facility.
Payment systems: The BoL should publicly disclose its payment system roles and the major policies it will follow to achieve its objectives. The BoL law makes the BoL responsible for the payment system but does not explicitly provide any mechanism by which such responsibility may be exercised. It is recommended that the BoL be given such explicit oversight responsibility. The planned amendments to the Credit Institutions Law that address the legal uncertainty associated with the finality of settlements should be adopted.	On 13 September 2001, the Council of the Bank of Latvia approved "Bank of Latvia's Payment Systems Policy" (Resolution No. 89/10) that contains the Bank of Latvia's objectives and role in the field of payment systems as well as oversight principles. The "Bank of Latvia's payment systems policy" is disclosed publicly by the publication of report on oversight of payment systems in Latvia in 2002. The "Law on Settlement Finality in Payment and Financial Instruments' Settlement Systems" was approved by the parliament on December 11, 2003 and has been effective from May 1, 2004. This law addresses all issues related to the finality of settlements.
Money laundering: The enforcement of anti-money laundering laws and regulations needs to be strengthened. There is scope to strengthen cooperation between banking supervision and the Money Laundering Board. Procedures could be re-examined and the fines for not reporting financial transactions increased.	On 27 January 2005, a new Advisory Board was created which is led by the Prime Minister (Board members are the Minister of Finance, the Minister of the Interior, the Minister of Justice, the Prosecutor General, the Chief Justice of the Supreme Court, the President of the Central Bank, the Chairman of the Financial and Capital Market Commission) in order to set up priorities in the AML area at the political level. Also amendments to the Law on Prevention of Laundering of Proceeds Derived from Criminal Activity are prepared ahead of time to fully comply with the requirements of the EU's third Anti-money Laundering Directive.
Securities markets: Insider trading and market manipulation should be made a criminal violation and the level of fines adjusted to provide for mandatory disgorgement of profits. Legal insider buying and selling should be disclosed to the market.	Criminal Code provides sanctions for insider trading and market manipulation. According to Article 193 of the Criminal Code, for a person, who acquires or disposes of a financial instrument on one's own or other person's behalf using the inside information or engages in the market manipulation, the applicable sentence is deprivation of liberty for a term not exceeding 10 years or a fine not exceeding two hundred times the minimum monthly wage prescribed in the Republic of Latvia at the time of the judgment,

RECOMMENDATIONS	ACTIONS TAKEN (as reported by the authorities)
	with or without confiscation of property. According to Article 86 of the Law on the Financial Instruments Market, persons included in the issuer's list of holders of inside information shall submit, within three business days of making a transaction in an issuer's financial instruments, a written notification to this effect to the respective market organizer. The market organizer shall post this information on its Internet homepage without delay.
Non-life insurance: As the volume of business grows, calculation of technical provisions for non-life insurance should be subject to certification by an actuary.	Article 49, Paragraph four of the Law on Insurance Companies and Supervision Thereof stipulates that a non-life insurance company engaged in any class of civil liability insurance shall append an actuarial valuation to an annual report, the volume and structure of which is determined by the respective FCMC regulations.
Pension reform: The FCMC should prepare itself for the licensing and supervision of second pillar private pension funds.	FCMC Regulations on Licensing of Managers of State-funded Pension Schemes and Regulations on Preparation of Reports of Managers of State-funded Pensions Schemes have been adopted, a system of on-site examination and off-site monitoring established.
SME financing: The authorities should improve the administration of, and increase the coordination between, the government funds that support SME development.	
Corporate governance: Sufficient funding should be made available to increase the re-registration of enterprises in the Enterprise Register as soon as possible.	This recommendation is no longer relevant since the reform of the Commercial Law is over: January 3, 2005 was the last date when companies/commercial enterprises to which the reform of the Commercial Law applies could submit to the Register of Enterprises (RE) documents to re-register in the Commercial Registry. The overall Commercial Law reform was financed from the state budget and with that financing the RE ensured the following measures regarding re-registration: - carrying out informative seminars to enterprises; - placing extensive information on the RE's homepage in the internet; - providing information to mass media; - distributing methodological materials via other information channels.
Issues for close watch or for the longer term	
Current account: The authorities should continue to closely monitor developments in the current account, especially given the possible slowdown in global economic activity.	Despite robust export development, high domestic demand has induced rapid import growth and deterioration of the foreign trade balance and the current account deficit in 2004. As further acceleration of the domestic demand facilitated by the growth of

RECOMMENDATIONS	ACTIONS TAKEN (as reported by the authorities)
	lending could trigger upward risk to external imbalances, the BoL's Council decided to tighten monetary policy stance in 2004. Measures taken with a view to reduce macroeconomic risks included a rise of the refinancing rate by one percentage point to 4%, an increase of the reserve requirement for financial institutions by one percentage point to 4% and an extension of the minimum reserve base including in the reserve base the financial institutions' liabilities to foreign banks with an agreed maturity or redeemable at notice of up to 2 years. The BoL is committed to conduct a careful analysis of macroeconomic trends also in the future and, if required, to use instruments at its disposal to ensure macroeconomic stability.
Bank lending: The authorities should continue to closely monitor the fast growth of bank lending for signs that imprudent lending may be taking place.	Banks' strategies, policies and risk management practices are examined; restrictions on lending are imposed when deficiencies are discovered (2 cases in 2003). About 50% of the loan portfolio is examined on-site. The assessment of the loan portfolio by supervisors is not materially different from that of banks. Off-site monitoring is enhanced through the introduction of a new detailed data system on banks' loan portfolio as from the 3rd quarter of 2004.
Insurance: There have been allegations that reinsurance is being used for tax evasion. The FCMC should study insurance practices relying on data collected from insurance companies.	Amendments to the Law on Insurance Companies and Supervision Thereof (Articles 60 and 60^1) define eligible reinsurers; provide the FCMC with powers to request a change in the placement of reinsurance or to ensure the meeting of reinsurance obligations by the reinsurer's pledge of monies transferred to the possession of the insurance company or the branch of the non-Member State in the amount of the technical provisions for reinsurance. If risks are transferred for reinsurance by using services of an insurance broker, the insurer is obliged to, prior to concluding a contract and during the whole period of validity of the contract, continually assesses the financial situation and reputation of the insurance broker. The insurer must have at its disposal documents showing the placement of reinsurance and the amount of the commission paid to the insurance broker.
Leasing: The FCMC should closely monitor the evolution of independent leasing companies and consider formal supervision over their operations.	Major leasing companies are subsidiaries of banks and are supervised on a consolidated basis.
Corporate governance: The authorities should consider developing detailed guidelines for both traded and non-traded companies on the structure and operation of committees within supervisory boards and minimum professional qualifications for supervisory board members.	<u>According to the Latvian Commercial Law:</u> (1) Only natural persons with the capacity to act may be council members. (2) The following may not be council members: 1) members of the board of directors, the auditor, proctor or commercial representative of the company; 2) members of the board of directors of any dependent company of the company or any person with the right

RECOMMENDATIONS	ACTIONS TAKEN (as reported by the authorities)
	to represent the dependent company. (3) The articles of association may specify stricter restrictions for council members. (4) The minimum number of council members shall be three, but if the stock of the company is in public circulation – the minimum number of council members shall be five. (5) The maximum number of council members shall be twenty. (6) A council member may not entrust to another person the performance of his or her duties. <u>According to the Credit Institution Law:</u> (1) The chairperson of the council and the members of the council of a bank may be persons who conform to the following requirements: 1) who are competent in issues of financial management; 2) who have the necessary education and three years professional work experience in an undertaking, organization or institution of relevant size; 3) who have an unimpeachable reputation; and 4) who have not had revoked the right of engaging in entrepreneurial activities. The chairperson of the council and the members of the council of a bank may not be persons: 1) who have been convicted of the intentional committing of a crime, including bankruptcy in bad faith; 2) who have been convicted of the intentional committing of a crime, even though released from serving the sentence because of a limitation period, clemency or amnesty; or 3) against whom criminal proceedings for the intentional committing of a crime have been terminated due to a limitation period or amnesty. (2) The meeting of stockholders has a duty on its own initiative or at the request of the Financial and Capital Market Commission to remove without delay from office the persons referred to in Paragraph one of this Section if they do not conform to the requirements specified in this Section. (Similar requirements for supervisory board members are included in other legislative acts and these apply to insurance companies, investment companies, securities market organizers and investment management companies.)

Latvia: Statistical Issues

1. The authorities have a very open and well-articulated data dissemination and publication policy. Most economic and financial statistics are reported to the Fund on a regular and timely basis, and many additional economic and financial aggregates are readily available on the websites of the Bank of Latvia (BoL) and Latvian government institutions and agencies. The authorities are reporting data for the Fund's *International Financial Statistics, Government Finance Statistics Yearbook*, the *Direction of Trade Statistics,* and the *Balance of Payments Statistics Yearbook*. Latvia has subscribed to the Special Data Dissemination Standard (SDDS) since November 1996 and meets SDDS specifications for the coverage, periodicity, and timeliness of the data, and for the dissemination of advance release calendars. Its metadata have been posted on the Fund's Dissemination Standards Bulletin Board (DSBB, http://dsbb.imf.org) since December 1997 and it has disseminated data on the reserves template since April 2000. There is increased cooperation on data issues between the Central Statistical Bureau (CSB), the BoL, the Ministry of Finance, and the customs authorities.

National accounts

2. The CSB compiles and publishes quarterly national accounts statistics using the production and expenditure approaches on a regular and timely basis, largely following the *1993 SNA* and *ESA 95*. However, there are significant discrepancies between the GDP estimates based on production and those based on expenditure. The underlying data for the production approach are obtained primarily through a comprehensive survey of businesses and individuals, and are supplemented by data from labor force surveys and from administrative sources. The CSB believes that the basic data understate economic activity, particularly in the private sector, and there is an ongoing effort to increase coverage. Official national accounts include an adjustment for under-recording, which the CSB currently estimates as 16 percent of total GDP. Additional data for the expenditure-based accounts are obtained from household budget surveys and other surveys from the State Treasury and ministries.

Prices

3. The CSB compiles a nationwide consumer price index. With Fund technical assistance, it has developed appropriate methodologies to deal with most of the technical problems resulting from the major structural shifts that have occurred in the economy. Reporting improved markedly during 1998, in part due to the implementation of a new household budget survey, based on World Bank technical assistance, enabling the CSB to compile indices for different types of households. Following advice from EUROSTAT, the weights in the CPI basket are now revised annually. The weights in the producer price index are updated annually and the index covers almost three quarters of total industrial activity. The CSB also publishes export and import unit value and volume indices.

Government finance statistics

4. 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

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

Balance of payments statistics

6. The BoL assumed responsibility for compiling the balance of payments statistics from the CSB in early 2000, and since 2001 has published monthly statistics based on source data derived from an international transactions reporting system (ITRS). These source data are being supplemented with the results of three quarterly surveys that were launched in 2000: non-financial enterprises, foreign direct investment and related income flows, and transportation services. An annual survey of other services will be launched beginning with data for 2002.

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

8. The trade account is affected by recording problems, and compilation of financial account transactions is hampered by inadequate sources. Merchandise trade data, based largely on customs data, underestimate imports and exports of about 140 Custom-bonded warehouses and three free trade zones. There is a need to improve procedures to ensure that goods passing through customs warehouses are properly valued. Coverage of exports to Russia and CIS countries is incomplete; and re-exports of cars and shuttle trade items are particularly difficult to capture. Estimates of travel credits and debits have been improved through a revised survey. In general, survey techniques need to be further improved. The BoL made methodological improvements in compiling statistics on private transfers and textile exports in 2002. The improvements in survey techniques related to private transfers better capture income that sailors and other Latvians repatriate to Latvia. Regarding textile

exports, the authorities found that many companies declared only the value added part of their processed textile exports, although they reported the full value of imported inputs. While these methodological improvements are welcome, no attempt has been made to revise earlier data. The resulting break in the data series hampers their usefulness for analysis. Debt data from Latvia's International Investment Position (IIP) show a more rapid buildup of debt than is indicated by the BOP statistics, and efforts are needed to explain and address this and other divergences between IIP and BOP data. These were among the issues addressed in a Data ROSC mission from the Fund in September 2003.

Latvia: Table of Common Indicators Required for Surveillance
As of June 27, 2005

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality Accuracy and reliability[8]
Exchange Rates	6/11/05	6/11/05	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	4/30/05	5/21/05	M	M	M		
Reserve/Base Money	4/30/05	5/21/05	M	M	M	O, O, LO, O	O, O, O, O, O
Broad Money	4/30/05	5/21/05	M	M	M		
Central Bank Balance Sheet	4/30/05	5/21/05	M	M	M		
Consolidated Balance Sheet of the Banking System	4/30/05	5/21/05	M	M	M		
Interest Rates[2]	2/28/05	3/17/05	M	M	M		
Consumer Price Index	May 2005	6/17/05	M	M	M	O, LO, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q1, 2005	04/30/05	Q	Q	Q	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Q1, 2005	4/30/05	Q	Q	Q		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	3/31/05	4/30/05	Q	Q	Q		
External Current Account Balance	Q4, 2004	3/30/05	Q	Q	Q	O, O, O, O	O, O, O, O, O
Exports and Imports of Goods and Services	Q4, 2004	3/30/05	Q	Q	Q		
GDP/GNP	Q4, 2004	3/15/05	Q	Q	Q	O, O, O, O	O, LO, LO, LO, LO
Gross External Debt	Q4, 2004	3/30/05	Q	Q	Q		

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

Statement by the IMF Staff Representative
July 27, 2005

1. This statement contains factual information that has become available since the Staff Report was circulated on July 14, 2004. This information does not materially alter the thrust of the staff appraisal.

2. The Bank of Latvia (BoL) raised banks' reserve requirements by 2 percentage points to 6 percent, with effect from late August 2005. According to the BoL, the decision was aimed at fostering macroeconomic stability by slowing bank lending and hence domestic demand. In addition, the BoL raised its inflation forecast for 2005 from 5 percent (year-average basis) to 6 percent in view of price developments during the first half of the year and projected increases during the second half. The BoL maintained its 2005 growth forecast at 7½ percent.

3. A high-level working group comprising the Finance and Economy Ministries and the BoL has been charged with formulating measures to bring down inflation. The measures are expected to be announced and, according to the Prime Minister, will include some "unpopular steps," including tax changes.

Statement by Jon A. Solheim, Executive Director for Republic of Latvia and Jelena Zubkova, Advisor to Executive Director July 27, 2005

On behalf of our Latvian authorities, we would like to thank staff for the valuable policy dialog on the key policy challenges facing Latvia on its way to economic transformation and towards euro introduction. Our authorities recognize that the strong economic development required for sustainable convergence with an average EU level and beyond contains risks and necessitates close monitoring and actions to address macroeconomic imbalances. By the accession to the ERM-2, our authorities have committed themselves to a sustainable reduction in inflation and containing external imbalances at a sustainable level. Although our authorities are in broad agreement with staff's analyses and recommendations, as outlined in the staff paper, our authorities and staff have in some areas different perspectives of the actual situation as well as the appropriate policy approach. This applies in particular to the somewhat different assessments of the extent to which output already for some time has been above potential, and the tradeoffs related to EU-financed spending. Accordingly, our authorities would like to underscore that the underlying factors behind the inflationary pressures remain mixed and that one-off supply factors make staff's conclusions on overheating of the Latvian economy less straightforward.

Economic developments and risks

Our authorities agree that domestic demand is the key driver of the strong economic activity. While domestic demand is driven by both consumption and investments, the growth is particularly strong for investments. The investment growth, in turn, builds up capacity and strengthens competitiveness, which is necessary for utilizing the possibilities provided by the EU accession. The sharp increase in manufacturing investments has expanded the supply side of the tradable sector, and the merchandise export growth (38 percent in the first five months of 2005) has recently significantly outpaced that of the import growth. The latest statistical data indicate that manufacturing activity after a temporary deceleration in the beginning of 2005 (reflecting the effects on the wood-processing sector of the January storm) is rebounding. All in all, our authorities project slightly lower GDP growth in 2005 than staff - or around 7.5 percent - which is broadly in line with the authorities' estimated potential GDP growth.

Although the rapid credit growth should be seen as part of the convergence of the Latvian economy and integration with EU's financial markets, our authorities acknowledge the risks. This is particularly related to the upward pressure on external accounts, while the impact on inflation appears more mixed. Our authorities share staff's view on the need to moderate credit growth, and are considering several tax-related and administrative measures to moderate credit growth.

Our authorities recognize the challenges related to increased inflationary pressures since 2004, but consider that the demand effects are somewhat overestimated by staff. One of the most influential factors behind the recent pick-up of inflation is the special increase in food prices, which was induced by the EU membership and a combination of other cost-push factors (surge in energy prices in combination with Latvia's relatively high energy intensity; increases in regulated prices; and harmonisation of indirect taxes). Notwithstanding that the Latvian core inflation is still relatively high (5.1 percent y-t-y in June 2005), it has shown a clear downward trend since end-2004. Moreover, even core inflation should not be regarded as solely demand-driven. Comprehensive analysis by the Bank of Latvia shows that the core inflation concept encompasses a range of supply-side factors, namely, indirect effects of oil and regulated prices, changes of indirect taxes and exchange rate as well as price convergence. Since food price equalisation is still ongoing and energy prices are on their way up, inflation is expected to average 6.0 percent in 2005.

Our authorities recognize the need to contain inflation expectations and to alleviate possible second round effects. An inter-institutional working group headed by the Ministry of Finance and composed of representatives of all the relevant ministries and the Bank of Latvia was, therefore, set up recently. The working group has submitted to the Cabinet a report on price developments and proposed measures to reduce inflation. The proposal includes measures to mitigate cost-push pressure on inflation, promote domestic competition and contain credit growth. The working group also considers direct measures, such as changes in indirect taxes. In light of our authorities' efforts to restrain inflationary pressures, average annual inflation is expected to fall to about 4 percent in 2006.

Fiscal policy

Our authorities remain fully aware of the role of fiscal policy in the promotion of macroeconomic stability, and agree with staff that the fiscal stance should be broadly neutral in light of the strong domestic demand. However, to achieve a substantial consolidation already in the course of the next few years may prove difficult due to the significant budget expenditures that will come from payments related to NATO, EU and required structural reforms. Moreover, in 2005 additional costs will be incurred by compensation to the agricultural sector created by extreme weather conditions. Given the difficult balance between future expenditure commitments, and securing a sustainable macroeconomic performance, our authorities will in the coming years aim at a budget deficit below 1.5 percent of GDP. The long-term objective of the government's medium term budgetary framework is a gradual reduction of the budget deficit towards a balanced budget. In this context, it should also be taken into account that the Latvian government has a long track record of cautious fiscal planning, resulting in regular undershooting of fiscal targets. This practice is expected to continue also in the future, implying that the fiscal outturn in 2005 and coming years could be markedly lower than budgeted.

Monetary and financial sector

Our authorities would like to reassure that the plans on euro introduction in 2008 are still high on their agenda, and they intend to make every effort to ensure compliance with the Maastricht criteria by mid-2007.
To mop up excess liquidity that could be used for lending, the Bank of Latvia on July 14, 2005 increased the reserve requirement for commercial banks from 4 percent to 6 percent

(effective August 24, 2005). The reserve base was previously extended to include resources acquired from non-resident banks, and this step will therefore influence both banks that acquire resources domestically and banks that raise funds abroad. To moderate the sharp credit growth, our authorities are currently considering a number of measures which could dampen the demand for loans. This would in turn contribute to reduce the demand pressures on inflation, reduce external imbalances and moderate net foreign debt growth.

Our authorities appreciate staff's evaluation of Latvia's efforts to strengthen the financial supervision. Our authorities concur with the importance of sound financial management, not least in light of the rapid credit growth, and will continue to improve the set of supervisory instruments. Even though financial stability indicators are published on an aggregate basis, they are monitored on individual basis, and our authorities will remain vigilant to the financial developments in individual banks. With regard to staff's concern about the recent relaxation of some prudential regulations, this should be seen in light of the continued evaluation of the financial soundness of individual banks and the level playing field in the EU context. Appropriate actions will be taken if risks to financial stability would emerge. In addition, the Latvian financial sector's risks and prudential policies should be viewed in the context of the strong presence of the European, especially Scandinavian, capital in the Latvian banking system.

Our authorities note staff's traditional concern about the high share of non-resident deposits in the Latvian banking system. In its latest published Financial Stability Report, The Bank of Latvia analyzed net assets and liabilities of resident deposit intensive (RD) and non-resident deposit intensive (NRD) banks. The analysis revealed significant differences between the two groups. RD banks attract funds available on the interbank market abroad, most notably from their parent banks and use them mostly for granting loans to resident non-banks. NRD banks mostly attract funds from non-resident non-banks and place a majority of them in foreign banks or securities. A minor part of the non-resident deposits was used for granting loans to residents. In 2004, NRD banks decreased the share of domestic loans financed by nonresident deposits, thus, reducing the liquidity risk. Past experience shows that non-resident deposit flights have been relatively small even during major unfavourable external developments (for example during the Russian crisis). Banks that were most severely affected by the outflows of NRDs managed quickly to convert even long-term external assets into liquidity. In addition, as for foreign indebtedness, NRD-intensive banks formed only 18.0 percent of total NFA of the commercial banks. The rest of the banks' foreign debt is due to parent banks borrowing, as well as syndicated loans from other foreign banks.

Structural issues

Staff argues that the current structure of the economy should be treated as a potential bottleneck to the medium term growth potential. Although some regional disparities are of concern, favourable structural changes that contribute to a build-up of productive capacity and strengthen the growth potential have taken place during the last years. There have been favourable changes in the investment structure, and in particular, investments are increasingly channelled in the tradable goods sector. Moreover, FDI has picked up after the EU accession and the share of greenfield investment projects has increased.

Our Latvian authorities recognize that threats to the economic development can be posed by structural impediments in the labor market, particularly workforce skills mismatches. Our authorities consider labor market flexibility as an important factor to ensure a smooth development of the Latvian economy, not least in light of the prospective accession to the EMU. Active labor market policies are addressing structural unemployment issues, and resources provided by EU funds will strengthen these activities. A substantial share of EU fund financing is earmarked for the development of human resources, and this will improve the quality of future labor supply. Furthermore, the Latvian Investment and Development Agency provides support to enterprises to strengthen their competitiveness and improve the workforce quality through active labor market initiatives, training, retraining and information dissemination.

Our authorities concur with staff that combating money laundering should be seen as an ongoing process. However, this has been the policy approach of our authorities, and all relevant EU legislation has been implemented. Latvia has already adopted the legislative provisions incorporating all FATF recommendations and fundamental AML/CFT principles (including know-your-customer principle and extended reporting of business and politically exposed persons, in accordance with the forthcoming Third EU Directive). In 2005, a number of specific measures were taken against some financial institutions by imposing fines, freezing accounts, applying enhanced supervision and even removing management. These results have been achieved by persistent efforts of the authorities and the financial institutions. In order to assess Latvia's progress, the authorities have requested AML/CFT ROSC in early 2006. In addition to AML/CFT, anti-corruption measures were addressed by strengthening of the independence of the Corruption Prevention and Combating Bureau and by implementing the medium term National Program for Corruption Prevention.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 05/109
FOR IMMEDIATE RELEASE
August 10, 2005

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

IMF Executive Board Concludes 2005 Article IV Consultation with the Republic of Latvia

On July 27, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Latvia.[1]

Background

During much of the past decade, Latvia's growth performance outstripped other new European Union (EU) members while inflation remained subdued. A sound policy framework and far-reaching structural reforms supported this performance, including a prudent fiscal policy that underpinned the exchange rate peg. These achievements were capped by Latvia's accession to the EU last year and, more recently, by ERM2 entry. Nonetheless, per capita GDP—at 40 percent of the EU-15 average in PPP terms—remains the lowest in the EU. Against the backdrop of an open trade and capital account regime, income convergence contributed to relatively large current account deficits, averaging 7¼ percent of GDP during 1996–2003, and sharply rising gross external debt, which reached 93 percent of GDP in 2004, though net debt remains a more modest 30 percent of GDP.

Economic growth picked up sharply in 2004 on very strong domestic demand, accompanied by a jump in underlying inflation and current account deficit. Investment and consumption were buoyed by expectations of sustained income convergence and declining real interest rates that

[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.

pushed GDP growth to 8½ percent. Unemployment continued to decline gradually, and is below 10 percent. Inflation rose to 6¼ percent and the current account deficit widened to 12⅓ percent of GDP in 2004, partly reflecting one-off factors related to EU accession and other supply shocks; but even excluding these effects, inflation and the current account deficit have increased, pointing to the presence of demand-induced imbalances. Private sector credit—particularly to households—continued to expand strongly, approaching 60 percent of GDP.

Latvia joined ERM2 at end-April 2005 at the prevailing exchange rate parity, having repegged from the IMF's Special Drawing Right (SDR) to the euro in January. Labor cost-based competitiveness was broadly unchanged in 2004 relative to the previous year, and considerably stronger than in earlier years. Rapid wage growth was compensated by strong productivity gains and a modest depreciation of the SDR-linked exchange rate. Exports of goods and services grew robustly in volume terms in 2004 and, together with a favorable terms of trade, further increased Latvia's export market share.

Booming bank credit added to demand pressures and macroprudential risks. With bank profits strong, nonperforming loans low and well provisioned, ready access to foreign financing, and capital adequacy—though moderating in recent years—well above the newly lowered minimum requirement of 8 percent of assets, banks faced few constraints in expanding their balance sheets. Mortgages continued to be the most dynamic segment. With most loans denominated in foreign currency, unhedged borrowers are exposed to exchange rate movements. Nonresident deposits—a significant funding source at many banks—represent more than half of total deposits, raising concerns about the growing shortfall between banks' liquid foreign assets and short-term foreign liabilities, as well as possible links with money laundering.

Macroeconomic policies sought to ease demand pressures in 2004. The general government deficit narrowed by ½ percentage point to 1.1 percent of GDP on stronger-than-budgeted revenues and lower spending than approved in the supplementary budgets. Monetary policy was tightened through an increase in the refinancing rate and a strengthening of mandatory reserve requirements, although real interest rates on lats-denominated bank loans declined. The repeg to the euro and ERM2 entry were effected smoothly and spreads on euro-denominated bonds have narrowed to 20 basis points.

Robust growth is expected to continue in 2005. The ongoing credit boom and faster real wage growth are expected to support private domestic demand while a sharp increase in net EU grants would also boost public spending, with growth reaching 7¾ percent, keeping output somewhat above potential. While inflation (on a 12-month basis) has remained on a downward track through mid-year reflecting the high base in early 2004, strong demand pressures and additional increases in energy prices will likely prevent a further decline in inflation in the second half of the year, with year-average inflation broadly unchanged relative to 2004. The current account deficit is expected to narrow to about 10½ percent of GDP on account of larger net EU transfers and the absence of bulky one-off investments that pushed up imports last year.

Executive Board Assessment

Executive Directors commended the strong performance of the economy, which had culminated in Latvia's admission to ERM2 earlier this year. They cautioned, however, that decisive and timely action to reduce inflation would be crucial to meeting the authorities' euro adoption timetable and, more generally, to preserving external competitiveness. While Directors generally considered rapid financial deepening and persistently large current account deficits to be broadly consistent with Latvia's stage of real convergence, they saw potential risks associated with these developments and welcomed the authorities' commitment to remain vigilant and to address these risks as needed.

Directors expected robust economic growth to continue in 2005. They attributed the increase in inflation in 2004 to both demand and supply factors. However, with growth remaining somewhat above potential and rising regulated and world energy prices, Directors saw inflation declining only marginally this year.

Given inflation inertia and overheating concerns, Directors called for macroeconomic policies to, at a minimum, avoid adding to demand pressures. In view of the pegged exchange rate, Directors considered fiscal policy to be the primary tool for ensuring macroeconomic stability. Directors also emphasized the need to moderate the recent pace of credit growth in order to subdue private demand and limit the buildup in macroprudential risks.

Directors considered that a broadly neutral fiscal stance for 2005 would balance the need to accommodate supply-enhancing EU-financed investment with that of containing the short-term demand effects of higher public spending. Directors welcomed efforts to contain the execution of the budget in 2004, but expected that the likely fiscal outturn in 2005—although significantly tighter than the approved budget—would add to demand pressures. To avoid a demand stimulus from fiscal policy, Directors urged the authorities to save the projected overperformance in revenue and hold fiscal spending excluding payments to the EU constant relative to GDP. Consistent with this, the size of the supplementary budget under preparation should be strictly limited.

Directors considered that fiscal consolidation over the medium term—beyond what is contemplated in the Convergence Program—was desirable to slow the build up in external debt. They welcomed recent improvements in medium-term budgeting associated with the tapping of EU funds and preparation of Convergence Programs. Notwithstanding the low level of Latvia's public debt, Directors also considered that medium-term fiscal adjustment would help to prefinance the cost of ongoing pension reform. Some Directors noted that some flexibility could be considered in the fiscal consolidation.

Directors, viewing rapid credit growth as adding to demand pressures, commended the Bank of Latvia's decision to raise interest rates and tighten reserve requirements over the past year. However, as Latvia's ERM2 entry further limits the scope for an independent monetary policy, Directors considered that the options for additional tightening had diminished, and they therefore called for other measures to moderate credit growth. In this regard, closing capital gains tax loopholes that could be fuelling the mortgage boom was seen as a priority. Directors also supported the authorities' intention to impose a temporary tax on mortgage borrowing if the pace of credit growth failed to moderate.

Directors considered that Latvia's external competitiveness remained adequate at present, and supported the decision to enter ERM2 at the prevailing euro-lats peg. However, Directors saw the recent acceleration of wages as a risk to future competitiveness. They therefore called for policies to contain wage and price inflation while preserving existing labor market flexibility.

Directors underscored the need for strong supervision and prudential safeguards in the present environment of very rapid credit growth. They welcomed recent improvements in monitoring and stress testing and the ongoing shift to euro-denominated borrowing in response to Latvia's repeg to the euro, but considered that the recent easing of prudential regulations amid the sustained credit boom could well exacerbate financial sector risks. They therefore urged continued close oversight of banks' credit standards and currency exposures, and maintenance of tighter loan conditions in situations of currency mismatch between borrowers' income and debt.

Directors recommended enhanced supervision of banks with substantial nonresident deposits. They considered that the recent outflows from a few small banks because of money laundering concerns attested to the risks associated with these deposits. Directors urged rigorous monitoring of large banks with substantial domestic and nonresident deposits to limit risks of contagion. Owing to the different profile of banks dealing with nonresident deposits, they also called for compiling macroprudential data separately for banks with and without substantial exposure to nonresident deposits.

Directors welcomed the recent antimoney laundering amendments and the authorities' request for an Anti-Money Laundering and Combatting the Financing of Terrorism (AML/CFT) Report on the Observance of Standards and Codes (ROSC). They stressed that strict implementation of the legal framework was critical for successfully combating money laundering. Directors urged that any remaining weaknesses identified by the ROSC be quickly addressed in order to safeguard Latvia's position as a regional financial center.

Directors encouraged the authorities to move ahead with structural measures to sustain vigorous growth. Efficiently allocating EU funds for infrastructure was seen as a key element of a framework for promoting efficient resource allocation, along with the authorities' continued reduction of corruption. Directors also called for removing constraints on effective labor supply by encouraging labor force participation through a narrowing of the tax wedge on low-wage earners, sharpening incentives to find employment, and by ensuring that the education system becomes more responsive to skill needs of employers.

Republic of Latvia: Selected Economic Indicators

	1999	2000	2001	2002	2003	2004
	Changes in percent					
Real Economy						
Real GDP	3.3	6.9	8.0	6.4	7.5	8.5
Unemployment rate (ILO, end of period)	14.5	14.6	12.8	11.6	10.3	10.1
Consumer price index (end of period)	3.2	1.8	3.2	1.4	3.6	7.2
	In percent of GDP					
Public Finance						
General government balance	-3.6	-3.0	-2.0	-2.4	-1.6	-1.1
Total government debt 1/	12.1	12.2	13.8	13.3	13.4	13.2
External government debt 1/	7.5	7.1	8.8	7.8	7.1	7.9
	End-period; changes in percent					
Money and credit						
Reserve money	11.6	7.7	8.8	22.4	6.8	18.6
Broad money	8.0	27.9	20.8	20.9	21.1	27.1
Domestic credit (non-government)	15.3	36.7	50.4	36.5	37.3	40.0
	In percent of GDP unless stated otherwise					
Balance of payments						
Trade balance	-15.4	-13.7	-16.4	-15.7	-18.1	-15.8
Current account balance	-9.7	-6.4	-8.9	-6.5	-8.6	-12.3
International reserves (in months of imports)	2.9	2.6	3.1	2.6	2.9	3.2
Exchange rate						
Exchange rate regime	Peg to the SDR 2/					
Exchange rate (lats per US$; period average)	0.585	0.607	0.628	0.618	0.571	0.540
Real effective exchange rate (2000 = 100) 3/	98.7	98.9	101.6	95.7	92.5	93.2

Sources: Latvian authorities and IMF staff estimates.
1/ Excludes government-guaranteed debt.
2/ On January 1, 2005 the lats was repegged to the euro.
3/ CPI-based, end-of-period.