Statement by Olli-Pekka Lehmussaari, Executive Director
for the Republic of Latvia
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My Latvian authorities wish to thank the staff team for their candid analysis of recent economic developments and balanced policy advice aimed at the reduction of potential risk to external sustainability. Last year was a difficult one for many countries affected by the Russian crisis. However, the Latvian government responded decisively by implementing a number of corrective measures and proved their ability to cope with external shocks in an efficient way. My authorities are delighted that constructive cooperation with Mr. Schiff and his team has developed into a number of important steps to promote economic development.

In May 2000, the Latvian Parliament gave its confidence to a new Government, which has a large parliamentary majority. In a few days a new Declaration on the government's work agenda based on the principle of *continuity* of policies was approved. The government is committed to speed up structural reforms and to continue fiscal consolidation.

Immediately after taking office the new government hosted the Annual Meeting of the EBRD in Riga – perhaps, the most notable financial event in the Baltics during the decade of transition. The EBRD decision to select Riga as the city for its Annual Meeting could be interpreted as an international appreciation of Latvia's progress in the final stage of transition. On the occasion of the Annual Meeting, the Prime Minister assured the business community that his Cabinet is determined to reinforce fiscal consolidation and to bring privatization to the completion point.

The Latvian authorities have put EU membership at the center of their economic and political agenda. Recently (end-March, 2000), in the framework of the EC-Latvia Joint Assessment of Economic Policy Priorities, the government adopted a new version of the medium term economic strategy, which fully corresponds with the program supported by the SBA. In June, during the meeting in Luxembourg, the provisional closing of the five chapters of *acquis communautaire* was confirmed. EU accession provides the strongest incentives for the continued implementation of the SBA supported program.

Recent economic developments and outlook

In 1999, the growth of the Latvian economy was roughly flat, but the economic rebound started to gain momentum in the fourth quarter of 1999. Fostered by export growth, GDP increased by 5.3 percent on a year-on-year basis in the first quarter of 2000, while inflation remained low. The unemployment rate fell to 8.8 percent in mid-May 2000, significantly below its peak of a year ago.

The current account deficit slightly decreased in 1999, and the overall balance of payments remains in surplus. In 1999, FDIs were sufficiently sizeable and, together with net portfolio investment, covered about 70 percent of the current account deficit. The external debt-to-GDP ratio stood at a relatively low level of 22 percent, of which the public debt-to-GDP ratio was only 12 percent. Short-term debt vis-à-vis reserves are at a comfortable level. Latvia is able to successfully compete in international markets. This view is underlined by an adequate level of external competitiveness, as measured by dollar wages, export market shares, and unit labor costs. The authorities will continue to monitor Latvia’s competitiveness.

The medium-term outlook is favorable. Economic growth in the EU and revitalization of CIS markets will help to maintain the export-led recovery in Latvia. The recent increase in domestic lending and the pace of structural reforms should promote investments and generate robust growth over the medium term. Inflation is expected to remain low. Faster growth should bring unemployment down.

The key challenge is to bring down the current account deficit, to attract more FDI, and to strengthen Latvian competitive capacity. The authorities are committed to implement the best possible “medicine” against potential external imbalances. Like the staff, they consider that fiscal tightening, coupled with structural reforms, is the only preventive measure to a potential risk to Latvia’s external sustainability.

Exchange rate and monetary policies

The fixed exchange rate policy has served Latvia well in bringing down inflation and creating a stable framework for economic growth. The authorities believe that the SDR peg has significantly enhanced the credibility of their anti-inflation policies and have no intention to alter it in the near future. They recognize the benefits of the euro peg, but a shift in the lats peg from the SDR to the euro should take place, at the earliest, at the time of Latvia’s accession to the EU. Joining the euro area will require Latvia’s membership in the ERM2 mechanism for two years.

Due to the fixed exchange rate regime, the monetary policy of the Bank of Latvia (BoL) incorporates all elements of the currency board arrangements (full backing of the monetary base, free convertibility of the national currency, automatic interventions). However, in its operational practice the BoL acts as a fully fledged central bank, managing the liquidity in the banking system by using its monetary policy instruments. Monetary policy instruments of the BoL are consistent with the monetary policy framework employed by the European System of Central Banks.

Starting from December 1999, the reserve requirement for credit institutions in Latvia was lowered by one percentage point (from 8 to 7 percent). Over the next 5-7 years the BoL intends to gradually lower the reserve requirement ratio to the 2 percent level set by the ECB. This move, on the one hand, is fully consistent with Latvia's integration strategy into the EU and, ultimately, the EMU. On the other hand, it will remove the burden placed on the banking system by reserve requirements which are not remunerated, thus facilitating the financial intermediation and enhancing the stability of the monetary policy pursued by the BoL. After the reserve requirement is brought in line with the ECB requirements it is not envisaged that it will be used as an active monetary policy instrument.

The BoL has always clearly demonstrated its determination to defend the currency and has by now established a high degree of credibility in the financial markets. The credibility in the central bank in Latvia is proved by the fact that there is practically no need of foreign exchange intervention in the BoL day-to-day operations, and the markets always calm down quickly after each shock. At the end of April 2000, net foreign assets of the BoL reached USD 881.2 million, which amounted to 105.8 percent of the monetary base. The amount of net foreign assets covered 3.7 months of imports.

In May 2000, BoL auctioned for the first time foreign exchange swaps with a maturity of two years to foster long-term lending in lats by commercial banks. The auctioned amounts were moderate and the overall amount of auctioned swaps will be strictly limited. The BoL is convinced that operations should not adversely affect its conduct of monetary policy. The experience of the issuance of auctioning foreign exchange swaps will be discussed with the staff during the second review of the program.

Fiscal policy

The key component of the program is fiscal consolidation. My authorities clearly understand that, given the limitations of monetary policy, keeping the current account deficit within sustainable limits requires strong discipline on the fiscal side.

The general government fiscal deficit was in line with the program in 1999 and has declined significantly this year. The government successfully launched bonds with a 3 year maturity in January 2000 and a 5 year maturity in March. The yields on long-term government bonds have been steadily declining.

Reduction of the general government fiscal deficit to at least 2 percent in 2000, 1 percent in 2001, and to a broadly balanced budget over the medium term, are necessary preconditions for improving the external balance. In the short term, the fiscal target is to be achieved primarily by a tight control on the wage bill of the public sector and other expenditure control measures. The efforts to enhance tax administration have intensified as well. All indications show that the fiscal target for this year should be met.

The Latvian authorities do not underestimate the risk of the growing external imbalances and are ready to respond by further budget tightening. In a first public statement after taking office, the Minister of Finance declared his strong commitment to implement "emergency" measures in the event of further worsening of the external stance. Like the staff, he sees the fiscal deficit as a ceiling rather than a target. This is why the Ministry of Finance has created a contingency plan to be implemented immediately if the current account deficit would be higher and/or FDI would be lower than projected. This plan contains one-time measures and the partial use of certain expenditure items.

Following consultations with the staff in May, the Minister of Finance and the Minister of Economy have send letters to the staff confirming that all privatization receipts, excluding administrative costs, transfers to local governments' privatization funds and the reserve fund of Latvian Privatization Agency, will be transferred to the Treasury aiming at enhancing the transparency and efficiency of public sector operations.

The demands of EU accession are likely to put pressure on public expenditure over the medium term. Coupled with the requirement to increase defense spending associated with potential NATO accession, the government will have to find resources to finance a significant upgrading of the country's infrastructure, and, more generally, to comply with the various demands of the EU's *acquis communautaire*. Thus, streamlining and reprioritizing expenditures is the most urgent task. In this context, my authorities highly value the recommendations of the Fund/Bank technical assistance mission on public expenditure policy. With regard to medium-term fiscal planning, significant progress has been achieved in creating a "Latvian National Development Plan" aimed at efficient reallocation of both domestic (public and private) and external resources to meet the set of determined economic policy priorities.

Structural reforms and financial sector policies

According to the new government's Declaration, the large-scale privatization program is to be completed within one year. The authorities believe that the involvement of international advisors for the sale of the Latvian Shipping Company, the major energy company (Latvenergo), the oil company (Ventspils Nafta) and telecommunication operator (Lattelekom) should help ensure the use of best commercial practices and reduce political interference in the process. The privatization of utilities will be accompanied by the implementation of a "superregulatory" agency according to the law, the enactment of which is expected this year.

The authorities are carrying on an aggressive campaign to further improve the business environment. The important part of this campaign is the introduction of a policy of "zero tolerance" for corruption and money laundering, as stated in the government's Declaration. The Corruption Prevention Council, which was established about three years ago, has succeeded in enhancing transparency and cooperation among public institutions to combat corruption.

The banking sector has largely recovered after the Russian crisis and has returned to profitability. The healthiness of the Latvian banking system is justified by a number of facts. Capital requirements for banks were increased this year, reaching EUR 5 million, and all banks comply with the requirements. During 1999, Scandinavian and German banks increased their equity investment in Latvia. The increasing presence of foreign banks has promoted competition between banks and led to higher cost efficiency. Also the recapitalization process of "*Rîgas Komercbanka"* has been completed.

Latvia is the first country which has completed a self-assessment of compliance with the Basle Core Principles Financial of Effective Banking Supervision. The preliminary results show that the BoL fully or largely complies with all Basle Core Principles and relevant EU banking directives.

At present, responsibility for market supervision is shared among several agencies. The central bank supervises the banking sector, while the state insurance supervision agency oversees insurance companies. Equity markets, the Riga stock exchange and investment funds are supervised by the Securities Market Commission. A new act by Latvia's parliament would consolidate supervision of financial institutions under a single agency, which begins operations on 1 July 2001. A politically independent five-member board will be appointed to head the Unified Financial Sector Supervision Agency, and its operations will be funded by the financial institutions themselves.

Latvia has been in the forefront of transition economies in pushing pension reform ahead despite strong resistance from the opposition. In mid-February, the parliament adopted the Law on State-Funded Pensions, which sets forth the principles of the establishment and operation of a state-funded defined contribution second pillar of the pension system, including general provisions for making contributions. Contributions will be collected starting July 1, 2000, gradually rising from 2 percent of income to 10 percent over 10 years. The adoption of the second, fully-funded pension pillar and the emergence of private pension funds as the third pension pillar, should help to ensure adequate retirement income and encourage private sector savings. By this year-end the government intends to submit to parliament additional amendments aimed at reducing the size of the informal labor market and enhancing social tax collection.