July 2002
IMF Country Report No. 02/149

Republic of Latvia: First and Second Reviews Under the Stand-By Arrangement and Request for Waiver of a Performance Criterion—Staff Report; Staff Statement; News Brief on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Latvia

In the context of the First and Second Reviews under the Stand-By Arrangement and Request for Waiver of a Performance Criterion, the following documents have been released and are included in this package:

- the staff report for the First and Second Reviews under the Stand-By Arrangement and Request for Waiver of a Performance Criterion, prepared by a staff team of the IMF, following discussions that ended on **May 8, 2002,** with the officials of the Republic of Latvia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on June 28, 2002**. 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 12, 2002** updating information on recent developments.

- a News Brief summarizing the **views of the Executive Board as expressed during its July 12, 2002 discussion** of the staff report that completed the request and review.

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

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

Letter of Intent sent to the IMF by the authorities of the Republic of Latvia*
Supplementary Memorandum of Economic Policies

*May also be included in Staff Report

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

First and Second Reviews Under the Stand-By Arrangement and Request for Waiver of a Performance Criterion

Prepared by the European II and Policy Development and Review Departments

Approved by Gérard Bélanger and Anne McGuirk

June 28, 2002

- On April 20, 2001, the Executive Board approved a 20-month Stand-By Arrangement (SBA) in an amount of SDR 33 million (26 percent of quota).
- A mission in October-November 2001 did not complete discussions for the first review. The staff felt that the deficit of 2¾ percent of GDP in the 2002 budget would significantly loosen fiscal policy at a time when Latvia faces a large external current account deficit, and that a fiscal deficit of 1½ percent of GDP would be more appropriate in Latvia's current economic circumstances.
- In concluding the stand-alone 2001 Article IV consultation on January 18, 2002, Directors noted that the authorities had successfully implemented their 2001 economic program and that economic performance had been among the best of the EU accession countries. While recognizing the spending needs associated with EU and NATO accession, Directors expressed reservations about the expansionary fiscal policy in the 2002 budget, which could exacerbate the large and persistent current account deficit. They regretted that the first review under the SBA had had to be delayed.
- Strong budget implementation during January-May 2002, including with respect to the indicative targets for the first two quarters proposed by the authorities in a letter to staff dated November 21, 2001 (SM/01/366, Attachment I), has put Latvia in a position to hold the 2002 deficit to 1.8 percent of GDP. Latvia's Supplementary Memorandum of Economic Policies (SMEP)—endorsed by the Cabinet of Ministers—expresses the authorities' commitment to this target and to appropriate macroeconomic and structural policies in other key areas.
- In the attached letter dated June 27, 2002, the authorities request the completion of the delayed first review and the second review, and seek a waiver for the nonobservance of the end-December 2001 fiscal performance criterion. The attached SMEP supplements the Memorandum of Economic Policies dated March 21, 2001, and describes the authorities' policy intentions for 2002.
- The authorities have made no purchases under this arrangement and do not intend to do so. Completion of the reviews would make Latvia eligible for purchases of SDR 23.6 million, including SDR 9.5 million that had been available until the first review was delayed on November 29, 2001. Based on a proposed revision of the disbursement schedule, Latvia could become eligible for a final purchase of SDR 9.4 million under this arrangement by observing the proposed end-September 2002 performance criteria.
- Discussions were held in Riga during April 29–May 8, 2002; staff representatives were Messrs. Mueller (head), McDonald, Beddies, Lundbäck (all EU2), and Risager (PDR). Mr. Isleifsson, Executive Director for Latvia, and Ms. Kupča, Assistant to the ED, joined the mission. The mission was assisted by Mr. Knöbl, the Fund's resident representative in Riga. It met with Prime Minister Bērziņš, Minister of Finance Bērziņš, Minister for Cooperation with International Institutions Zile; Bank of Latvia (BoL) Governor Rimševičs; other senior government officials; members of parliament; and representatives of the European Commission, EU member governments, Transparency International, and the financial and business communities.
- Relations with the Fund and the World Bank are summarized in Appendices I and II. The Stage One safeguards assessment of the BoL, completed in October 2001, found that BoL safeguards appeared generally adequate, with a need for limited follow-up (Appendix I).

Contents Page

Latvia: Basic Data

Social and demographic indicators					
Area	64,589 sq. km.				
Population	2.4 million				
Urban	68.2 percent				
Rate of population growth	-0.6 percent per year				
Life expectancy at birth					
Male	64.9 years				
Female	76.0 years				
Infant mortality rate (per 1,000 births)	10.4				
Hospital beds (per 10,000 inhabitants)	87.3				
Physicians (per 10,000 inhabitants)	34.4				
	1997	1998	1999	2000	2001
Shares of GDP at current prices (excl. subsidies and indirect taxes)					
Agriculture, hunting and forestry	5.6	4.1	4.1	4.2	4.1
Fishing	0.2	0.3	0.4	0.4	0.3
Mining and quarrying	0.2	0.2	0.1	0.1	0.1
Manufacturing	22.2	17.9	15.3	14.7	14.9
Electricity, gas, and water	5.0	5.3	4.5	3.9	3.8
Construction	4.8	6.8	7.1	6.7	6.2
Services	62.0	65.4	68.5	70.0	70.6
GDP					
Nominal GDP (in millions of lats)	3,275	3,589	3,897	4,336	4,741
Nominal GDP (in millions of US$)	5,638	6,086	6,660	7,149	7,550
GDP per capita (in US$)	2,274	2,475	2,778	3,004	3,191
Real GDP (percentage change)	8.6	3.9	1.1	6.8	7.6
Unemployment rate (end of period)	7.0	9.2	9.1	7.8	7.7
Consumer prices (percentage change, end-period)	7.0	2.8	3.2	1.8	3.2
	(in millions of lats, unless otherwise indicated)				
General government finances					
Total revenue	1,352	1,529	1,561	1,620	1,700
(in percent of GDP)	41.3	42.6	40.0	37.4	35.9
Total expenditure	1,332	1,554	1,707	1,764	1,793
(in percent of GDP)	40.7	43.3	43.8	40.7	37.8
Financial balance	20	-25	-146	-144	-93
(in percent of GDP)	0.6	-0.7	-3.8	-3.3	-2.0
Net lending	10	3	7	0	-2
(in percent of GDP)	0.3	0.1	0.2	0.0	0.0
Fiscal balance	10	-27	-153	-143	-91
(in percent of GDP)	0.3	-0.8	-3.9	-3.3	-1.9
Money and credit (end-period)					
Net foreign assets	619	415	364	538	534
Broad money	871	923	997	1,275	1,541
Domestic credit	479	647	745	1,062	1,447
Velocity (level)	4.1	4.0	4.2	3.7	3.4
Balance of payments					
Total exports (GNFS)	1,701	1,872	1,704	1,984	2,168
Total imports (GNFS)	1,945	2,328	2,109	2,357	2,713
Current account balance	-167	-351	-382	-299	-476
(in percent of GDP)	-5.1	-9.8	-9.8	-6.9	-10.0
Official reserves (in months of imports of goods and nonfactor services)	2.5	2.9	2.9	2.6	3.2
Exchange rate, lats per US$, period average	0.581	0.590	0.585	0.607	0.628

Sources: Latvian authorities; and Fund staff estimates.

EXECUTIVE SUMMARY

The slowdown in the economies of its western European trading partners has brought more moderate growth in Latvia. Led by investment and private consumption, real GDP grew by 7½ percent in 2001, but growth slowed in the second half of the year and is estimated at about 4 percent in the first quarter of 2002. Inflation has remained low. Reflecting weakness abroad and continued strong domestic demand, including major one-time investment purchases, the current account deficit widened in the second half of 2001, reaching 10 percent of GDP for the year. Despite the high current account deficit, foreign direct investment (FDI) inflows have kept debt levels moderate.

Latvia has continued to follow prudent macroeconomic policies. All performance criteria under the Fund-supported program have been observed—except that the end-December 2001 fiscal deficit ceiling was exceeded by 0.2 percent of GDP because of local government budget overruns. Still, Latvia reduced its fiscal deficit by 1½ percentage points to less than 2 percent of GDP in 2001. Cautious expenditure implementation and improved revenue performance have sustained this prudent fiscal policy through the early months of 2002—despite the much looser fiscal deficit target of 2¾ percent of GDP in the 2002 budget. The BoL has kept monetary developments on track and the rapid credit growth of 2001 shows signs of abating. Key financial sector indicators suggest no major vulnerabilities at this time. The authorities have aligned their prudential framework with international standards, while strengthening their frameworks for anti-money laundering and combating terrorist financing. Progress has been achieved in privatizing large-scale enterprises, fighting corruption, and in other structural areas.

The current account deficit remains the main risk to Latvia's economy. Continued strong investment and private consumption demand—together with an anticipated mid-year recovery in exports—are expected to generate growth of 5 percent for 2002. To help contain the current account deficit to 8½ percent of GDP, the authorities have anchored their 2002 program in a commitment to hold the fiscal deficit to 1.8 percent of GDP—nearly 1 percentage point below that in the adopted budget. This commitment is complemented by a monetary program aimed at supporting the exchange rate peg and by several key structural measures. Over the medium term, the need for public sector investments to support EU and NATO accession, other expenditure priorities, and the authorities' intention to reduce tax rates suggest that the current account deficit would narrow only slowly. However, it is expected that the coverage of this deficit by FDI will remain high, thereby keeping external debt indicators in check.

I. Recent Economic Developments and Performance under the Program

1. **The slowdown in Latvia's trading partners has led to more moderate growth, broadly as foreseen in SM/01/366.** Led by investment and private consumption, real GDP grew by 7½ percent in 2001 but growth slowed in the second half of the year and is estimated at about 4 percent in the first quarter of 2002. Inflation has remained low.

Latvia: Selected Economic and Financial Indicators, 1999–2002

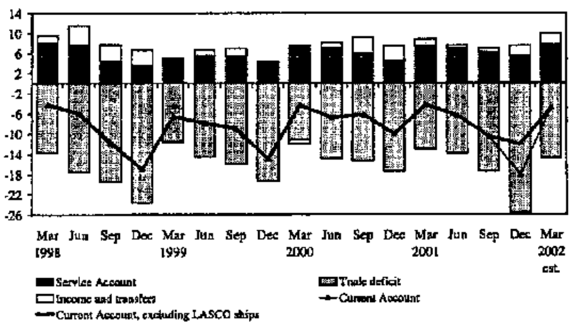
	1999	2000	2001					2002
			Q1	Q2	Q3	Q4	Year	Proj.
Real Sector								
Nominal GDP (millions of lats)	3,897	4,336	1,095	1,177	1,178	1,290	4,741	5,127
Real GDP (annual growth)	1.1	6.8	8.3	9.3	6.4	6.3	7.6	5.0
Unemployment rate (end of period)	9.1	7.8	8.1	7.8	7.6	7.7	7.7	...
Consumer price index (end-period annual change)	3.2	1.8	1.4	3.1	3.6	3.2	3.2	3.0
General government (in percent of GDP)								
Revenue	40.0	37.4	36.1	37.2	36.0	34.3	35.9	36.3
Expenditure and net lending	44.0	40.7	37.1	39.2	37.1	37.7	37.8	38.1
Fiscal balance	-3.9	-3.3	-0.9	-1.9	-1.2	-3.4	-1.9	-1.8
Gross government debt 1/	13.1	13.1	13.0	12.0	13.4	15.0	15.0	...
External sector								
Current acct. (incl. official transfers, percent of GDP)	-9.8	-6.9	-4.2	-6.3	-10.5	-18.1	-10.0	-8.5
Real exchange rate index 2/	98.9	98.9	96.6	98.1	98.4	97.2	97.2	...
International reserves (in months of imports)	2.9	2.6	2.4	2.5	2.6	3.2	3.2	3.3
Exchange rate (lats per $US; p.a.)	0.585	0.607	0.619	0.634	0.630	0.629	0.628	...
Money and credit (end-of-period, change in percent)								
Reserve money	11.6	7.7	12.1	19.2	8.0	8.8	8.8	12.0
Domestic credit (non-government)	15.3	36.7	39.8	42.7	43.1	50.4	50.4	26.4
Broad money	8.0	27.9	24.2	24.2	21.4	20.8	20.8	24.3

Sources: Latvian authorities and Fund staff estimates and projections.
1/ Excluding government guaranteed debt.
2/ CPI-based, (e.o.p., 2000 average=100).

2. **The external current account deficit widened in the second half of 2001—reaching 10 percent of GDP for the year.**[1] This reflected weaker external demand and strong domestic demand, especially for investment goods, which continued in the first quarter of 2002. During that quarter, merchandise exports were broadly flat, as exports to the EU—the destination of over 60 percent of Latvia's exports—declined by 8 percent. This falloff

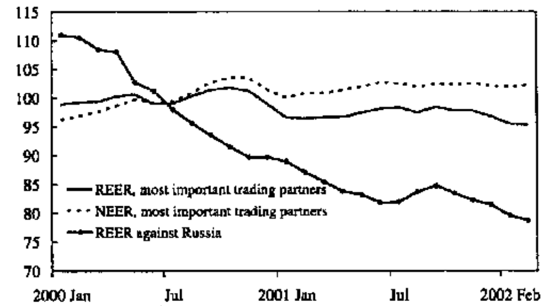
[1] One-time purchases of ships by the state-owned Latvian Shipping Company (LASCO) accounted for 1½ percentage points of the deficit.

Latvia: Balance of Payments, 1998-2002
(percent of GDP)



Source: Bank of Latvia.

Latvia: Real and Nominal Effective Exchange Rates, 2000-2002
(average 2000 = 100)



Source: Fund staff estimates.

appears to reflect slower EU growth rather than an erosion of competitiveness, as the real effective exchange rate has been broadly stable and wage growth remains moderate (see also SM/01/366, Box 2). By contrast, exports to Russia and other CIS countries in the first quarter grew by 9 percent. As merchandise import growth moderated to 3 percent, shipping income from the expansion of LASCO's tanker fleet boosted the services account surplus, and inflows of income and transfers strengthened, the first quarter current account deficit was held to 4.8 percent of GDP, relative to 4.2 percent a year earlier.

3. **Despite the wider current account deficit and much lower FDI coverage in 2001 than in previous years, debt indicators—including those for short-term debt—remain moderate.**[2] The November 2001 Eurobond issue and BoL spot foreign exchange purchases boosted official reserves, and public external debt remains low, at 11½ percent of GDP. Following a disappointing outcome in 2001, when FDI covered just one-fourth of the current account deficit,[3] such inflows returned to previous trends in the first quarter of 2002, covering the entire current account deficit. Market sentiment toward

Latvia: Indicators of External Debt and Vulnerability, 1999-2001

	1999	2000	2001
Total external debt (in millions of U.S. dollars)	3,821	4,489	5,375
(in percent of GDP)	57.4	62.8	71.2
of which:			
Public sector external debt (in millions of U.S. dollars)	708	706	859
(in percent of GDP)	10.6	9.9	11.4
Short-term external debt (in millions of U.S. dollars) 1/	2,344	2,817	3,289
(in percent of GDP)	35.2	39.4	43.6
Gross official reserves (in millions of U.S. dollars)	944	919	1,218
(ratio to short-term debt)	0.40	0.33	0.37
(ratio to short-term debt less non-resident deposits)	0.86	0.93	1.19
(ratio to reserve money)	1.05	0.99	1.26
Bond market indicators			
Foreign currency long-term debt rating 2/	BBB	BBB	BBB
Spread of benchmark bond (percentage points) 3/	1.84	0.94	0.68

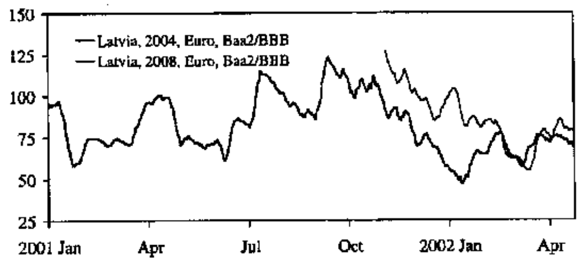
Sources: Latvian Authorities, Datastream, Standard & Poor's.
1/ Remaining maturity basis.
2/ S&P.
3/ End-of-period spread of Eurobond maturing in 2004.

[2] See Box 5 in SM/01/366 for an analysis of Latvia's short-term debt and the level of reserves.

[3] Excluding one-time factors—the purchase of the LASCO ships and a restructuring of ownership of a Latvian leasing subsidiary by its foreign parent—FDI coverage was 53 percent.

Latvia remains favorable, as evidenced by low Eurobond spreads—well below emerging markets standards—and discussions with market participants.

Latvia: Yield of Latvia's Eurobonds over Comparable German Government Bonds, 2001-2002 [1/]
(basis points)

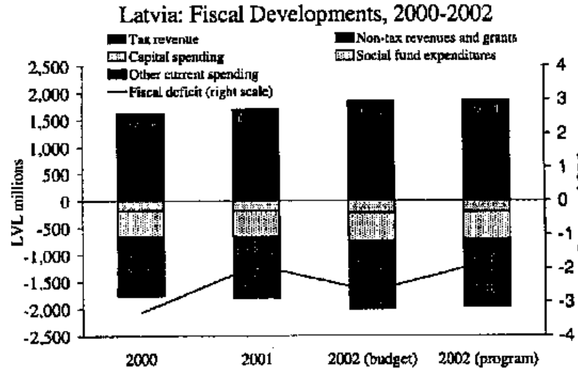


Source: DataStream.
1/ The difference between yields to final date, data type RYFL, as defined in DataStream, five days moving average.

4. **All performance criteria under the program have been observed, except that the December 2001 ceiling on the general government fiscal deficit was exceeded by 0.2 percent of GDP because of overruns in the Riga municipal budget** (Table 1a). The authorities have adopted key measures to strengthen control over local government finances (see Box 3) and are requesting a waiver of the end-December 2001 fiscal deficit performance criterion. The authorities also met all end-March indicative targets they proposed during the October-November 2001 mission and are on track to meet all end-June targets as well.[4] The structural benchmarks have been largely implemented, although sometimes with delay (Table 1b).

5. **The fiscal deficit was reduced by 1½ percentage points to 1.9 percent of GDP in 2001 mainly through expenditure restraint, continuing the trend decline in the expenditure-to-GDP ratio.** The authorities maintained this tight fiscal stance during the first five months of 2002, keeping the consolidated general government deficit to just LVL 10 million. Despite more moderate growth and the reduction (from January 2002) in the corporate income tax rate, tax revenues rose 9 percent over the same period in 2001, reflecting improved tax administration and sustained counter-smuggling efforts.

Latvia: Fiscal Developments, 2000-2002



Source: Latvian authorities and Fund staff estimates.

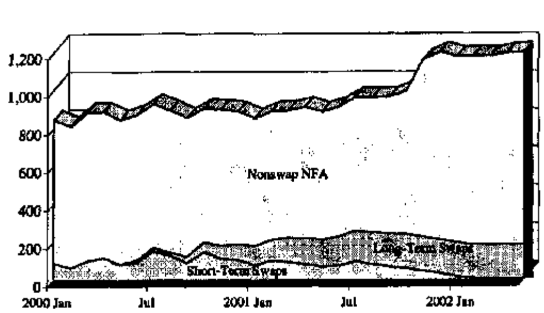
6. **Efforts to improve tax compliance and reduce tax evasion have advanced well, but progress with public sector reforms has been mixed.** Effective January 1, 2002, limits on duty-free imports (including fuel) for personal consumption were reduced and the coverage of fuel-related excises was broadened. These steps are helping, but difficulties with excise tax collections remain—particularly for alcohol products. The adoption of regulations

[4] The targets were proposed in a letter to staff dated November 21, 2001 (SM/01/366, Attachment I), as the discussions for completion of the first review could not be completed and no performance criteria be set.

under the *Law on Public Agencies* (a structural benchmark for end-September 2001) proceeded more slowly than anticipated, but the final set of regulations—concerning remuneration in state agencies—could receive Cabinet approval by end-June. While progress under the *Public Administration Reform Strategy, 2001-2006* has been furthered by the Cabinet's adoption in December 2001 of a detailed action plan and by the passage of the *Law on Framework of Public Administration* in June 2002, enhancements to medium-term budget planning and the adoption of regulations to implement the new civil service pay scale are advancing slowly, the latter due to cost considerations.

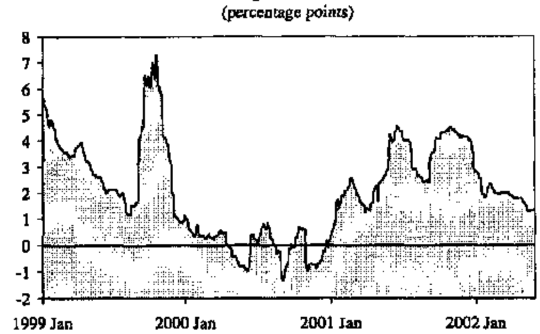
7. **Following strong policy implementation throughout 2001, monetary developments remain on track.** The LVL/SDR short-term interest rate spread narrowed significantly over the last few months as BoL spot foreign exchange purchases eased bank liquidity. In addition, the BoL reduced reserve requirements to 5 percent beginning this year and recently streamlined rules for fulfilling required reserves to facilitate banks' liquidity management. The BoL discontinued new issues of long-term foreign exchange swaps in

Latvia: NFA and Foreign Exchange Swaps, 2000-02
(in millions of U.S. dollars)



Source: Bank of Latvia.

Latvia: 1-Month Interest Spread RIGIBOR-SDR, 1999-2002
(percentage points)



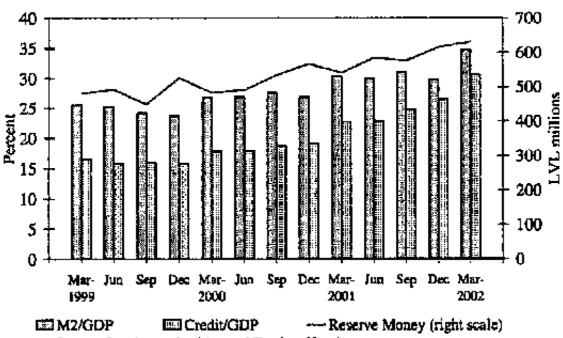
Source: Latvian authorities and Fund staff estimates.

December 2001, meeting an end-March 2002 structural benchmark, and is limiting its use of short-term foreign exchange swaps to monetary fine-tuning.

8. **Key financial sector indicators suggest no major vulnerabilities at this time.** Nonperforming loans are low, capital adequacy remains appropriate, and profitability is still high by international standards. The rapid 50 percent growth of private sector credit observed in 2001 abated in the first quarter of 2002 to an annualized rate of about 26 percent.[5]

[5] Credit growth in 2001 exceeded staff projections because of a loan from one bank to its leasing affiliate in the context of a restructuring operation. Excluding this loan, credit growth would have been 40 percent, as projected in SM/01/366. This rapid credit expansion resulted in a decline in the liquidity ratio.

Latvia: Money and Credit, 1999-2002



Source: Latvian authorities and Fund staff estimates.

Selected Financial Sector Indicators, 1999-2002
(In percent, unless otherwise indicated)

	1999	2000	2001	2002 Q1
Capital adequacy—risk-weighted average 1/	16.0	14.0	14.2	14.9
Liquidity ratio 2/	42.9	44.2	32.0	34.5
Asset quality				
Nonperforming loans/total loans	6.0	4.6	2.8	2.8
Loan-loss provisioning/gross loans	4.0	3.0	1.7	1.9
Loan-loss provisioning/nonperforming loans	79.3	74.1	80.4	82.0
Profitability				
Return on equity	11.0	19.0	19.0	15.3
Return on assets	1.0	2.0	1.5	1.4
Income from fees/total income	23.5	26.2	23.1	24.0
Loans and deposits				
Loans/deposits	65.9	58.3	70.3	67.8
Loans/total assets	43.4	40.3	47.3	47.0
Nonresident deposits as a share of total deposits	46.9	51.3	51.9	52.2
Memorandum Items				
Credit to nongovernment/GDP 3/	15.8	19.6	26.5	30.6
Stock market index, level				
DJRSE 4/	87.8	139.2	200.4	173.0
RICI 5/	170.8	174.1	162.6	188.7
Stock market capitalization/GDP 3/	5.4	7.8	8.5	7.8

Source: Bank of Latvia and Financial and Capital Market Commission.
1/ Year-end data are based on audited financial statements.
2/ (Cash + claims on central bank + claims on other credit institutions + fixed-income gov't. bonds - liabilities to central bank - liabilities to other credit institutions)/deposits.
3/ GDP using annualized quarterly data.
4/ Dow Jones Riga stock exchange index (capiatalization weighted), end-of-period data. The rise in 2001 is primarily due to the privatization of Latvijas Gaze, which accounts for a large share of total market capitalization, via the stock exchange.
5/ Riga stock exchange index (unweighted), end-of-period data.

9. **The adoption of amendments to the *Law on Credit Institutions* in April 2002 should align Latvia's prudential framework with international standards.** In addition, Parliament is expected to pass by end-June legislative amendments aimed at enhancing the anti-money laundering framework (AML) and, in particular, combating terrorist financing (CFT)—important steps in light of the extent of nonresident deposits.[6] The Financial and Capital Markets Commission (FCMC) is making good progress in harmonizing the legal and regulatory framework across sectors to fully reap the benefits of unified supervision.

10. **Good progress has been made with structural reforms.**[7] Recent privatization actions include the sale of all remaining shares in *Latvijas Gaze* in February, and the sale of one-third of LASCO shares for vouchers in February-March and just over half of shares for cash through the Riga Stock Exchange in June.[8] The creation of competitive frameworks in the energy and telecom sectors is developing as planned. The government has implemented 68 of the 77 suggested measures in its *Action Plan to Improve the Business Environment.* A recent cooperation agreement with the Russian customs authorities should reduce bottlenecks at posts along the Russian border. The anti-corruption fight was aided by the adoption of key legislation and the creation of the *Office for the Prevention of and Fight against Corruption*

[6] Nonresident deposits continue to constitute some 52 percent of deposits; about half of these deposits reportedly originate from Delaware in the United States.

[7] The World Bank staff and the authorities have reached understandings on measures to be taken under a second Programmatic Structural Adjustment Loan (PSAL II), expected to be presented to the World Bank Board in early August.

[8] The World Bank would have preferred that a larger share be sold to a strategic investor.

(OPFC), which ended the previous agency fragmentation in this area. These measures are considered adequate by World Bank staff, Transparency International, the Council of Europe's Group of States Against Corruption (GRECO), and the Foreign Investors Council of Latvia.

II. Program Objectives and Policies

A. Overview

11. **The current account deficit remains the main risk to Latvia's continued strong economic performance.** Given the role of fiscal policy as the main macroeconomic policy instrument to contain current account pressures in view of Latvia's fixed exchange rate regime, the authorities recognize the need for fiscal discipline. They have anchored their 2002 program in a commitment to hold the general government fiscal deficit to 1.8 percent of GDP, compared with 2¾ percent in the budget adopted by the Saeima, while ensuring that adequate resources are directed toward such strategic priorities as EU and NATO accession. This commitment is complemented by a monetary program aimed at supporting the exchange rate peg and by structural measures to control local government budgets, enhance medium-term expenditure planning, and shore up the revenue base.

B. Macroeconomic Framework and External Sector Prospects

Program discussions focused on:

- *Assumptions underlying the 2002 and medium-term macroeconomic framework*
- *Projections of the external current account and its financing*

12. **Growth in 2002 is now projected to be about 5 percent, based on a strengthening of external demand during the second half of the year, reflecting an anticipated recovery in western Europe.**[9] Because of the nascent recovery abroad, together with the continued strength of domestic demand, the program foresees a 2002 current account deficit of 8½ percent of GDP. In addition to the recovery of exports, other current account components are expected to improve as well, partly reflecting the beneficial impact on Latvia's services account of an anticipated removal of internal Russian rail tariff policies that discourage transport through Latvia. The main risk to the 2002 macroeconomic framework is a delay in the recovery of external demand, which could lead to a higher current account deficit and lower growth.

---

[9] The projections are based on growth in EU countries of 1½ percent in 2002, in line with the WEO. The upward revision of growth by ½ percentage point relative to SM/01/366 is based on (i) signs that the recovery in the EU is taking hold; (ii) the stronger-than-expected growth in the last quarter of 2001 and the first quarter of 2002; and (iii) lead indicators suggesting somewhat stronger growth in the second quarter of 2002.

13. **Staff expects the current account deficit to improve over the medium term** (Tables 2 and 5). In 2003, a decline in the private sector saving-investment imbalance resulting from a recovery in external demand would drive the reduction in the current account deficit; this would be supported by further fiscal consolidation. Over the medium term, sustained implementation of structural reforms would foster private sector activity, enhance efficiency, promote job creation, and spur growth. Along with Latvia's liberal trade regime and the country's expected integration into the EU and NATO, these efforts should promote FDI inflows and more robust export growth. Large public and private investment needs suggest, however, that improvements in the current account may come only slowly, and would mainly result from further fiscal consolidation. Nevertheless, FDI inflows would keep external debt at moderate levels. To help safeguard external competitiveness and promote employment and growth, the program emphasizes the need to refrain from increases in the minimum wage.

C. Fiscal Policy and Public Sector Reforms

Program discussions focused on:

- *Containing the 2002 fiscal deficit to 1.8 percent of GDP*
- *Measures to strengthen control over local government finances*
- *Public sector reforms*

14. **In view of the persistence and magnitude of the current account deficit, the Latvian authorities recognize the need to contain the fiscal deficit well below the ceiling under the budget law.** Fiscal policy implementation has been guided by the March and June indicative fiscal targets, which are consistent with an annual deficit of about 1½ percent of GDP (SM/01/366, Attachment I). With outcomes through May indicating a cumulative fiscal deficit of just LVL 10 million, Latvia is on track to comfortably meet the end-June target of LVL 46 million.

15. **The authorities' resolve is noteworthy in the current pre-election environment** (Box 1). They are committed to prevent a supplementary budget for this year before the

Box 1. Election-Year Politics in Latvia

Parliamentary elections scheduled for October 6, 2002 have already created a politically charged atmosphere. The current center-right government under Prime Minister Berzinš has been in office since May 2000, making it the longest serving of the nine governments since independence.

The ruling four-party coalition enjoys a majority in the Saeima, but the left-wing opposition parties won last year's municipal elections, most importantly in Riga. A new party founded by former BoL Governor Repše leads the polls.

This pre-election context makes the implementation of a tight fiscal stance difficult. Nevertheless, the discipline provided by a Fund-supported program could prevent a significant loosening of fiscal policy in the third quarter. This was also the case four years ago when the incumbent government successfully resisted election-year spending pressures and kept the deficit within the program ceiling for the end-September test date (see EBS/98/171 and SM/99/168).

election. On the basis of the strong outcome through May, the authorities intend to contain the annual fiscal deficit to LVL 94 million (1.8 percent of GDP), compared with LVL 146 million (2.7 percent of GDP) in the budget, through expenditure restraint and a strong revenue performance. Box 2 provides details on how the authorities could meet this fiscal deficit target.

16. **The program includes several measures to protect fiscal objectives** (SMEP, paragraphs 9 to 11). In addition to the commitment not to open the budget for possible expenditure increases before the elections, the authorities are moving quickly to enhance control over local government budgets, including through changes in legislation (Box 3). The Cabinet will not authorize the spending of privatization receipts outside the budget, as was occasionally done until early 2001, except possibly to finance unforeseen court judgments.[10] Although corporate tax exemptions have recently been granted for large-scale investments of two companies, the authorities reaffirmed their intention to introduce no new tax exemptions, and will reinvigorate, and complete by end-September 2002, the long-planned review of tax exemptions.

17. **The authorities' intention to move toward a balanced fiscal position over the medium term faces difficulties.** Although it will be the task of the new government to draft and present a budget for 2003,[11] staff urged the authorities to continue their fiscal adjustment next year and aim for a fiscal deficit no larger than 1½ percent of GDP. However, tax revenues could be reduced by about 1 percent of GDP as a result of reductions—either planned or already enacted—in the rates of the corporate income tax, property tax, and social tax. Moreover, domestic and international expenditure priorities will create additional pressures in 2003 and beyond. These include public sector investments to support EU and NATO accession and promote medium-term growth, reform of the civil service to reduce staff turnover and retain highly-qualified staff, and further increases in teacher salaries. To facilitate expanded spending in key areas, the program, as well as the World Bank PSAL, includes steps to revitalize public sector reforms and enhance expenditure efficiency (see SMEP, paragraph 12, and Box 4 below). In addition, EU accession requires more forceful action to establish a medium-term budget planning framework (see SM/01/369).

---

[10] The budget law already authorizes up to LVL 14 million in spending from the possible sale of UMTS (telecommunications) licenses, beyond the existing expenditure and deficit ceilings. However, the sale of these licenses in 2002 remains uncertain.

[11] As the budget law is expected to be passed only in the first quarter of 2003, monthly spending limits of 1/12 of this year's authorized spending will apply in the interim.

Box 2. Fiscal Tightening Relative to the 2002 Budget

The strong budgetary outcome through May provides a solid basis for tighter fiscal implementation throughout 2002, relative to the adopted budget. This can be accomplished as follows:

- Tax **revenues** would exceed the budget figures by LVL 15 million (0.3 percent of GDP). While excise tax collections would fall substantially short of the budget target, particularly for alcohol products, the social tax and the property tax have both performed very well in early 2002 and, as foreseen in SM/01/366, collections should exceed budget targets. Personal income tax collections have also been strong and are expected to exceed the budget target.

- **Nontax collections** have performed in line with the budget, but will be supplemented by a LVL 6 million dividend in June from state-owned Lattelekom. A shortfall of EU grants (LVL 12 million) would reduce overall revenues but concomitantly lead to lower spending on agricultural subsidies and investment projects (see below).

- **On the expenditure side**, modest savings in the **central government wage bill** (LVL 3 million) are expected. Spending on **goods and services** at the central government level should also fall below the budget figures. However, higher property and personal income taxes (noted above) accrue largely to local governments and may trigger additional spending; as a result, total goods and services spending at all levels of government could exceed the budget figures by LVL 6 million.

- **Interest** savings of about LVL 5 million are foreseen, partly because of the favorable Eurobond terms in late 2001.

- **Social fund** expenditures (including pensions) in the early months of 2002 have been below projections. Despite a court judgment benefiting working pensioners and requiring unanticipated spending of LVL 5 million, social fund expenditures should be LVL 5 million below the budgeted amount.

- Savings of LVL 5 million are expected in **subsidies to farmers** under the EU SAPARD program.

- The budget law features a near doubling of the central government **public investment program.** In light of capacity constraints and procedures in place to promote efficient program implementation, actual investment spending (including amounts related to EU-funded projects) could be below the budgeted amounts by LVL 24 million (½ percent of GDP).

Latvia: Consolidated General Government, 2001-2002
(in millions of lats, unless stated otherwise)

	2001	2002					
					Q1		Q2
	Est.	Budget	Proj.	Diff.	Ind.	Est.	Ind.
Revenue	1700	1849	1860	11	447	437	466
Tax revenue	1442	1560	1575	15	378	365	396
Corporate income tax	98	94	99	5	25	22	29
Personal income tax	285	309	315	6	72	75	75
Social taxes 1/	481	511	517	6	126	125	131
VAT	351	397	397	...	97	89	98
Excises	161	184	175	-9	43	38	46
Customs duty	15	16	16	...	3	3	4
Property taxes	47	41	49	8	11	12	11
Other (incl. taxes in transit)	4	6	6	...	1	0	1
Non-tax revenue	258	289	285	-4	68	73	70
of which : EU grants	28	51	39	-12	12	7	12
Expenditure	1793	2001	1965	-36	464	453	493
Current expenditure	1615	1778	1766	-12	423	424	441
Wages & salaries	425	460	457	-3	111	109	113
Goods & services	308	320	326	6	76	81	79
Interest	40	54	49	-5	10	10	18
Subsidies & transfers	839	944	934	-10	227	224	231
Transfers to households	590	617	612	-5	150	150	154
Other	248	327	322	-5	77	75	77
of which: SAPARD	...	14	9	-5	...	...	...
Other expenditure	3	0	0	...	0	0	0
Capital expenditure	178	223	199	-24	41	28	52
Financial balance	-93	-152	-105	47	-17	-15	-27
Net lending (+)	-2	-12	-12	...	0	-12	0
Fiscal balance	-91	-140	-94	47	-17	-3	-27
(Percent of GDP)	-1.9	-2.7	-1.8	...	-1.5	-0.3	-2.1
				Q1	**Q2**	**Q3**	**Q4**
Cumulative fiscal deficit targets, 2002				**20**	**46**	**73**	**94**

Sources: Ministry of Finance; and Fund staff estimates.

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

Box 3. Local Government Finances

Latvia relies on borrowing limits to control local government (LG) fiscal balances (see the Fiscal Transparency ROSC for Latvia, SM/01/98). Although the *Law on Budget and Financial Management* (LBFM) and the *Law on Local Government Budgets (LLGB)* provide borrowing authority to LGs, a 1997 Cabinet regulation under the LBFM stipulates that LG borrowing requires approval of the state government, represented by the Minister of Finance. In practice, an aggregate LG borrowing limit is specified in the annual budget law.

Excess borrowing by the City of Riga led to nonobservance of the end-December 2001 fiscal deficit performance criterion, as the city accessed previously-established overdraft arrangements with two Latvian banks to borrow some LVL 15 million. Riga officials maintain that the LLGB provided them with broader borrowing authority, notwithstanding the Cabinet regulation. Excess borrowing in much smaller amounts may also have occurred in earlier years.

The program includes several key measures to enhance LG fiscal control: (i) amendments to the LLGB clarifying that LG borrowing requires approval by the Minister of Finance and is subject to the LG borrowing limit under the budget law are expected to be adopted by parliament in the final reading by end-June; (ii) the government does not intend to propose or support any increase to the 2002 budget law's LG borrowing limit of LVL 11.5 million; (iii) following an examination of LG budgets in early 2002, the authorities sent official communications to the banks involved and to the BoL, the FCMC, and the Auditor General indicating their view that the excess borrowing had lacked legal authority; and (iv) the Ministry of Finance has intensified its monitoring of LG budget implementation, including by monthly monitoring of the budgets of each LG.

These measures go far toward protecting against a repeat of the problems encountered in 2001 but risks remain. LG budget plans—submitted to the Treasury but not subject to approval—indicate fiscal deficits that are LVL 20 million (0.4 percent of GDP) above the borrowing limit. The expected over-performance on property and personal income taxes (which accrue primarily to LGs) would narrow this difference (and is accounted for in the program; see Box 2). Even with tighter LG borrowing constraints, however, LGs could resort to other types of financing—possibly involving a drawdown of bank deposits, which currently stand at about LVL 35 million. This prospect is, however, limited by the need for working balances, which historically have shown little variation.

D. Exchange Rate, Monetary and Financial Sector Policies

Program discussions focused on:

- *The monetary program for the remainder of 2002*
- *Anti-money laundering and combating the financing of terrorism*

18. **The peg to the SDR remains instrumental in maintaining low inflation, supporting confidence, and sustaining financial sector stability**. In addition, the Latvian economy continues to display flexibility in adjusting to shocks and maintaining competitiveness. The staff continues to back the authorities' plans to adopt a euro-based peg after EU accession.

19. **The 2002 monetary program supports the exchange rate peg**. It anticipates further monetization of the Latvian economy and continued strong confidence in the financial system and reflects assumptions of moderate increases in money demand and the money multiplier. The BoL will rely primarily on open market operations to contain reserve money growth to 12 percent, while broad money would rise by 24 percent and private sector credit growth

would moderate to 26 percent.[12] The FCMC already scrutinizes banks' credit policy and risk strategies, and the program calls for continued careful monitoring of credit developments.

20. **The financial sector framework is continuously being upgraded**. The FCMC is on track in implementing the FSAP recommendations (SMEP, paragraph 15). The authorities consider refining the AML and CFT frameworks a key priority and are moving on the legislative and enforcement front (SMEP, paragraph 16). In particular, proposed amendments to the *Law on the Prevention of Laundering of Proceeds Derived from Criminal Activity* are intended to implement the FATF recommendations and comply with UN and EU requirements.[13]

E. Structural Policies

Program discussions focused on:

- *Large-scale privatization and competition in energy and telecommunications*
- *Improving the business climate and fighting corruption*

21. **The structural reform agenda is driven by EU accession requirements and conditionality under the World Bank PSAL**. With the agreement in mid-June on the tax and regional policy chapters, Latvia has provisionally closed 27 of the 31 EU negotiation chapters; the government is committed to close the remaining chapters by fall. On privatization, in addition to Latvijas Gaze and LASCO (discussed above), the government intends to complete the divestiture of Ventspils Nafta and Krajbanka within the next year. Sale of the state share in Lattelekom still hinges on concluding the arbitration process with the foreign minority owner (SMEP, paragraph 20). To create competitive energy and telecom markets, Latvia is reforming its regulatory framework for public utilities, in line with World Bank recommendations and EU requirements (SMEP, paragraph 19); completion of the Latvenergo restructuring program (by end-2002) and implementing the recently adopted tariff-setting principles (for application across sectors) are key steps for the remainder of 2002. The government is working with representatives of the foreign investor and local business communities on a new action plan to improve the business environment, for

[12] The revised end-June indicative targets relative to SM/01/366 largely reflect the accumulation of foreign exchange toward end-2001 and an assumed Eurobond issue in the second quarter of 2002.

[13] The amendments were reviewed by MAE and LEG, and some recommendations were forwarded to the authorities. Among other things, the amendments would: (i) stipulate that all crimes are predicate offenses for money laundering purposes; (ii) enable the Financial Intelligence Unit (FIU) to stop all financial transactions related to criminal activity for up to three months, in addition to its ability to stop terrorism-related financial transactions for up to six months; and (iii) further enhance customer identification requirements.

adoption in mid-2002. Anti-corruption efforts focus on implementing the existing framework, including by making the OPFC fully operational (SMEP, paragraph 21).

III. Program Monitoring and Capacity to Repay the Fund

22. Program implementation will be monitored according to quantitative performance criteria and indicative targets for end-September 2002 (Attachment I, Table 1a).[14] The high quality and timeliness of data permit effective program monitoring.[15] The program includes two end-September 2002 structural benchmarks (Box 4 and Attachment I, Table 1b). It is proposed that the disbursement schedule be revised as shown in Table 6.

Box 4. Structural Conditionality

1. Proposed Coverage of Structural Conditionality

Structural conditionality focuses on the fiscal sector (Attachment I, Table 1b). The structural benchmarks seek to facilitate expenditures on strategic priorities such as EU and NATO accession while moving toward a balanced budget over the medium term: the benchmark on tax exemptions would constitute an important step toward more efficient tax policy and a broadened revenue base, while the benchmark on strategic planning reviews would help improve the prioritization and efficiency of public expenditures. As no further reviews are planned under this arrangement, there are no conditions for future reviews.

2. Status of Previous Structural Benchmarks

Two previous structural benchmarks have not been fully observed. A small number of accounts of budget-financed institutions remain outside the Treasury, but the staff believes that the objective of this measure has been fulfilled and that no further action is required. The final regulation under the Law on Public Agencies *is expected to be approved by Cabinet in mid-2002.*

3. Structural Areas Covered by World Bank Lending and Conditionality

The World Bank PSAL, expected to be presented to the Bank's Board in early August 2002, covers public sector reform, privatization, anti-corruption measures, and energy and telecommunications deregulation.

23. Latvia has a strong record of servicing its Fund obligations and should face no difficulties in servicing future obligations. Even if Latvia were to make purchases under this arrangement, debt service to the Fund would peak in 2005 at less than ½ percent of exports (Table 7).

[14] The program definition of short-term debt has been modified to exclude the BoL, since the latter is captured in the target on net international reserves.

[15] See Appendix III and Annexes I to IV to Attachment I.

IV. Staff Appraisal

24. **Latvia's Fund-supported program is meeting its key objective by helping the authorities to attain their medium-term fiscal goal of a broadly-balanced fiscal stance while accommodating increased expenditures for EU and NATO accession and selective tax rate cuts** (EBS/01/44). Latvia reduced its fiscal deficit by 1½ percentage points to below 2 percent of GDP in 2001, and the authorities have forged further fiscal consolidation in early 2002. Strong fiscal policy, together with appropriate monetary and exchange rate policies and structural reforms, have contributed to continued strong growth and low inflation, despite slower growth among major trading partners.

25. **Prudent fiscal policy is critical to reducing the vulnerabilities associated with the persistently large current account deficit—which remains the main risk to the economy.** But the authorities face challenges in sustaining their recent fiscal policy record. For 2002, the budget law's relatively loose fiscal stance (a deficit of 2¾ percent of GDP) will need to be offset by tight expenditure implementation and an ambitious revenue effort. In both these respects, performance through May is encouraging. However, it must be continued through the year. Demands for additional expenditures or tax favors in advance of the October elections are likely, and the staff urges the authorities to abide by their intention to reject all such proposals. In the staff's assessment, the program's provisions on improving control over local government budgets are adequate to avoid a repeat of the problems experienced in late 2001 that led to the non-observance of the fiscal deficit performance criterion.

26. **Assisted by the framework of a Fund-supported program, the staff believes the authorities are in a position to achieve the targeted 2002 fiscal deficit of 1.8 percent of GDP, as well as other key program targets**. While the staff would have preferred more fiscal adjustment, under the assumptions of the current macroeconomic framework and taking into consideration the difficult pre-election context, the program's policy targets are acceptable. However, should external demand not recover as projected—which could occur if the recovery in western Europe were delayed—and so long as Latvian growth remains strong, the authorities should undertake more ambitious tightening to limit the impact on Latvia's external position.

27. **The likelihood of continued large current account deficits in 2003 and beyond make further fiscal consolidation critical**. The staff supports the authorities' efforts to reduce the tax burden, but such an undertaking would need to be weighed against the overriding objective of balancing the budget over the medium term. Staff, therefore, sees a need for a more gradual approach—for example, by postponing the social tax rate reduction scheduled for January 2003. The program measures to improve expenditure prioritization and medium-term budget planning will be crucial to meeting the spending needs associated with important priorities such as EU and NATO accession, while helping reduce fiscal deficits and, possibly, gaining some room to cut tax rates further.

28. **The exchange rate peg to the SDR has served Latvia well and continues to provide an effective nominal anchor.** The Bank of Latvia's monetary policy is appropriately tight to support the exchange rate objective.

29. **Staff commends the Latvian authorities for their resolve in further strengthening the AML and CFT frameworks.** This is especially important in light of the prominent role of non-resident deposits in the Latvian banking system. The staff believes that the move toward unified financial sector supervision and the FCMC's work program for the period ahead will ensure a high-caliber supervisory framework in line with international standards. The recent moderation of credit growth is welcome, and while the financial system appears robust, staff urges continued vigilance in monitoring banks' loan portfolio quality.

30. **Latvia has continued to make good progress with structural reforms.** The staff welcomes the authorities' strong implementation of the *Action Plan to Improve the Business Environment* and their recent actions to accelerate the privatization of the remaining large public enterprises, and encourages them to persevere in both areas. The recent strengthening of corruption-related legislation is noteworthy, and the staff urges the authorities to sustain this effort with strong and effective implementation.

31. The staff supports the authorities' requests for a waiver of the December 2001 fiscal performance criterion and for the completion of the first and second reviews under the Stand-By Arrangement.

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

Variable and Periods		Adjusted Target		Outcome	
				(In millions of lats)	
I.	Ceilings on the general government fiscal deficit 2/				
	From January 1, 2001 to:				
	March 31, 2001: Indicative		20		10
	June 30, 2001: Performance criterion		46		33
	September 30, 2001: Performance criterion		62		47
	December 31, 2001: Performance criterion		79		91
II.	Ceilings on net domestic assets of the Bank of Latvia 3/				
	March 31, 2001: Indicative		1		-14
	June 30, 2001: Performance criterion		12		12
	September 30, 2001: Performance criterion		33		-12
	December 31, 2001: Performance criterion		-42		-134
				(In millions of US$)	
III.	Floor on convertible net international reserves of the Bank of Latvia 4/ 5/				
	March 31, 2001: Indicative		831		906
	June 30, 2001: Performance criterion		851		936
	September 30, 2001: Performance criterion		890		962
	December 31, 2001: Performance criterion		1,015		1,224
IV.	Ceilings on contracting and guaranteeing of medium-and long-term nonconcessional external debt 6/ 7/	Total	Of which: maturity of more than 1 and up to 5 years	Total	Of which: maturity of more than 1 and up to 5 years
	Reference point: December 31, 2000				
	March 31, 2001: Indicative	52	52	0	0
	June 30, 2001: Performance criterion	242	52	0	0
	September 30, 2001: Performance criterion	300	52	0	0
	December 31, 2001: Performance criterion	320	72	209	0
V.	Ceilings on contracting or guaranteeing of external debt of up to and including one year 6/ 7/				
	March 31, 2001: Indicative		0		0
	June 30, 2001: Performance criterion		0		0
	September 30, 2001: Performance criterion		0		0
	December 31, 2001: Performance criterion		0		0
VI.	Indicative ceilings on reserve money 8/				
	March 31, 2001:		572		541
	June 30, 2001:		595		586
	September 30, 2001:		640		577
	December 31, 2001:		641		616

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

Variable and Periods		Adjusted Target	Outcome
			(In millions of lats)
VII.	Indicative ceilings on net domestic assets of the banking system 3/ 9/		
	March 31, 2001:	790	810
	June 30, 2001:	850	842
	September 30, 2001:	918	918
	December 31, 2001:	1,009	1,006
VIII.	Zero ceiling on the non-accumulation of external arrears by the general government	Continuous	

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

Table 1b. Latvia: Structural Benchmarks
Under the Stand-By Arrangement, 2001-2002

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

1/ See Box 4.
2/ The final regulation under the *Law on Public Agencies* is expected to be approved by Cabinet in mid-2002 (Box 4).

Table 2. Latvia-Balance of Payments, 1999-2007

	1999	2000	2001 Est.	2002	2003	2004	2005	2006	2007
				Projections					
				(In millions of U.S. dollars)					
Current Account	-653.6	-493.4	-757.8	-681.6	-657.8	-702.7	-744.6	-710.8	-689.1
excluding official transfers	-714.4	-528.9	-781.6	-744.1	-776.4	-845.4	-915.4	-907.1	-885.5
Goods	-1,027.1	-1,058.1	-1,350.7	-1,365.2	-1,465.5	-1,566.4	-1,665.7	-1,722.1	-1,771.8
Exports	1,889.1	2,058.3	2,215.8	2,370.5	2,601.4	2,880.8	3,201.1	3,578.8	4,009.3
Imports	-2,916.1	-3,116.5	-3,566.5	-3,735.8	-4,066.9	-4,447.2	-4,866.8	-5,300.9	-5,781.1
Services	336.0	442.7	483.4	545.5	629.3	677.9	741.1	820.8	910.3
Transportation	521.7	559.5	578.2	619.2	683.2	721.2	768.2	823.1	881.8
Travel	-150.6	-117.3	-104.5	-105.0	-104.6	-104.4	-101.8	-98.3	-93.3
Other	-35.2	0.5	9.7	31.3	50.7	61.1	74.6	96.1	121.8
Income	-55.4	24.4	29.8	18.2	0.7	-17.9	-53.5	-70.5	-90.5
Current transfers	93.0	97.5	79.7	119.9	177.7	203.6	233.6	260.9	262.9
Official	60.9	35.5	23.7	62.5	118.6	142.7	170.8	196.3	196.3
Private	32.1	62.0	55.9	57.4	59.1	60.9	62.7	64.6	66.6
Capital and Financial Account	780.7	543.3	1,034.1	831.6	718.8	783.6	847.1	819.6	809.7
Capital Account	12.6	29.4	37.1	40.1	44.0	48.0	52.4	57.2	62.5
Financial Account	768.1	513.9	997.0	791.5	674.8	735.7	794.7	762.5	747.2
Direct Investment	330.6	398.0	193.7	445.4	489.5	537.4	556.6	549.1	526.0
Portfolio investment	273.5	-319.2	132.1	10.4	-106.4	-170.3	-187.2	-205.9	-226.6
Other Investment	164.1	435.1	671.2	335.7	291.7	368.5	425.3	419.3	447.8
Trade Credits, Loans, and Other	-61.0	273.3	376.3	...	...	...	...	...	...
Deposits	225.1	161.8	294.9	...	...	...	...	...	...
Errors and omissions	37.9	-22.1	38.2	0.0	0.0	0.0	0.0	0.0	0.0
Overall Balance, Net reserve assets	165.0	27.8	314.5	150.0	61.0	80.9	102.5	108.8	120.5
Memorandum items:				(In percent of GDP, unless otherwise indicated)					
Current account balance 1/	-9.8	-6.9	-10.0	-8.5	-7.5	-7.3	-7.1	-6.2	-5.5
Trade balance 1/	-15.4	-14.8	-17.9	-17.0	-16.7	-16.2	-15.8	-15.0	-14.1
Merchandise exports	28.4	28.8	29.4	29.6	29.6	29.8	30.3	31.1	31.9
Merchandise imports	-43.8	-43.6	-47.3	-46.7	-46.2	-46.0	-46.1	-46.0	-46.0
Services, income & transfers balance	5.6	7.9	7.9	8.5	9.2	8.9	8.7	8.8	8.6
Gross official reserves (millions of US$)	944.4	919.3	1,218.3	1,358.7	1,410.2	1,486.8	1,589.3	1,698.1	1,818.7
in months of GNFS imports	2.9	2.6	3.2	3.3	3.1	3.0	2.9	2.9	2.8
Value growth of merchandise exports (percent)	-6.1	9.0	7.6	7.0	9.7	10.7	11.1	11.8	12.0
Value growth of merchandise imports (percent)2/3/	-7.2	6.9	14.4	4.7	8.9	9.3	9.4	8.9	9.1
Terms of Trade, GNFS (percent)	1.8	-3.4	0.9	0.7	-0.7	0.5	-0.6	-0.3	0.8
Net FDI / Current Account, percent 4/	51	81	26	65	74	76	75	77	76
External debt 5/	57.4	62.8	71.2	74.7	74.3	74.0	74.6	74.6	74.6

Source: Data provided by Latvian authorities and staff estimates.

1/ Without the state-owned shipping company's (LASCO) import of three ships, the deficit would have been 1.6 percentage point lower in 2001.

2/ Without LASCO's import of three ships, import growth would have been 3.9 percentage points lower in 2001.

3/ Without LASCO's import of three ships in 2001, import growth would be 8.5 percent in 2002.

4/ Without LASCO's import of three ships in 2001, the FDI coverage of the current account deficit would be 31 percent, and 53 percent if also a loan repayment from a leasing subsidiary to its foreign parent (resulting from a restructuring of the concern) in December 2001 is excluded.

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

Table 3. Latvia: Consolidated General Government, 2000-2002
(In millions of lats, unless stated otherwise)

	2000	2001		2002							
					SM/		Q1		Q2	Q3	Q4
	Act.	Prog.	Act.	Budget	01/366	Prog.	Ind.	Est.	Ind.	Program	
Revenue 1/	1620	1760	1700	1849	1871	1860	447	437	466	480	467
Tax revenue	1362	1481	1442	1560	1583	1575	378	365	396	402	397
Direct taxes	801	878	865	915	931	931	223	222	236	234	238
Corporate income tax	74	98	98	94	96	99	25	22	29	24	21
Personal income tax	261	284	285	309	309	315	72	75	75	80	89
Social taxes 2/	466	496	481	511	525	517	126	125	131	131	129
Indirect taxes	560	603	573	639	646	638	154	143	158	166	158
Taxes on goods & services	516	566	527	598	597	589	143	131	147	154	143
VAT	338	369	351	397	397	397	97	89	98	104	99
Excises	164	185	161	184	184	175	43	38	46	46	40
Customs duty	14	12	15	16	16	16	3	3	4	4	5
Property taxes	44	38	47	41	49	49	11	12	11	13	14
Other (incl. taxes in transit)	0	0	4	6	6	6	1	0	1	2	1
Non-tax revenue	258	279	258	289	288	285	68	73	70	78	70
of which: EU grants	21	47	28	51	49	39	12	7	12	12	3
Expenditure	1764	1827	1793	2001	1951	1965	464	453	493	514	494
Current expenditure	1591	1665	1615	1778	1751	1766	423	424	441	456	447
Wages & salaries	397	417	425	460	460	457	111	109	113	117	116
of which: soc sec contributions	82	89	85	98	98	97	24	22	24	25	24
Goods & services	305	317	308	320	316	326	76	81	79	85	87
Interest	49	39	40	54	52	49	10	10	18	11	11
Subsidies & transfers	820	888	839	944	923	934	227	224	231	243	232
Transfers to households	604	610	590	617	612	612	150	150	154	157	151
Other	216	278	248	327	311	322	77	75	77	87	81
Other expenditure	20	3	3	0	0	0	0	0	0	0	0
Capital expenditure	173	163	178	223	200	199	41	28	52	58	48
Financial balance	-144	-67	-93	-152	-80	-105	-17	-15	-27	-34	-27
Net lending (+)	0	12	-2	-12	-1	-12	0	-12	0	-6	-6
Fiscal balance	-143	-79	-91	-140	-79	-94	-17	-3	-27	-28	-21
Financing	143	79	91	140	79	94	17	3	27	28	21
Privatization receipts	25	15	20	8	8	27	2	1	6	20	-1
Domestic	129	35	-38	79	17	-7	6	6	-39	5	21
Banks	99	20	-81	-8	13	-80	2	27	-73	-10	2
BOL	49	-18	-99	0	52	-45	23	35	-67	4	-5
Commercial banks	50	38	18	-8	-39	-35	-22	-8	-6	-14	6
Other domestic	30	15	43	87	4	73	4	-21	34	15	19
Foreign	-11	29	108	53	53	73	10	-4	59	3	1
Memorandum items:					(In percent of GDP)						
Revenue, *of which*:	37.4	37.5	35.9	35.7	36.4	36.3	39.0	37.0	36.5	37.5	33.1
Tax revenue	31.4	31.5	30.4	30.1	30.8	30.7	33.0	30.8	31.1	31.5	28.1
Expenditure, *of which:*	40.7	38.9	37.8	38.6	38.0	38.3	40.5	38.2	38.6	40.2	35.0
Expenditure financed by EU grants	0.5	1.0	0.6	1.0	1.0	0.8	1.1	0.7	1.0	0.9	0.2
Wages & salaries (net of social taxes)	7.2	7.0	7.2	7.0	7.0	7.0	7.6	7.3	7.0	7.2	6.5
Transfers to households	13.9	13.0	12.5	11.9	11.9	11.9	13.1	12.7	12.1	12.3	10.7
Capital expenditure	4.0	3.5	3.8	4.3	3.9	3.9	3.6	2.4	4.1	4.5	3.4
Net lending	0.0	0.3	0.0	-0.2	0.0	-0.2	0.0	-1.0	0.0	-0.5	-0.4
Fiscal balance	-3.3	-1.7	-1.9	-2.7	-1.5	-1.8	-1.5	-0.3	-2.1	-2.2	-1.5
Excluding the cost of pension reform 3/	...	-1.6	-1.8	-2.3	-1.1	-1.4	-1.1	0.1	-1.7	-1.8	-1.1
Social Budget					(In millions of lats)						
Revenues (social taxes)	466	496	481	511	525	517	126	125	131	131	129
Transfers to individuals	486	509	478	512	507	507	125	122	126	129	127
Pensions	445	448	439	431	426	426	105	111	106	108	107
Balance	-19	-14	3	-1	18	10	1	2	5	2	2
In percent of GDP	-0.4	-0.3	0.1	0.0	0.4	0.2	0.1	0.2	0.4	0.2	0.1

Sources: Ministry of Finance; and Fund staff estimates.

1/ Revenues exclude receipts from privatization.

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

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

Table 4. Latvia: Monetary Developments, 1999-2002
(in millions of lats)

	1999	2000	2001	2002			
	Dec.	Dec.	Dec.	Mar.	Jun. Proj.	Sep. Prog.	Dec. Prog.
Bank of Latvia							
Reserve money	526.3	566.7	616.4	631.9	650.0	674.4	690.6
Currency	426.1	482.3	556.0	532.8	546.0	573.2	582.9
Reserves	100.2	84.4	60.4	99.2	104.0	101.2	107.7
Net foreign assets	523.4	542.0	762.0	751.1	818.1	824.0	851.3
Net domestic assets	2.9	24.7	-145.6	-119.2	-168.1	-149.6	-160.7
Domestic credit	68.0	70.1	-57.4	-28.5	-84.9	-74.0	-90.7
Banks	63.3	42.5	18.8	14.6	27.9	36.3	37.3
Government (net) 1/	4.6	27.5	-76.3	-43.1	-112.8	-110.3	-128.0
Other items net	-65.1	-45.4	-88.1	-90.6	-83.1	-75.6	-70.0
Of which: Time deposits	...	...	22.0	30.6	23.1	15.6	10.0
Monetary Survey							
Broad money	996.9	1,275.3	1,540.5	1,644.6	1,723.6	1,819.2	1,914.6
Currency	377.4	427.7	485.2	471.9	483.6	507.8	516.3
Deposits	619.4	847.7	1,055.2	1,172.7	1,240.0	1,311.4	1,398.3
Of which: residents' FX deposits	298.5	396.8	474.4	543.6	565.3	582.1	612.7
Net foreign assets	363.7	538.3	534.4	496.0	564.2	570.1	597.4
Net domestic assets	633.1	737.0	1,006.1	1,148.6	1,159.4	1,249.1	1,317.2
Domestic credit	745.0	1,062.5	1,447.0	1,556.2	1,567.0	1,656.7	1,724.7
Private sector	665.1	909.4	1,368.0	1,448.4	1,534.6	1,635.4	1,729.4
Government (net)	79.9	153.0	79.0	107.8	32.3	21.2	-4.7
Other items net	-111.9	-325.5	-440.9	-407.6	-407.6	-407.6	-407.6
Memorandum Items:							
Annual percentage change							
Reserve money	11.6	7.7	8.8	...	...	...	12.0
Broad money	8.0	27.9	20.8	...	...	...	24.3
Private sector credit 2/	15.3	36.7	50.4	...	...	...	26.4
Velocity	4.2	3.7	3.4	...	...	...	3.0
Money multiplier	1.894	2.250	2.499	2.602	2.652	2.697	2.772
Exchange rate (LVL/US$)	0.583	0.613	0.638	0.641	0.638	0.638	0.638
Net foreign assets (in millions of US$)	623.9	878.2	837.5	773.8	884.3	893.6	936.4
Bank of Latvia	897.7	884.3	1,194.4	1,171.8	1,282.3	1,291.6	1,334.4
Commercial banks 3/	-273.8	-6.0	-356.8	-398.0	-398.0	-398.0	-398.0
Change in NIR (in millions of US$, cumulative)	...	-13.0	310.1	-22.6	87.9	97.2	140.0
Domestic interest rates (end of period)							
Deposit rate (three to six months)	6.0	4.9	5.8	4.3	...	...	...
Lending rate (three to six months)	14.7	11.3	12.2	9.9	...	...	...
Money market rate (one month)	4.9	5.1	6.3	4.3	...	...	...

Sources: Bank of Latvia; and IMF staff estimates.

1/ The Bank of Latvia and the Treasury have agreed that the proceeds from the Eurobond issue are to be kept in government deposits in 2002.
2/ Private sector credit growth in 2001 would have been 40 percent excluding a loan from one bank to its leasing affiliate in the context of a restructuring operation.
3/ Commercial banks' NFA declined toward the end of 2001 because of increased use of funds from foreign parents and one bank's full acquisition of its leasing affiliate.

Table 5. Latvia: Medium Term Macroeconomic Framework, 2000-2007

	2000	2001	2002	2003	2004	2005	2006	2007
		Est.	Projections					
	(In percent of GDP)							
Foreign savings 1/	6.9	10.0	8.5	7.5	7.3	7.1	6.2	5.5
Gross national saving	19.8	18.9	19.3	20.6	21.8	22.5	23.7	24.3
Nongovernment	19.2	17.1	17.5	17.9	17.7	17.8	18.0	18.4
Government 2/	0.7	1.8	1.8	2.7	4.1	4.8	5.7	5.9
Gross investment	26.7	29.0	27.8	28.0	29.0	29.6	29.8	29.8
Nongovernment fixed capital formation	22.6	23.7	22.6	22.3	22.5	22.9	22.6	22.3
Government fixed capital formation 3/	4.0	3.7	3.7	4.2	5.0	5.1	5.7	5.9
Change in inventories	0.2	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Memorandum item:								
Nongovernment savings-investment balance	-3.6	-8.1	-6.7	-6.0	-6.4	-6.7	-6.2	-5.5
Government savings-investment balance	-3.3	-1.9	-1.8	-1.5	-0.9	-0.3	0.0	0.0
Revenues	37.4	35.9	36.3	36.9	38.3	38.4	38.6	38.4
Expenditures and Net lending	40.7	37.8	38.1	38.4	39.1	38.8	38.6	38.4
Real GDP growth rate	6.8	7.6	5.0	6.0	6.0	6.0	6.0	6.0
Inflation (annual average rate)	2.6	2.5	3.0	3.0	3.0	3.0	3.0	3.0

Sources: Latvian authorities; and Fund staff estimates.

1/ External current account deficit.

2/ Government revenues do not include privatization receipts.

3/ Including net lending.

Table 6. Latvia: Schedule of Purchases Under the Stand-By Arrangement

Amount of Purchase	Original Schedule		Proposed Revised Schedule		Status
	Available On or After	Contingent On	Available On or After	Contingent On	
SDR 4.8 million (3.7 percent of quota)	Board approval	Board approval	Board approval	Board approval (April 2001)	1/
SDR 4.7 million (3.7 percent of quota)	August 31, 2001	Observance of end-June 2001 PCs	August 31, 2001	Observance of end-June 2001 PCs 2/	1/
SDR 4.7 million (3.7 percent of quota)	November 30, 2001	Observance of end-September 2001 PCs, completion of program review	June 30, 2002	Observance of end-December 2001 PCs and completion of 1st and 2nd reviews 2/	3/
SDR 4.7 million (3.7 percent of quota)	February 28, 2002	Observance of end-December 2001 PCs	June 30, 2002	Observance of end-December 2001 PCs and completion of 1st and 2nd reviews 2/	3/
SDR 4.7 million (3.7 percent of quota)	May 31, 2002	Observance of end-March 2002 PCs and completion of program review	June 30, 2002	Observance of end-December 2001 PCs and completion of 1st and 2nd reviews 2/	3/
SDR 4.7 million (3.7 percent of quota)	August 31, 2002	Observance of end-June 2002 PCs	November 30, 2002	Observance of end-September 2002 PCs 2/	
SDR 4.7 million (3.7 percent of quota)	November 30, 2002	Observance of end-September 2002 PCs	November 30, 2002	Observance of end-September 2002 PCs 2/	

1/ These purchases were available until November 29, 2001, when the first program review was delayed, but remained undrawn. They become available again upon completion of the first and second program reviews.
2/ In addition to other standard clauses in the arrangements.
3/ Available on or after June 30, 2002 upon completion of the first and second program reviews and waiver of non-observance of the fiscal deficit performance criterion for end-December 2001.

Table 7. Latvia: Indicators of Financial Obligations to the Fund, 2001-2007

	2002 1/	2003	2004	2005	2006	2007
Debt service to the Fund (in millions of SDRs)	6.3	8.9	7.9	17.2	13.8	0.0
Debt service to the Fund (in millions of USD)	7.9	11.1	9.9	21.6	17.4	0.0
Repurchases (in millions of SDRs)	5.7	7.6	6.8	16.5	13.6	0.0
Charges (in millions of SDRs)	0.6	1.3	1.1	0.7	0.2	0.0
Charges (in millions of USD)	0.7	1.6	1.4	0.9	0.3	0.0
In percent of exports of goods and non factor services	0.2	0.3	0.2	0.4	0.3	0.0
In percent of convertible currencies debt service	7.1	9.2	3.0	16.5	11.1	0.0
In percent of gross official reserves	0.6	0.8	0.7	1.3	1.0	0.0
Memorandum items:						
Fund credit outstanding 2/						
In millions of SDRs	44.4	36.8	30.1	13.6	0.0	0.0
In millions of U.S. dollars	55.5	46.0	37.9	17.1	0.0	0.0
In percent of quota	35.0	29.0	23.7	10.7	0.0	0.0
In percent of convertible currencies debt	6.7	5.7	4.7	1.9	0.0	0.0
In percent of GDP	0.7	0.5	0.4	0.2	0.0	0.0

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

1/ Data for 2002 relate to the remainder of the year; i.e. June 1, 2002 to December 31, 2002.

2/ Projections assume that all drawings are made under the stand-by arrangement. It is further assumed that the undrawn amounts that were scheduled for April 20, 2001, August 31, 2001, November 30, 2001, February 28, 2002 and May 31, 2002 (SDR 23.6 million) would be drawn on July 15, 2002. The remaining drawing is assumed to be made according to the revised schedule (SDR 9.4 million on November 30, 2002). Projections use the expectation schedule.

LATVIA: FUND RELATIONS
(As of May 31, 2002)

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	143.92	113.5
Reserve position in Fund	0.06	0.04

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Holdings	0.04	N.A.

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent of Quota**
Systemic Transformation	17.16	13.53

V. **Latest Financial Arrangements:**

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR million)**	**Amount Drawn (SDR million)**
Stand-by	04/20/01	12/19/02	33.0	0.00
Stand-by	12/10/99	4/9/01	33.0	0.00
Stand-by	10/10/97	4/9/99	33.0	0.00

VI. **Projected Obligations to Fund**
Under the Repurchase Expectations Assumptions (SDR million)

	Forthcoming					
	2002	2003	2004	2005	2006	2007
Principal	5.70	7.60	3.80	0.0	0.0	0.0
Charges/interest	0.20	0.30	0.10	0.0	0.0	0.0
Total	5.90	7.90	3.90	0.0	0.0	0.0

VII. **Safeguards Assessment:**

Under the Fund's safeguards assessment policy, Bank of Latvia (BOL) was subject to an assessment with respect to the SBA arrangement, which was approved on April 20, 2001 and is scheduled to expire on December 19, 2002. A safeguards assessment of the BOL was completed on October 25, 2001. The assessment concluded that there were no widespread vulnerabilities that could pose a risk to IMF resources and that an on-site assessment was not necessary, but identified certain weaknesses and made appropriate recommendations. Implementation of the recommended measures by the BOL is being monitored by staff.

VIII. **Exchange Arrangements:**

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

IX. **Article IV Consultation:**

Latvia is on the 12-month consultation cycle. The Executive Board concluded the 2001 Article IV Consultation on January 18, 2002. Directors noted that Latvia's economic performance in 2001 had been among the best of the EU accession candidate countries, but expressed concern about the magnitude and persistence of the external current account deficit. They emphasized that Latvia's medium-term growth prospects were strong, provided that the authorities continue to pursue disciplined macroeconomic policies, further improve public sector efficiency, and sustain the momentum of structural reforms. The exchange rate peg to the SDR remained appropriate, but Directors cautioned that it needed to be underpinned by continued sound fiscal and monetary policies. Directors supported the authorities' intention to move toward a balanced budget over the medium-term, while they expressed reservations about the expansionary fiscal policy in the 2002 budget, which could exacerbate pressure on the external current account. Directors recognized the spending needs associated with EU and NATO accession and supported the authorities' intention to lower the tax burden. To make room for these important steps, Directors saw as crucial the improved prioritization and containment of public expenditure, enhanced tax administration, and more determined public sector reforms, including at the municipal level.

X. **FSAP Participation and ROSCs:**

A joint World Bank-International Monetary Fund mission conducted an assessment of Latvia's financial sector as part of the Financial Sector Assessment Program (FSAP) between February 14-28, 2001. An FSAP update was conducted between October 22-26, 2001, as part of the 2001 Article IV consultation. The Financial Sector Stability Assessment (FSSA) report (SM/02/1) was discussed at the Board on January 18, 2002, together with the 2001 Article IV staff report (SM/01/366).

ROSC Modules

Standard/Code assessed	Issue date	Document number
Code of Good Practices on Fiscal Transparency	March 29, 2001	SM/01/98
Code of Good Practices on Transparency in Monetary and Financial Policies	January 2, 2002	SM/02/01
Basel Core Principles for Effective Banking Supervision	January 2, 2002	SM/02/01
CPSS Core Principles for Systemically Important	January 2, 2002	SM/02/01

Payment Systems		
IOSCO Objectives and Principles of Securities Regulation	January 2, 2002	SM/02/01
IAIS Core Principles	January 2, 2002	SM/02/01
OECD Corporate Governance Principles	January 2, 2002	SM/02/01

XI. **Technical Assistance:**

TECHNICAL ASSISTANCE FROM THE FUND, 1999–2001

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

A FAD mission will visit Latvia late June to early July to provide technical assistance in the area of tax policy.

XII. **Resident Representative:**

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

XIII. **Fourth Amendment:**

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

World Bank Relations
(As of end-April, 2002)

1. Latvia became a member of the World Bank on August 11, 1992. The Bank's current lending and economic sector work program emphasizes improvements in public sector governance. In support of this strategy, the Bank has seven projects under implementation totaling US$103.7 million in commitments, of which US$65.7 million has been disbursed. The total amount of original commitments and principal, including closed operations, is US$395.8 million, of which US$306.0 million has been disbursed. The current amount of outstanding obligations is US$244.5 million.

2. Since 1992, the Bank has financed a variety of loans in the following areas: agriculture, enterprise and financial restructuring, environment, heating and other municipal services, highway maintenance, and welfare reform. More recent loans include the Education Improvement Project (August 1999, US$31 million), which aims to improve education by strengthening the management of both resource inputs and the learning process, and the Liepaja Region Solid Waste Management Project (December 2000, USS 2.2 million). Other projects under implementation are the State Revenue Service Modernization Project, Municipal Services Development Project, the Municipal Solid Waste Management Project in Riga, the Health Reform Project, and the Welfare Reform Project. A Housing Project is under preparation. More recently, the government has worked with the World Bank to undertake a Programmatic Structural Adjustment Operation, which focuses on improving governance. The Bank's Board approved the first loan under this three-year reform program in March 2000, and US$40.4 million has been disbursed. Negotiations for the second PSAL were completed in October 2001 and board presentation is expected in early August 2002.

3. A new Country Assistance Strategy (CAS) was discussed by the Bank's Board on April 25, 2002. Over the years, the Bank has prepared a series of policy notes that provide advice on various poverty-related issues, macroeconomic issues, and structural reform issues, such as local government expenditure and resource transfer; and on macroeconomic and financial sector vulnerability. Several missions in the period July 2000-February 2002 conducted a Public Expenditure Review (PER) to advise the Government on: (i) improving the efficiency and effectiveness of its programs, and (ii) further rationalizing its policy and budget decision-making processes. A PER report provided recommendations on public expenditure planning, programming, and management. In February 2001, a Financial Sector Assessment (FSA) of the Latvian financial system was carried out under the joint IMF/World Bank FSA Program. In addition, the Bank has provided technical assistance on tariff policy, customs administration, the design of a duty drawback scheme, and the preparation of the public investment program.

Statistical Appendix

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

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

National accounts

3. The CSB compiles and publishes quarterly national accounts 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 data 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. Input-output tables are currently being prepared for 1998.

Prices

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

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

Government finance statistics

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

Monetary statistics

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

Balance of payments statistics

7. 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 an international transactions reporting system (ITRS). This source is to be 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.

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, surveys techniques need to be further improved.

9. 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 identified whether the survey on foreign bank accounts of enterprises programmed for 2001 has been implemented.

Data dissemination standards

10. Latvia has subscribed to the Fund's SDDS since November 1996 and has been posting metadata on the DSBB since December 1997. Latvia has disseminated data on the reserves template since April 2000.

Survey of Reporting of Main Statistical Indicators
(As of June 19, 2002)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance 2/	Overall Government Balance	GDP/ GNP	Public External Debt and Debt Scheduling
Date of latest observation	18-Jun	14-Jun	14-Jun	14-Jun	31-May	31-May	May-02	Apr-02	Q4, 2001	31-May	Q1, 2002	31-May
Date received	19-Jun	19-Jun	19-Jun	19-Jun	17-Jun	17-Jun	10-Jun	14-Jun	29-Mar	17-Jun	14-Jun	17-Jun
Frequency of data	D	W	W	W	M	M	M	M	Q	M	Q	M
Frequency of reporting	D	W	W	W	M	M	M	M	Q	M	Q	M
Source of data	C	A 1/	A 1/	A 1/	A 1/	A 1/, C	C	C	C	A 1/	A, N	A,N
Mode of reporting	E	E	E	E	E	E	E	E	E	E	E	E
Confidentiality	C	C	C	B	C	C	C	C	C	C	C	C
Frequency of Publication	D	W	W	M	M	M	M	M	Q	M	Q	M

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

1/ Through the resident representative office.

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

Notes:

Frequency of data: D-daily, W-weekly, M-Monthly, Q-Quarterly.

Frequency of reporting: M-Monthly, Q-Quarterly, V-irregular in conjunction with staff visits.

Mode of reporting: C-cable or facsimile, E-electronic news reporting, V-staff visits, or O-other.

Confidentiality: (B) for use by the staff and the Executive Board, (C) for unrestricted use.

June 27, 2002

Dear Mr. Köhler:

The attached Supplementary Memorandum of Economic Policies (SMEP), adopted by the Cabinet of Ministers, describes the policies the Government and the Bank of Latvia intend to follow for the remainder of the program period under the stand-by arrangement approved by the IMF Executive Board on April 20, 2001. The program is based on our Memorandum of Economic Policies, dated March 21, 2001, and has been discussed and updated with the staff of the IMF during the first and second reviews of economic developments and policies under the stand-by arrangement. As stated before, we do not intend to make any purchases under the stand-by arrangement, but would do so if circumstances warrant.

Despite our best efforts, the performance criterion on the general government fiscal deficit for end-December 2001 was not observed, because of higher-than-expected spending by local governments. We regret that we could not observe this target and wish to request a waiver, and we want to reassure you that we are currently addressing this issue with local governments. We request the completion of the first and second reviews under the stand-by arrangement, in support of our policy program detailed in the attached SMEP.

Our economy has performed very well over the past two years. To sustain strong growth and safeguard our external position, the cornerstone of our economic program remains a return to a balanced budget over the medium term, combined with policies aimed at enhancing the efficiency of the public sector. In addition, our structural reform program is directed at completing the transition to a full-fledged market economy. These policies are also an integral part of our EU accession strategy.

We believe that the policies described in the attached memorandum are adequate to meet the objectives of our economic program, but we will take additional measures to meet these goals should the need arise. Progress in program implementation will continue to be monitored through performance criteria and structural benchmarks (Table 1), which have been set through end-September 2002, the end of the program.

Sincerely,

//s//

Gundars Bērziņš
Minister of Finance
Ministry of Finance

//s//

Ilmārs Rimšēvičs
Governor
Bank of Latvia

Attachments

Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431

SUPPLEMENTARY MEMORANDUM OF ECONOMIC POLICIES

A. Introduction

1. The Latvian economy has experienced high and robust growth in a low-inflation environment over the last two years. Real GDP grew by 7½ percent in 2001 despite the slowdown in external demand in the second half of the year. Growth continued to be broad-based and was the highest among EU accession candidate countries. At the same time, inflation has remained subdued, with the twelve-month inflation rate at 3¼ percent in March 2002. Latvia has made considerable progress in its EU accession negotiations, with 27 of the 31 chapters of the *acquis communautaire* closed to date. Given Latvia's moderate external debt indicators, vulnerability to external shocks remains low, notwithstanding a significant widening of the current account deficit and lower-than-expected FDI inflows in 2001. We also successfully placed our second Eurobond in November 2001.

2. We have reduced the fiscal deficit to 1.9 percent of GDP in 2001, an improvement of about 1½ percentage points over 2000. Nonetheless, the general government fiscal deficit target for end-December 2001 was exceeded by 0.2 percent of GDP because of a budget overrun by the City of Riga. We believe that the deviation from the deficit target did not interfere with program objectives. Moreover, the government has made progress toward implementation of the public sector reform measures under the program. The 2002 budget law sets a higher deficit as compared to 2001, which mainly reflects our spending priorities related to EU and NATO accession and domestic priorities such as education and health, as well as an acceleration of our public investment program. We have, however, shown prudence in the execution of the budget and have observed the indicative end-March 2002 deficit target, specified in the letter to the IMF mission chief dated November 21, 2001, with a comfortable margin.

3. Monetary conditions during 2001 were sufficiently tight to support the Bank of Latvia's (BoL) exchange rate objective. As a result, all end-December 2001 monetary performance criteria under the program were observed. In addition, the BoL discontinued new issues of long-term foreign exchange swaps in December 2001, ahead of schedule. Finally, the BoL began managing liquidity primarily through repo operations, while limiting short-term foreign exchange swaps to monetary fine-tuning. Despite strong credit growth, the financial position of the banking system remains strong.

4. We have fully aligned our prudential framework with international standards through the adoption of amendments to the *Law on Credit Institutions* (LCI). In addition, Parliament is expected to pass legislative amendments aimed at enhancing our anti-money laundering framework, including combating terrorist financing.

5. Latvia has made steady progress in the area of structural reforms. The privatization process has gained momentum, with the privatization of Latvijas Gaze completed and the divestiture of the Latvian Shipping Company (LASCO) well underway. Significant steps have also been taken in other areas. In particular, the new commercial law became effective in January 2002. Additionally, our efforts have focused

on improving the business climate, enhancing competition in the energy and telecommunications sectors, and combating corruption. Our liberal trade regime continues to be in line with EU requirements and our WTO obligations.

B. The Government's Program for 2002

Program Objectives and Macroeconomic Framework

6. Notwithstanding the strong economic performance during 2001 and the largely successful implementation of the program, the widening of the external current account deficit, combined with a decline in its financing through FDI inflows, runs counter to our objective to limit Latvia's vulnerability to exogenous shocks. Against this background, recognizing the pivotal role of fiscal policy as our key macroeconomic policy instrument, we will redouble our efforts to implement a tight fiscal policy in 2002 and, over the medium term, move toward a balanced budget. Furthermore, we will proceed with our structural reform agenda so as to foster strong FDI inflows and create an environment conducive to private sector activity. These efforts will be underpinned by maintaining our successful exchange rate peg to the SDR. With a view to preserving our competitiveness, we will postpone the consideration of a minimum wage increase. We recognize the need to closely monitor external developments, and stand ready to further tighten policies as needed to maintain external sustainability.

7. While the slowdown in external demand appears to have led to a temporary moderation of growth in Latvia, we expect that economic activity will rebound quickly and be buoyant and sustained over the medium term. Our main macroeconomic objectives for 2002 and beyond are as follows: (i) real GDP growth at 5 percent in 2002 and 6 percent annually thereafter; (ii) inflation at about 3 percent per year; and (iii) containing the external current account deficit at about 8½ percent of GDP in 2002, with a declining trend thereafter. We also anticipate strong FDI inflows so that about two-thirds of the current account deficit will be financed through these flows, thereby keeping our external debt indicators at low levels.

Fiscal Policies

8. Our fiscal policy aims at achieving a balanced budget over the medium term. While the 2002 budget law envisages a fiscal deficit of 2¾ percent of GDP (including the costs of pension reform), we recognize that under Latvia's present economic circumstances a deficit of 1.8 percent of GDP would be more appropriate. To this end, we will observe the end-June 2002 indicative fiscal deficit target set forth in our letter to the IMF mission chief dated November 21, 2001, as well as the fiscal deficit targets for end-September and end-December 2002 specified in Table 1a attached to this memorandum. We envisage further fiscal adjustment for next year.

9. We expect to achieve these targets through both a strong revenue performance and expenditure restraint. Tax and nontax collections during the first four months of the year have been buoyant and, if sustained as a result of the strengthening economy and improved tax administration, could lead to higher total revenue than budgeted. Based on actual data through April, we will keep spending below the ceilings under the 2002

budget law by 0.7 percent of GDP. Most importantly, we anticipate some delays in the implementation of our public investment program because of the time-consuming appraisal and tender procedures for individual investment projects. In addition, while a recent constitutional court ruling will lead to unanticipated spending of some LVL 5 million on pensions to working pensioners, we nevertheless expect that the financial position of the social fund will be better than budgeted. We will not adopt a supplementary budget during the program period. Furthermore, we will refrain from adopting any Cabinet decisions authorizing the spending of privatization receipts outside of the budget, unless related to unforeseen court decissions.

10. To improve budget discipline at the local government level, we have submitted to Parliament amendments to the *Law on Local Government Budgets;* we expect these amendments to be adopted by end-June 2002. The amendments will clarify that local government borrowing requires the approval of the Minister of Finance and is subject to the overall local government borrowing limit under the annual budget law. We will not increase the 2002 local government borrowing limit above the ceiling of LVL 11.5 million set in the budget law. In addition, the Ministry of Finance has enhanced its monitoring of local government budgets, including by the monthly monitoring of the budgets of each local government.

11. To shore up our revenue base, we will refrain from reducing the tax rate for social insurance contributions during the course of the year and from introducing any new tax exemptions beyond those currently in force. We will, by end-September 2002, complete the review of all current tax exemptions under the corporate income tax law, in conjunction with the FAD tax policy mission (structural benchmark). In order to enhance excise and VAT collections, we have submitted to Parliament amendments to two laws: (i) amendments to the *Law on Taxes and Fees* that would give greater enforcement power, including for the collection of tax arrears, to the State Revenue Service and would streamline the appeals procedure; and (ii) amendments to the *Law on the Excise Tax for Oil Products* that would align the payment period for excise taxes on oil products that enter customs warehouses to the payment period for other taxes, reducing this period from 45 to 10 days. In addition, we are preparing amendments to the *Law on the Excise Tax on Alcohol Products* to broaden the definition of alcohol products and align it with EU Directives.

12. We continue to implement our public sector reform agenda to raise the effectiveness and efficiency of our public sector. A Coordination Council of senior civil servants is overseeing the implementation of the *Public Administration Reform Strategy* according to the action plan adopted by the Cabinet in December 2001. The final set of regulations under the *Law on Public Agencies* is expected to receive Cabinet approval by end-June 2002. Improvements in medium-term budget planning are continuing with the completion of the Ministry of Agriculture's *Strategic Planning Pilot Project*, which has reviewed the delivery of goods and services provided by all programs under the Ministry's responsibility and is leading to the establishment of performance-based measures under these programs. By end-September 2002, the Cabinet will decide on a framework for extending strategic planning reviews to other line ministries (structural benchmark).

Exchange Rate, Monetary, and Financial Sector Policies

13. Our monetary policy anchor, the exchange rate peg to the SDR, remains key to maintaining low inflation and supporting confidence, and we intend to retain this peg until EU accession. The BoL's monetary policy will continue to be geared at supporting the peg and sustaining financial sector stability.

14. We anticipate further monetization of our economy and strong confidence in our financial system. Therefore, our monetary program for the remainder of 2002 is based on the assumption of an increase in money demand and the money multiplier. We will contain the growth of reserve money to 12 percent in 2002, by relying primarily on open market operations. Private sector credit growth is expected to moderate to 26 percent in 2002. While we believe that the rate of credit expansion has passed its peak, we are nonetheless carefully monitoring credit developments. The Financial and Capital Market Commission (FCMC) is already scrutinizing banks' credit policy and risk strategies. In addition, if deemed necessary, the BoL will not hesitate to tighten monetary policy to contain credit expansion.

15. The FCMC has made substantial progress in implementing the recommendations set forth in the joint World Bank/IMF Financial Sector Assessment Program (FSAP). Following the re-approval of existing financial sector regulations, the FCMC will harmonize all sector-specific legislation, regulations, and supervisory methods across sectors by end-December 2002 to reap the full benefits of unified supervision. Risk profiles for financial institutions have been prepared and the FCMC will consider introducing a rating system for financial institutions to enhance the effectiveness of its oversight function at a later date. In addition, the FCMC will update its examination manual to effectively cover all branches of the financial sector. Finally, the FCMC will continue to enhance risk-based supervision in all sectors and to promote the introduction of key consumer protection measures for the financial sector.

16. While we have made considerable progress in aligning our anti-money laundering and combating the financing of terrorism frameworks with international practice, we recognize the need to further refine these frameworks and step up our enforcement capacity. To this end, we will, by end-December 2002, submit to Parliament amendments to the *Law on the Prevention of Laundering of Proceeds derived from Criminal Activity*. The revised law will be in full compliance with FATF, UN, and EU requirements. In addition, a newly established unit under the Financial Police will vigorously pursue reports of suspicious activity identified by our Financial Intelligence Unit (FIU). We will also create a second unit under the Economics Crime Police and ensure that it is fully operational by end-December 2002. Finally, we are committed to increase staffing in our FIU to more effectively process reports of suspicious transactions.

Structural and Trade Policies

17. Our structural reform program is directed at attracting foreign investment and sustaining growth. The focus of our structural reform agenda will be to (i) implement measures identified as catalysts to improve the business climate; (ii) foster competition in

the energy and telecommunications sectors; (iii) complete the privatization of large-scale public enterprises; and (iv) combat corruption.

18. We have implemented 68 of the 77 suggested measures in our *Action Plan to Improve the Business Environment.* We expect that the Cabinet of Ministers will adopt a new *Action Plan* by mid-2002 based on input from both foreign investors and the domestic business community.

19. We recognize that the foundation of an efficient energy and telecommunications sector is competition and sound regulation. To this end, and in line with the strategy paper and work program of the Public Utilities Commission (PUC), we envisage a transition from regulated monopolies to regulatory frameworks for competitive markets. Key steps in this direction include the completion of the restructuring program of Latvenergo by end-2002 and the implementation of the recently adopted principles for tariff setting, which will be applied across sectors.

20. As already noted, the divestiture of our remaining state enterprises has gained momentum. Following our guidelines for the privatization of LASCO, we will complete the divesture of a majority share to strategic and financial investors by mid-2002 and of the remaining shares by end-2002. Based on the recommendations of our financial advisors, we will strive to sell our minority share in Ventspils Nafta during the second half of 2002. In addition, we will dispose of the remaining state shares in Krajbanka no later than the first quarter of 2003. The divestiture of the state share in Lattelekom still hinges on the resolution of the legal dispute related to the WTO obligation to relinquish the monopoly rights by 2003.

21. The fight against corruption remains one of our key priorities. To this end, the new *Law on Prevention of Conflict of Interest* has been passed, and the *Law on the Establishment of the Office for the Prevention of and Fight against Corruption* (OPFC) came into effect May 1, 2002. A head of the office will be appointed and the office will begin all its operations no later than August 1, 2002. By end-December, 2002, the Executive Secretariat of the Crime and Corruption Prevention Council will prepare the 2003 Corruption Prevention Program, which will include well-defined tasks, responsibilities, and timetables.

22. We are committed to maintaining our liberal trade regime and remain in line with EU requirements and our WTO obligations. The MFN rate of 0.5 percent, applied to some industrial goods, has been eliminated and the simple average MFN tariff has been reduced to about 5 percent. Furthermore, we will refrain from raising tariffs.

Résumé

23. We believe that these policies will bolster Latvia's medium-term growth prospects and facilitate our accession to the EU. We are prepared to implement any additional measures deemed necessary to meet these goals.

Table 1a. Latvia: Quantitative Performance Criteria and Indicative Targets Under the Stand-By Arrangement, 2002 1/

Variable and Periods	Target		Outcome	
			(In millions of lats)	
I. Ceilings on the general government fiscal deficit 2/				
From January 1, 2002 to:				
March 31, 2002: Indicative		20		3
June 30, 2002: Indicative		46		
September 30, 2002: Performance criterion		73		
December 31, 2002: Indicative		94		
II. Ceilings on net domestic assets of the Bank of Latvia 3/				
March 31, 2002: Indicative		-47		-102
June 30, 2002: Indicative		-168		
September 30, 2002: Performance criterion		-150		
December 31, 2002: Indicative		-161		
			(In millions of US$)	
III. Floor on convertible net international reserves of the Bank of Latvia 4/				
March 31, 2002: Indicative		1,048		1,198
June 30, 2002: Indicative		1,182		
September 30, 2002: Performance criterion		1,192		
December 31, 2002: Indicative		1,234		
IV. Ceilings on contracting and guaranteeing of medium-and long-term nonconcessional external debt 5/ 6/	Total	Of which: maturity of more than 1 and up to 5 years	Total	Of which: maturity of more than 1 and up to 5 years
Reference point: December 31, 2001				
March 31, 2002: Indicative	0	0	0	0
June 30, 2002: Indicative	150	0		
September 30, 2002: Performance criterion	200	60		
December 31, 2002: Indicative	300	60		
V. Ceilings on contracting or guaranteeing of external debt of up to and including one year 5/ 6/				
March 31, 2002: Indicative		0		
June 30, 2002: Indicative		0		
September 30, 2002: Performance criterion		0		
December 31, 2002: Indicative		0		
VI. Indicative ceilings on reserve money 7/				
March 31, 2002:		656		632
June 30, 2002:		650		
September 30, 2002:		674		
December 31, 2002:		691		

Table 1a. Latvia: Quantitative Performance Criteria and Indicative Targets Under the Stand-By Arrangement, 2002 1/

Variable and Periods		Target	Outcome
			(In millions of lats)
VII.	Indicative ceilings on net domestic assets of the banking system 3/ 8/		
	March 31, 2002:	1,000	1,149
	June 30, 2002:	1,159	
	September 30, 2002:	1,249	
	December 31, 2002:	1,317	
VIII.	Zero ceiling on the non-accumulation of external arrears by the general government	Continuous	

1/ Definitions of the performance criteria and indicative targets are included in the Annexes to the Supplementary Memorandum of Economic Policies. The targets for end-December 2002 are indicative as they fall after the expiration of the stand-by arrangement on December 19, 2002.
2/ The ceilings on the general government fiscal deficit will be adjusted downward by the amount by which central government tax revenue exceeds the indicative targets mentioned in Annex I of the SMEP.
3/ The ceilings will be adjusted upward (downward) for any shortfall (excess) from programmed levels of disbursements of foreign balance of payments assistance (see Annex II of SMEP).
4/ The floors will be adjusted downward (upward) for any shortfall (excess) from programmed levels of disbursements of foreign balance of payments assistance (see Annex III of SMEP).
5/ Applies to the general government or any other agencies acting on behalf of the government.
6/ The performance criteria on debt ceilings apply not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274 – (00/85), adopted August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received. Because of difficulties in ensuring effective monitoring of leasing and import financing by local entities, such transactions by local governments are not included under the external debt limits (see Annex IV of SMEP).
7/ The program definition excludes time deposits of commercial banks and deposits of other financial institutions held with the BoL (see Annex II of SMEP).
8/ The program definition includes foreign equity of commercial banks, which is recorded in "other net assets" (see Annex II of SMEP).

Table 1b. Latvia: Structural Benchmarks
Under the Stand-By Arrangement, 2002

By end-September 2002:

1. Complete the review of all current tax exemptions under the corporate income tax law, as described in paragraph 11 of the SMEP.

2. Cabinet to adopt the framework for implementing strategic planning reviews in line ministries, as described in paragraph 12 of the SMEP.

General Government Fiscal Deficit and Central Government Tax Revenue

Ceilings on the General Government Fiscal Deficit

(In millions of lats)

From January 1, 2002 to:

	Target	Outcome
March 31, 2002 (indicative)	20	3
June 30, 2002 (indicative)	46	
September 30, 2002 (performance criterion)	73	
December 31, 2002 (indicative)	94	

Indicative Targets on Central Government Tax Revenue

(In millions of lats)

From January 1, 2002 to:

	Target	Outcome
March 31, 2002	316	299
June 30, 2002	648	
September 30, 2002	975	
December 31, 2002	1,309	

The general government is defined to include the central government basic and special budgets and the local governments basic and special budgets. The general government fiscal deficit is defined as the increase in net claims on the general government of the domestic banking system comprising the Bank of Latvia and licensed commercial banks; plus the net increase in all other claims on the general government of domestic and foreign financial and nonfinancial institutions or households; plus the privatization receipts net of the legally stipulated administrative expenditures and allocations to the reserve fund of the Latvian Privatization Agency (LPA). Upon closure of the LPA, the privatization receipts will accrue to the Ministry of Economy and, as is currently the case under the LPA, be transferred to the treasury.

The net claims of the domestic banking system on the general government are defined as all claims of the Bank of Latvia and licensed commercial banks on the general government, less all deposits of the general government with these institutions. The claims of the banking system on the general government include, but are not limited to: bank loans (including overdrafts) to the general government and securities issued by the general government held by banks. Deposits of the general government with banks include domestic or foreign currency deposits.

The ceilings on the general government fiscal deficit will be adjusted downward by the extent to which central government tax revenues exceed the respective indicative targets outlined above. The taxes to be included in this calculation are: (i) the corporate income tax; (ii) the value added tax (VAT); (iii) all excises; (iv) customs duties; (v) the personal income tax accruing to the central government special budgets; (vi) central government taxes in transit; and (vii) the social tax.

Monthly data on net claims of the domestic banking system on the general government are taken from the balance sheet of the Bank of Latvia and the consolidated balance sheet of all licensed commercial banks. In addition to providing the monthly Treasury Report showing all general government revenue and expenditure by economic classification, the Ministry of Finance shall provide information on: (i) net sales of all Latvian State Treasury securities and any other general government debt instruments; (ii) other general government net borrowing; (iii) net changes in general government deposits held abroad; (iv) disbursements and repayments related to foreign loans extended to the general government; (v) gross receipts from foreigners from privatization received by the LPA and the sale of UMTS and GSM licenses and the uses of such receipts; (vi) net lending operations of the general government; and (vii) the receipt and use of foreign grants, including from the European Union. All such information is to be provided monthly to the IMF by electronic means and in hardcopy by the 17th day of the following month. In addition, the official quarterly debt tables should be provided to the IMF by electronic means and in hardcopy within two months following the end of the quarter in question.

If any data taken from the above sources are subsequently revised due to errors, omissions, or any other reasons, the IMF will be notified, without any delays, of such revisions.

NET DOMESTIC ASSETS OF THE BANK OF LATVIA AND THE BANKING SYSTEM

Net domestic assets of the Bank of Latvia are defined as the difference between: (i) reserve money, i.e., the issuance of lats plus deposits of commercial banks with the Bank of Latvia (including obligatory reserves but excluding banks' term deposits and deposits of other financial institutions with the Bank of Latvia); and (ii) the Bank of Latvia's net international reserves (as defined in Annex III). Net domestic assets of the Bank of Latvia would thus include: net credit to the general government; credit to commercial banks; and other net assets. Both (i) and (ii) will be expressed in lats.

The ceilings on net domestic assets for 2002 are established on the basis of an assumption of (i) disbursements in balance of payments assistance of $0 million in the first quarter of 2002, $90 million in the second quarter of 2002, $0 million in the third quarter of 2002, and $20 million in the fourth quarter of 2002.

The ceilings on net domestic assets (both at the Bank of Latvia and banking system levels) will be adjusted upward (downward) for any shortfall (excess) in disbursements from foreign creditors of balance of payments assistance relative to the programmed levels. The limits indicated in the table below are stock numbers for the respective date and will be monitored monthly based on the balance sheet of the Bank of Latvia. The balance sheet at the program exchange rate and at the actual exchange rate is to be provided monthly by the Bank of Latvia to the IMF by electronic means and in hardcopy by the 17th day of the following month.

Net Domestic Assets of the Bank of Latvia

	Target	Outcome
	(In millions of lats)	
Ceiling for March 31, 2002 (indicative)	-47	-102
Ceiling for June 30, 2002 (indicative)	-168	
Ceiling for September 30, 2002 (performance criterion)	-150	
Ceiling for December 31, 2002 (indicative)	-161	

Net domestic assets of the banking system are defined as the difference between the liabilities of the banking system to the nonbank public (M2X) and net foreign assets of the banking system. Net foreign assets of the banking system are the sum of all gross claims on nonresidents, *less* liabilities to nonresidents (excluding foreign equity). Thus, net domestic assets of the banking system include: net credit to the general government; gross credit to the nongovernment sector; and other net assets (including foreign equity).

The indicative limits shown in the table below are stock numbers and will be monitored monthly from the consolidated balance sheets of the banking system. The balance sheet at the actual exchange rate is to be provided monthly by the Bank of Latvia to the IMF by electronic means and in hardcopy by the 17th day of the following month.

If any data taken from the above source are subsequently revised due to errors, omissions, or any other reasons, the IMF will be notified, without any delays, of such revisions.

Net Domestic Assets of the Banking System

	Adjusted Target	Outcome
	(In millions of lats)	
Ceiling for March 31, 2002 (indicative)	1,000	1,149
Ceiling for June 30, 2002 (indicative)	1,159	
Ceiling for September 30, 2002 (indicative)	1,249	
Ceiling for December 31, 2002 (indicative)	1,317	

CONVERTIBLE NET INTERNATIONAL RESERVES OF THE BANK OF LATVIA

Convertible net international reserves of the Bank of Latvia consist of gross international reserves *less* foreign liabilities in all convertible currencies, both expressed in U.S. dollars.

For purposes of the program, gross international reserves will comprise all liquid foreign assets of the Bank of Latvia which are readily available, including monetary gold, holdings of SDRs, any reserve position in the Fund, holdings of foreign exchange, and any deposits with nonresident financial institutions. For purposes of the program, foreign liabilities will be defined as use of Fund credit, and on balance sheet foreign currency liabilities of the Bank of Latvia.

For the entire period of the program, the exchange rates of the SDR and other currencies vis-à-vis the U.S. dollar will be those prevailing at end-December 2001.

The performance criteria on the floor on net international reserves of the Bank of Latvia are specified below. The floor on net international reserves is established on the basis of an assumption of (i) disbursements in balance of payments assistance of $0 million in the first quarter of 2002, $90 million in the second quarter of 2002, $0 million in the third quarter of 2002, and $20 million in the fourth quarter of 2002.

The net international reserves floor will be adjusted downward (upward) for any shortfall (excess) in disbursements from foreign creditors of balance of payments assistance relative to the programmed levels. The stock of net international reserves of the Bank of Latvia, as well as the stock of all outstanding swap operations, are to be provided monthly by the Bank of Latvia to the IMF by electronic means and in hardcopy by the 17th day of the following month.

If any data taken from the above source are subsequently revised due to errors, omissions, or any other reasons, the IMF will be notified, without any delays, of such revisions.

Net international Reserves of the Bank of Latvia

Minimum	Adjusted Target	Outcome
	(In millions of U.S. dollars)	
Floor on March 31, 2002 (indicative)	1,048	1,198
Floor on June 30, 2002 (indicative)	1,182	
Floor on September 30, 2002 (performance criterion)	1,192	
Floor on December 31, 2002 (indicative)	1,234	

EXTERNAL DEBT

Ceiling on the contracting and guaranteeing of nonconcessional external debt 1/ 2/	Maximum Ceilings Maturity of up to and including 1 year	Medium- and long-term maturities	Of which: more than 1 and up to 5 years	Outcome Maturity of up to and including 1 year	Medium- and long-term maturities	Of which: more than 1 and up to 5 years
	(In millions of U.S. dollars)					
Reference point: December 31, 2001						
March 31, 2002 (indicative)	0	0	0			
June 30, 2002 (indicative)	0	150	0			
September 30, 2002 (performance criterion)	0	200	60			
December 31, 2002 (indicative)	0	300	60			

1/ Concessional borrowing refers to loans with a grant element of at least 35 percent discounted on the basis of the OECD Commercial Reference Interest Rates (CIRRs).
2/ The performance criteria on debt ceilings apply not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-(00/85) adopted August 24, 2000), but also to commitments contracted or guaranteed for which value has not been received. Temporary exchanges of assets, such as swaps and lease arrangements with non-residents, are included under this definition of external debt. Because of difficulties in ensuring effective monitoring of leasing by local entities, such transactions by local governments are excluded from the external debt limits.

External debt limits apply to external debt—with original maturities of up to and including one year; to nonconcessional medium- and long-term external debt of original maturities of more than one year; and to commitments contracted or guaranteed for which value has not been received. For the purpose of the program, the so defined external debt limits apply to debt contracted or guaranteed by the government, the Bank of Latvia, or any other agencies on behalf of the government, with sub-ceilings for such debt of maturities of more than one year up to and including five years. Beginning January 2002, the limit on external debt with original maturity of up to and including one year does not apply to the Bank of Latvia. The definition of the government is the same as in Annex I. The stock of medium- and long-term debt was $ 216 million as of December 31, 2001. For the purpose of measuring the performance criteria on short-term external debt with a maturity of up to and including one year, the outstanding stock of this debt, which excludes normal import-related trade credits, was zero at December 31, 2001. Excluded from the limits are the use of Fund resources; but other balance of payments support would be covered by these limits, including loans from official creditors and foreign banks. Contracted loans shall be valued in the currency of transactions and converted into U.S. dollars at the exchange rate prevailing at the time the loan is contracted.

Compliance with the limits shall be verified at quarterly intervals for the dates shown above. Information on the contracting and guaranteeing of external debt, as well as the outstanding stock of government debt, will be reported monthly to the IMF by electronic means and in hardcopy by the Ministry of Finance by the 17th day of the following month. In addition, the official quarterly debt tables should be provided to the IMF by electronic means and in hardcopy within two months following the end of the quarter in question. In addition to the performance criteria specified above, a continuous performance criterion respecting the nonaccumulation of external payments arrears by the government applies.

If any data taken from the above source are subsequently revised due to errors, omissions, or any other reasons, the IMF will be notified, without any delays, of such revisions.

Statement by the IMF Staff Representative
July 12, 2002

Since issuance of the staff report (EBS/02/118), the following information has become available on macroeconomic developments, fiscal performance, legislative developments, and privatization. This information does not alter the thrust of the staff appraisal.

1. **Twelve-month inflation dropped to 0.9 percent in June, reflecting lower prices for food products and telecom services.**

2. **The current account deficit for the first quarter of 2002 was 3.9 percent of GDP, about one percentage point below the preliminary estimate in EBS/02/118.** This improvement was mainly due to unexpectedly strong private transfers, while the trade and services account balances developed as projected. Preliminary data for April show a strong recovery in exports of both goods and services, which grew year-on-year by 9 percent and 17 percent, respectively, with exports to Russia expanding particularly strongly. However, as import growth continues to outpace export growth, staff does not propose a revision of the projected annual current account deficit.

3. **The end-June indicative target on the *general* government fiscal deficit is likely to have been met comfortably.** The *central* government recorded a surplus of LVL 8 million in June, leading to a cumulative deficit of LVL 2 million since the beginning of the year. The excellent June outcome was helped, among other things, by a dividend payment of Lattelekom (as expected; see Box 2 of EBS/02/118) and strong inflows of EU grants. *Local* government data for June are not yet available, but are expected to show a deficit, given the normal seasonality in executing investment projects during the warmer summer months.

4. **As expected, Parliament adopted two key legislative amendments at end-June:**

- To the *Law on the Prevention of Laundering of Proceeds from Criminal Activity*, which will enhance customer identification requirements and extend the law to also cover terrorism, including regarding the freezing of terrorism-related funds.
- To the *Law on Local Government Budgets*, which are intended to strengthen control of local government borrowing. However, while explicitly recognizing the merits of the law, the President did not promulgate the amendments but returned them to Parliament so that certain definitions could be clarified. The authorities are working on new wording in the affected paragraphs and will put the law back on the agenda of Parliament in due course.

5. **The auction of 51 percent of shares in the Latvian Shipping Company (LASCO) at the Riga Stock Exchange yielded LVL 36 million of privatization receipts.** However, the auction result is being disputed in court by a foreign shipping company that was excluded from the auction because it had missed a deadline for submitting paperwork.

INTERNATIONAL MONETARY FUND

NEWS BRIEF

FOR IMMEDIATE RELEASE

News Brief No. 02/65
FOR IMMEDIATE RELEASE
July 12, 2002

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

IMF Completes First and Second Review of Latvia Under Stand-By Arrangement

The Executive Board of the International Monetary Fund (IMF) today completed its first and second review of Latvia's economic performance under the 20-month stand-by arrangement. Completion of the review entitles Latvia to purchase a total amount equivalent to SDR 23.6 million (about US$31 million). Latvia has not so far drawn any of those resources, and the authorities have indicated their intention not to make any purchase under the arrangement.

The IMF's Executive Board approved the stand-by arrangement on April 20, 2001 for a total of SDR 33 million (about US$44 million--see Press Release No. 01/15).

Following the discussion of the Executive Board, Shigemitsu Sugisaki, Deputy Managing Director and Acting Chairman, said:

"The Latvian authorities' implementation of sound economic and structural policies has been the cornerstone of Latvia's strong macroeconomic performance over the past two years. Latvia continues to be well placed to sustain high growth in a low-inflation environment over the medium term, supported by its stable exchange regime and the prospect of EU accession. Growth is expected to reach 5 percent in 2002, among the highest of EU accession countries. Nonetheless, the persistently large current account deficit, projected at 8½ percent of GDP for 2002, poses a potential risk to Latvia's external sustainability.

"Prudent fiscal policy is critical to containing vulnerabilities associated with the large external current account deficit. Following the overall strong fiscal adjustment in 2001, the authorities' tight budget implementation during the first half of 2002 bodes well for achieving the 2002 fiscal deficit target of 1.8 percent of GDP, about 1 percentage point less than under the budget law. Further fiscal consolidation is called for in 2003, with a view to achieving broad budget balance over the medium term. To this end, and in view of the key spending priorities related to EU and NATO accession, the authorities need to improve expenditure prioritization and medium-term budget planning while moving cautiously in reducing the tax burden. In addition, the authorities need to bring local government borrowing under control in light of the nonobservance of the end-December 2001 deficit target, for which a waiver had to be granted. In this context, it is hoped that the amendments to the Law on Local Government Budgets would become effective expeditiously as soon as the definitional clarifications requested by the President of Latvia have been incorporated into the law.

"The currency peg to the SDR has served Latvia well and remains appropriate in the current external environment. To this end, the authorities' monetary program supports the peg and is based on further monetization of the economy and strong confidence in the financial system. The transition toward unified financial sector supervision has been managed very successfully, and Latvia is on track in implementing a high-caliber supervisory framework in line with international standards. The authorities have also taken significant steps to enhance the legal framework for combating money laundering and the financing of terrorism.

"Progress in the area of structural reforms has been good, driven by EU accession prospects. In particular, the recent strengthening of the anti-corruption framework is noteworthy, and this effort should be accompanied with strong and effective implementation. In addition, the divestiture of the remaining large state enterprises nears completion," Mr. Sugisaki said.

Statement by Ólafur Ísleifsson, Executive Director and Inguna Kupča, Assistant to the Executive Director for the Republic of Latvia
July 12, 2002

Our Latvian authorities appreciate the fruitful exchange of views they had with Mr. Mueller and his team during the mission's visit to Riga. The authorities are very pleased that the review discussions have been successfully completed. This review coincides with the tenth anniversary of Latvia's membership in the Fund. A constructive dialogue and cooperation with the Fund during this period has facilitated a sustainable development of the Latvian economy.

For the second consecutive year, Latvia recorded one of the highest growth rates in Europe, while continuously aiming at macroeconomic stability. Since the middle of last year Latvia has been affected by the global economic slowdown, as a result of which the current account deficit has risen. The Latvian government responded decisively by tightening macroeconomic policies. This demonstrates the authorities' ability to cope with adverse external developments in an efficient way.

Latvia has made good progress in the EU accession negotiations. By the end of the Spanish presidency 27 negotiation chapters of the *acquis* had been provisionally closed, thus placing Latvia in the forefront of the accession process.

Recent economic developments and prospects

During the last two years, the Latvian economy has been growing briskly, with a GDP growth rate of 6.8 percent in 2000 and 7.6 percent in 2001. Despite a deterioration of external factors, growth trends have continued to be fairly strong with real GDP growing by 3.8 percent in the first quarter of 2002. GDP growth is projected to accelerate up to 5 percent for the year as a whole. Economic growth is broadly based, with major sectors of the economy developing steadily. The main engine of growth has been strong domestic demand, which in turn is driven by increased investments and private consumption.

Inflation remains at historically low levels, with an annual average increase of consumer prices below 3 percent for the last three years. For the period ending June 2002, twelve-month inflation was 0.9 percent.

After a two years' downward trend, the current account deficit increased in the second half of 2001, reflecting high imports of capital goods and lower exports due to weakening in external demand. The recovery of external demand in 2002 is expected to lead to improved export performance and a narrower trade deficit, reducing the current account deficit to 8.5 percent. A comfortable surplus in the services account has partly countered the trade deficit, and significant FDI inflows appear to be largely sufficient to finance the current account deficit in 2002.
Despite the economic slowdown in the EU - Latvia's main trade partner - exports to the EU countries increased by about 5 percent in 2001, demonstrating the ability of Latvian enterprises to cope with the competitive pressures in Western European markets. At the same time,

exports to the neighboring Baltic countries and the CIS countries rose strongly during the last year and the first months of 2002, with the increase in 2001 reaching 19 percent and 32 percent, respectively. Further diversification of export markets and the external competitiveness of Latvian producers, together with the development of high value added export sectors and the establishment of new export markets, should further enhance export growth.

Fiscal policy

The 2002 fiscal deficit relates significantly to the growing commitments due to Latvia's accession to EU and NATO and further implementation of reforms in education and health care, and regional development. Further, as is highlighted in the staff paper, running a tight fiscal policy in a politically charged pre-election atmosphere is no easy task. In order to contain the current account deficit, however, the government realizes the need to adopt a fiscal stance tighter than the one budgeted for the year. Hence, the authorities have decided to keep the 2002 fiscal deficit at 1.8 percent of GDP, which is slightly better than last year's outcome.

The tightened fiscal stance already shows up in the fiscal data. The cumulative fiscal deficit for the first five months of 2002 amounted to just 10 million lats. The May outcome for the general government, which is further aided by a central government surplus in June, puts Latvia well on track to comfortably meet the end-June indicative target of 46 million lats. The authorities are determined to stay the fiscal course by monitoring revenue performance and tightening spending relative to the budget, including savings on debt service due to lower interest rates, savings on expenditure on goods and services at the central government level, and lower investment expenditures.

In 2003 the authorities aim at continued fiscal consolidation in line with macroeconomic requirements and their declared objective of balancing the budget over the medium term. The authorities place emphasis on restructuring and optimizing public expenditure and improving the financial control and accountability of public sector agencies. They have taken measures to enhance fiscal transparency: adopted a new procurement law, initiated medium-term budget planning, implemented pension reform, and established an improved framework for governance of public sector agencies.

The overall objective of the Latvian government in the field of tax policy is to create a fair, neutral and simple tax system that would guarantee sustainable budget revenue, facilitate production and promote savings. In this regard, the authorities highly appreciate the Fund's recent technical assistance mission in the field of tax policy. One of the key directions of the tax reform in Latvia is to lower the tax burden on individuals and enterprises. In the area of indirect taxation, the Latvian government acts in accordance to the commitments undertaken in the course of accession negotiations, i.e. by harmonizing the VAT and excise tax legislation with the respective EU directives.
The central government fiscal deficit has been decreasing over the last two years. The consolidated general government budget, however, is negatively affected by lack of fiscal discipline of local governments. The program includes several key measures to strengthen

control of local government finances. Following a presidential requirement for elaboration of some of the provisions in the amendments to the Law on Local Government Budgets adopted by the Saeima in late June, the authorities currently are preparing clarifications of certain definitions in the amendments and plan to put these to the Saeima for consideration. Furthermore, the Ministry of Finance has introduced monthly monitoring of the local government budgets and has communicated to the banks and the supervisory institutions its view that past excess borrowing on part of local governments had lacked the required legal basis. Against this background, the authorities request a waiver for the end-2001 performance criteria on the fiscal deficit. They are confident that the measures under the program relating to the local government finances will minimize the risk of a repetition of the end-2001 events that caused the overrun in the fiscal deficit.

Exchange rate and monetary policy

Since 1994, the Bank of Latvia has pegged the lat to the SDR. The peg has proven successful in its main objectives: facilitating low inflation, supporting business confidence, and enhancing stability in financial markets. After the accession to the EU the authorities plan to enter the ERM II mechanism aiming finally to adopt the euro upon meeting the Maastricht criteria. The range of the Bank of Latvia's monetary policy instruments as well as their usage has been modified to correspond to the practice of the European System of Central Banks. The authorities consider that their monetary policy stance adequately supports the exchange peg.

The rapid growth of the Latvian economy has facilitated a significant growth in monetary aggregates. Credit growth also was stimulated by increased competition between banks, favorable lending rates, improving quality of collateral, and the introduction of new banking products. However, the increase in the banks' credit portfolio appears to be slowing down compared to the previous year. The bulk of newly granted credit are medium and long-term loans aimed at boosting industrial capacity or secured by property. The banking community and supervisors are well aware of the risks related to high credit growth. Banks have stringent rules for evaluation of loan applications and closely monitor granted loans.

Financial sector policies

The cornerstone of the development of a modern and competitive financial system was laid down at an early stage of the transition process. The successful establishment of the essentials of a market-oriented financial system such as liberalization in the area of financial services and opening the domestic market to foreign competition induced rapid development, while further consistent steps have facilitated keeping up the momentum. The level of integration into the European financial markets has been constantly increasing. The restructuring process of the Latvian banking sector is at an advanced stage, with almost all banks being privately owned, often with a strong foreign ownership.

During the second half of 2001 and in the beginning of 2002, the Financial and Capital Market Commission (FCMC) proceeded with the harmonization of regulatory requirements governing the activities of financial and capital market participants with the European Community directives and recommendations. Considerable work had already been done adopting a framework of regulatory requirements. In particular, the adoption by the Saeima in April 2002 of the new amendments to the Law on Credit Institutions align Latvia's supervisory framework with the Basle Core Principles for Effective Banking Supervision.

The Latvian policy in combating money laundering and financing of terrorism is strongly linked to international efforts in this area. In June 2002, the Saima adopted the amendments to the Law on the prevention of laundering of proceeds from criminal activities, which further strengthened the legal basis for combating money laundering and the financing of terrorism. The authorities, in coordination with international bodies, are working on further legal amendments with a view to bring Latvia in full compliance with FATF recommendations and UN and EU requirements.

Structural reforms

The EU accession process has worked as a catalyst for the structural reform agenda. Since 1999 the government has implemented 68 of 77 suggested measures in the *Action Plan to Improve the Business Environment* in Latvia. Recently the government has placed emphasis on improving customs procedures. To further promote competitiveness, notably through measures aimed at stimulating domestic and inward investment in growth-generating activities, Latvia has developed a favorable legislative regime. The adopted legislation includes strengthening of anti-corruption measures and the authorities' key priority remains strong and effective implementation. A new office established for the prevention of and fight against corruption will begin operations in August this year. As indicated in the staff report, these measures have received strong support by the foreign investors, NGOs and international bodies.

Pension reform is being successfully implemented, with all three pillars now in operation. Contributions to the second, fully funded, pillar, started in July 2001, and gradually serve to promote investment of long-term financial resources in the capital markets. This serves to foster the development of the Latvian financial and capital markets.

Significant progress has been made in privatization. The sale of the few remaining state-owned enterprises is under way and is expected to be completed by early next year. The remaining state owned shares of JSC Latvijas Gaze were successfully sold in March 2002. Major progress has been achieved in the privatization of the Latvian Shipping Company (LASCO). In March 2002, 32 percent of shares were successfully sold through a public offering program for privatization vouchers and in June 51 percent of shares were sold in a public auction. The auction results, however, are currently being disputed in court by a late bidder.