July 27, 1999

Statement by Mr. Hansen on the Republic of Latvia
Executive Board Meeting
July 28, 1999

Introduction

Staff has provided a fair and balanced description of the relatively eventful year for the Latvian economy since the previous Article IV discussion. As a small and open economy, Latvia will always be subject to external influences, and the recent impact from the Russian economic crisis is yet another evidence of this. The time since our last meeting in November has also been somewhat turbulent on the political scene, and a new coalition government came into power earlier this month. The new government is in broad agreement with staff's assessment and policy recommendations, and it is their intention to immediately take firm measures in several key areas to stabilize the economic situation.

Early accession to the European Union remains Latvia's overall strategic objective, and the desire to integrate into the economic structures of the EU has created a consensus for acceleration of reforms in Latvia. My Latvian authorities have also made great progress in improving the consistency of economic policy making through the adoption of a medium-term strategy and Joint Assessment of Economic Policy Priorities with the European Commission in early 1999.

Fiscal Policy

Fiscal policy has taken center stage in Latvia, largely because the fixed exchange rate regime gives limited scope to active use of monetary policy. Thus, fiscal policy remains a key component in a strategy aimed at establishing the foundation for sustainable economic development. Indeed, Latvia has a tradition of very prudent fiscal policy, which has contributed to macroeconomic stability and low inflation.

Over recent years the authorities' commitment to sound fiscal policies have considerably improved the climate for economic decision making and investment, and provided scope for a market expansion of credit to the private sector. The actual outcome of the government budget balance in the previous two years was more favorable than projected, notwithstanding the pressures of the 1998 parliamentary elections and the consequences of the Russian crisis.

Due to economic slowdown in 1999, fiscal policy remains at the core of attention of the government. A more expansionary stance for this year's budget was, up until recently, considered appropriate in light of the economic downturn. The new government, however, is somewhat more in line with staff's view on what is the appropriate level of the budget deficit. The political consensus has been achieved with a view to avoiding expansionary fiscal policy in light of the more uncertain external environment. Hence, the government has already declared its intention to present a supplementary budget that would come into effect in September and aim at reducing the fiscal deficit this year to around 3 percent of GDP. For the next fiscal year, the government intends to bring the budget even closer to balance. This is expected to alleviate, to some degree, the external imbalances.

The government has also begun to design fiscal policies in a medium term framework geared towards maintaining sound macroeconomic fundamentals, and with a view to achieving gradual convergence to EU standards, and attracting the financing of EU Structural Funds.

Monetary and Exchange Rate Policy

The peg to the SDR has served Latvia well, and the advantages of a fixed exchange rate arrangement have been widely recognized. At the same time, the possible constraints on economic development and competitiveness have been very limited as reflected in the fact that Latvia, in many respects, is one of the more successful transition countries, and in the fact that the appreciation of the real effective exchange rate has led to only marginal losses of competitiveness vis-a-vis Latvia's main trading partners. In addition, the peg to the SDR has minimized the fluctuations that would otherwise have been more pronounced in case of a peg to a single currency. Although the authorities are technically prepared to switch the peg to the euro at any time, and the Bank of Latvia (BOL) is fully authorized to do so, they feel obliged to thoroughly consider all implicit and explicit consequences of revising the exchange arrangement. They will carefully study all possible changes in the behavior of various foreign trade agents and, equally important, closely follow the performance of the euro in world financial markets.

During the first five months of 1999, nearly 64 percent of Latvia's foreign trade was with the European Union. However, more than one third of total exports is with three countries staying outside the EMU - the United Kingdom, Sweden and Denmark. Thus, Latvia is somewhat less dependent on the behavior of the euro, compared to some other transition countries whose European trade is more directed at the single currency area.

Furthermore, it is important to ascertain that the currency composition of Latvia's foreign trade by and large corresponds to the composition of the SDR basket. Currently, roughly forty-seven percent of the foreign trade transactions are carried out in US dollars, indicating that the link to the SDR still is relevant. It would be reasonable, however, to expect that a gradual shift to a wider use of the euro would somewhat reduce the importance of the dollar in Latvia's foreign trade in the future. If and when that happens, pegging the national currency to the euro would be a logical step, perfectly in tune with Latvia's pre-accession strategy.

Privatization and other Structural Reforms

While my authorities have been making good progress regarding structural reforms, they are conscious of the need for a deepening and broadening of reforms in various areas in order to reach Latvia's full growth potential. Staff rightly notes that there has been some delays in the privatization of large enterprises compared to the original schedule. This is a difficult and in certain ways sensitive process that needs careful considerations.

The new government has declared that it will attach high priority to accelerating the privatization process, but, at the same time, it will be careful in choosing the most efficient ownership structure and not risk ending up with inefficient private monopolies. They envisage privatization of the Latvian Shipping Company to be in place before the end of the year, and the remaining state owned enterprises within a year's time. In addition to improving competition and corporate governance, a successful completion of the privatization process will be beneficial in attracting foreign direct investment, thereby contributing to a strengthening of the foreign balance.

Financial Sector Issues

The Russian crisis has indeed had a significant impact on the Latvian banking system. To varying degrees several banks were relatively highly exposed to ruble denominated assets. Hence, a number of banks ended up making losses in 1998, and three small banks have been closed or suspended. In this way, the shock contributed to speeding up the consolidation of the banking sector, and the number of banks have now come down to 28, compared to 65 in 1994. The fifth largest bank, Rigas KomercBanka (RKB), became insolvent and its operations were suspended. Intensive negotiations on a recapitalization plan are still ongoing, and while a large number of private depositors have indicated their willingness to capitalize their deposits, the new government has yet to confirm its participation in providing funding. As regards the involvement of Bank of Latvia in this process, the Bank did consider at an early stage of the Russian crisis that the failure of RKB could have significant systemic repercussions. Therefore, BOL decided to provide the bank with collateralized liquidity support in an attempt to revive the bank. They are in full agreement with staff that their share holdings in the bank should be divested as soon as possible, and they are firmly committed to doing so.

As well illustrated in the Selected Issues paper, my Latvian authorities have not spared any efforts, or time, during the past year to improve bank supervision and prudential regulations. The cooperation with and assistance from highly qualified Fund experts in this area has been excellent and the authorities are highly appreciative of these efforts. The aim in this area is to align BOL's regulatory framework fully with the Basel Core Principles of Effective Bank Supervision and the relevant EU directives. Limiting banks' exposure to individual non-OECD countries and groups of countries as well as raising the risk weights on non-OECD government debt for calculating the capital adequacy ratio are examples of regulatory measures that have been implemented in the wake of the Russian crisis.

External Balance

The current account deficits widened in 1998 to 9.5 percent of GDP. However, with still robust export to non-CIS countries, total exports in 1998 grew by 11 percent. As imports declined in the wake of the slowdown of domestic demand, the current account balance improved somewhat in the first quarter of this year. My Latvian authorities recognize the importance of the reduction of the current account deficit by further fiscal tightening. However, the concerns about the magnitude and medium-term sustainability of the current account should not be exaggerated. First, there is no evidence of over-valuation of the national currency. Second, a significant share of the growth of imports is the counterpart of the large FDIs and other private long-term capital inflows. The ongoing restructuring of enterprises as well as economic reorientation are considered to be the principal factors in coping with the problem of the current account deficit in the medium term.