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March 13, 1998

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Latvia—Selected Issues and Statistical Appendix**

This paper provides background information to the staff report on the 1997 Article IV consultation discussions with the Republic of Latvia and the first review under the Stand-By Arrangement, which was circulated as EBS/98/42 on March 9, 1998.

Mr. Schiff (ext. 38717) or Ms. Westin (ext. 34982) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

Selected Issues and Statistical Appendix

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Approved by European II Department

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Latvia: Basic Data

Social and demographic indicators 1/				
Area	64,589 sq. km.			
Population	2.5 million			
Urban	69 percent			
Rate of population growth	-0.9 percent per year			
Life expectancy at birth				
Male	64 years			
Female	76 years			
Infant mortality rate (per 1,000 births)	15.8			
Hospital beds (per 10,000 inhabitants)	103			
Physicians (per 10,000 inhabitants)	35			

	1994	1995	1996	1997
	In percent of GDP			
Shares of gross domestic product 2/				
Agriculture and fishing	9.5	10.8	9.1	8.1
Industry	20.2	22.6	22.1	21.2
Electricity	5.2	5.5	5.6	4.4
Construction	5.9	5.1	4.9	4.6
Services	59.2	56.0	58.3	61.7
GDP 2/				
Nominal GDP (in million of lats)	2,043	2,492	2,944	3,337
GDP per capita (in lats)	801	991	1,182	1,351
Real GDP (percentage change)	2	0	2.8	6
Consumer prices (percentage change, end-period)	26	23	13	7
General government finances				
Total revenue	746	884	1,084	1,330
(in percent of GDP)	36.5	35.5	36.8	39.9
Total expenditure	780	952	1,118	1,275
(in percent of GDP)	38.2	38.2	38.0	38.2
Financial balance	-35	-68	-35	55
(in percent of GDP)	-1.7	-2.7	-1.2	1.6
Net lending	-48	-15	-5	-10
(in percent of GDP)	-2.3	-0.6	-0.2	-0.3
Fiscal balance	-83	-83	-40	45
(in percent of GDP)	-4.0	-3.3	-1.3	1.3
Money and credit (end-period)				
Net foreign assets	370	300	445	619
Broad money	687	524	628	871
Domestic credit	448	332	349	479
Velocity (level)	3.3	5.2	5.0	4.1
Balance of payments				
Total exports 2/	997	1,368	1,488	1,745
Total imports 2/	1,375	1,947	2,286	2,632
Current account balance 2/	-9	-159	-217	-397
Official reserves (in months of imports of goods and nonfactor services)	4.7	3	3.1	3
Exchange rate, lats per US$, end-period	0.548	0.537	0.556	0.59

Sources: Latvian authorities; and Fund staff estimates.

1/ Data for 1994 or latest available.

2/ Estimated data for 1997.

I. Introduction

1. Latvia is at an advanced stage of transition, having essentially achieved the objective of macroeconomic stabilization, and is now in the process of putting in place the comprehensive and deep-seated structural changes required to establish the institutional basis of a market economy. The authorities have established a record of prudent financial policies, enhanced the soundness of the banking system, and moved forward on a broad front of structural reforms. A substantial start has been made on the second generation agenda of reforms: public sector reform, improvements in governance, financial sector supervision and regulation, enhancing of property rights, and strengthening of the judicial system.

2. These policies were reflected in an excellent economic performance during 1997. Real GDP growth accelerated in the second half of 1997, and is estimated at 6 percent for the year (Statistical Appendix Table 26). Growth was broad-based, with particularly strong performance in the services sector and construction, and has been led by increased investment, with real capital formation rising by an estimated 10 percent, and enhanced efficiency. Reflecting the strong economic growth, official unemployment has begun to decline, falling from 7½ percent in mid-year to 6.7 percent at end-January 1998, although unemployment remains as high as 30 percent in several rural regions.

3. Inflation fell more rapidly than expected in 1997, with consumer prices rising by 7 percent for the year (Statistical Appendix Table 31). Through February 1998, the downward trend has continued, and annual inflation now stands at just over 6 percent. This development reflects a number of factors, including cheaper food imports following the implementation of the Baltic Free Trade Agreement, and the sizable fiscal surplus accumulated by the general government. Excluding increases in remaining administered prices, such as for utilities and housing, consumer prices rose by just 4.5 percent during 1997.

4. The general government accumulated a surplus of 1.3 percent of GDP, contributing to lower inflation and interest rates and higher private sector investment (Statistical Appendix Table 32). Revenue increased sharply as a percent of GDP, owing to improvements in tax administration, in particular for customs duties and social insurance contributions, and the impact of increased profits on the corporate income tax (Statistical Appendix Table 33).[1] On the expenditure side, smaller-than-expected increases in indexed transfers resulting from the better inflation performance, lower interest payments, and shortfalls in public investment, in particular by local governments and extrabudgetary funds, all contributed to the sizable surplus. The tight fiscal stance has continued into 1998, with the general government registering a sizable financial surplus (excluding net lending) of some LVL 30 million (almost 1 percent of 1997 annual GDP) in January.

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[1]Measured revenue was also higher as a result of improved coverage of extrabudgetary funds. This is reflected as well in the expenditure data.

5. Monetary developments during 1997 reflected a continued increase in confidence in economic policies and the banking system, and an acceleration in the development of the financial sector. Reserve money grew by 22 percent (Statistical Appendix Table 38) and broad money by nearly 32 percent during the year, in real terms, while velocity declined by about 18 percent over the same period (Statistical Appendix Table 39). The increased demand for money was satisfied primarily through the Bank of Latvia's foreign exchange operations and strong growth in domestic credit to the nongovernment sector, equal to 69 percent in real terms for the year. Despite this rapid credit growth, however, Latvia's domestic credit-to-GDP ratio, at about 10 percent, remains quite low by international standards and relative to similar transition economies. Real interest rates in Latvia have remained low owing to, inter alia, the tight fiscal stance and continued falling inflation. Despite interest rates on bank deposits slightly below current inflation, the level of deposits grew by 57 percent last year, reflecting increased confidence in the banking system and strong expectations of further inflation decline. Real interest rates increased during 1997, and have continued this trend in the first two months of 1998, and virtually all interest rates are now positive on a forward-looking basis. In addition, interest rate spreads began to narrow in the second half of 1997 due, in part, to banks' perceptions of lower credit risk.

6. Banking supervision continued its improvement since the banking crisis of 1995, and the banking system strengthened considerably, with the number of banks meeting core bank requirements for accepting household deposits increasing from 13 to 19 during the course of 1997,[2] and the quality of loan portfolios improving. The process of financial widening accelerated in 1997 as well, with the establishment of a number of leasing companies, investment funds and other nonbank financial institutions. Banking regulation is being further enhanced in 1998, including by expanding the focus of financial oversight to nonbank financial institutions.

7. The external current account deficit for the first nine months of 1997 was 6.6 percent of GDP, and is estimated at just under 7 percent of GDP for the year as a whole (Statistical Appendix Table 44). Exports grew strongly, by an estimated 13 percent (in volume terms), but import growth was just as rapid, reflecting an acceleration in the second half of the year in imports of intermediate and capital goods. The trade deficit in 1997 is estimated to have widened slightly from 1996, from 14.9 percent of GDP to 15.5 percent of GDP. However, inflows of foreign direct investment continued to strengthen, encouraged by the stable macroeconomic situation, ongoing privatization and new projects, contributing to a balance of payments surplus for the year, and the debt-to-GDP ratio declined to about 7 percent of GDP. At end-1997, gross international reserves of the Bank of Latvia were equivalent to three months of imports of goods and nonfactor services.

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[2]There are 33 banks in total; of the 14 non-core banks, 7 are finance companies and the remainder are small. All 33 banks currently meet capital adequacy requirements, minimum capital levels, and liquidity floors.

8. Latvia made significant progress in liberalizing trade in 1997, and the regime is characterized by generally low tariffs (with the exception of some agricultural goods), no quantitative restrictions and virtually automatic import licensing, and only a few specific import tariffs and export duties. The Customs Law adopted in July 1997 modified the provisions on customs valuation of goods in accordance with GATT/WTO rules and lowered tariffs on most products, including some agricultural goods, which still retain high tariffs. Tariffs on several goods were lowered to zero or 1 percent, reducing the (unweighted) average basic tariff for all non-agricultural goods to 4.5 percent, with 1 percent the most common rate. With respect to agricultural products, the production-weighted basic tariff for all products was reduced from 53 percent to 34 percent in July 1997. In January 1998, tariffs on a number of products (including wine and cigarettes) were lowered further. A free trade agreement (FTA) with the Baltic states for agricultural products entered into effect in January 1997, complementing an existing agreement on industrial goods, and several other bilateral FTAs were signed in 1997 or went into effect. All together FTAs exist with 25 countries while Most Favored Nation (MFN) agreements exist with 22 countries. Substantial progress has been made toward accession to the WTO, with agreements on bilateral negotiations effectively reached with all countries except the United States.

9. Good overall progress has been made on implementing structural reforms. With respect to enterprise privatization, over 300 purchase agreements were concluded in 1997 (about 200 remain) and the private sector now accounts for about 65 percent of GDP. However, the process of privatizing the largest infrastructure enterprises has slowed somewhat, and may not be completed during 1998. Apartment privatization has moved ahead as scheduled, with over 20 percent of all previously government-owned apartments now in private hands, and measures have been taken to address obstacles to further progress over the medium term. In the area of enhancing property rights, land registration is advancing, and draft legislation before parliament would establish registers for movable property, further supporting credit market development. With regard to the public sector, the process of improving tax administration is continuing, a civil service census was completed and recommendations for public sector reform drafted, and legislation for the second stage of pension reform is being prepared.

10. The following chapters address in detail a number of important issues. Chapter II examines the development to date of the financial sector in Latvia, in terms of both financial deepening and widening, and describes and evaluates progress made in supervision and regulation of both banks and nonbank financial institutions. Chapter III describes the already completed first stage of pension reform, as well as the steps taken to create a fully funded tier in the near future. Chapter IV examines the related issues of Latvia's external competitiveness and its potential vulnerability to external crisis. Chapter V looks at developments in the labor market over the course of Latvia's transition, including trends in employment, unemployment and wages, and relates these developments to policies and institutions. Finally, Chapter VI examines Latvia's path to EU accession, focusing on steps taken to date to meet accession requirements, and challenges and opportunities in the future.

II. FINANCIAL SECTOR REFORM

11. This chapter assesses the evolution of Latvia's financial sector, analyzing both the extent to which financial deepening and widening[1] have occurred as of end-1997, and comparing Latvia's development with other economies in transitions and developing countries. In addition, the chapter includes an assessment of the quality and soundness of the growing financial sector. The remainder of the paper is organized as follows. The first section presents an overview of the financial system in Latvia, including the banking sector, nonbank financial institutions (NBFIs) and instruments, regulatory framework, and systemic safeguards. The second section briefly reviews the literature on financial sector development, with particular attention to the use of indicators of the degree of development. The third section assesses Latvia's financial sector development and compares it to selected countries in transition and other developing economies. The final section presents a summary and conclusions.

A. Overview of the Financial System in Latvia

12. The development of the financial system in Latvia can be attributed in part to the adoption of universal banking laws. But in addition, the combination of consistent and prudent monetary policy credibly supporting a pegged exchange rate regime, along with tight fiscal policy and accelerated privatization, have resulted in the decline of inflation to single digits, the resumption of real economic growth, and the gradual restoration and building of confidence in the banking sector. It has taken two years since the banking crisis of 1995 to restore borrowers' confidence in the security (i.e., of deposits) of the banking system, in part due to the implementation of strong prudential regulations. In addition, due to the increase in the level of collateralizable assets and new investment opportunities (resulting from privatization and private sector development), banks are more willing to lend. As a result, both demand and supply pressures for a deeper and wider financial market have intensified.

13. Latvia's current banking system is built on the recovery from the banking crisis which came to light in late-May 1995. In brief, the banking crisis began when published annual reports for 1994 revealed that two-thirds of audited banks recorded losses in 1994 and lacked

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[1]The concepts of financial "deepening" and "widening" are in themselves not precise. The paper defines financial deepening as the process by which assets or facilities grow such that they are more able to withstand or mitigate shocks (both individually—individual banks—and on aggregate—the banking sector as a whole). Financial widening is the creation and activation of new financial instruments such that the degree of substitutability between instruments grows. A perfectly "wide" financial system does not imply perfect substitutability; rather it implies that a shock to one part of the financial market would be partially offset by the use of another instrument (such as the periodic switch between stocks and bonds in developed financial markets). Moreover, financial deepening and widening can occur simultaneously although at different rates.

enough capital to be able to absorb the losses. The crisis culminated in the closure of 15 banks over the ensuing year, including Bank Baltija (which accounted for 30 percent of total deposits at end-March 1995). Poor implementation of credit policies, with widespread insider lending, capitalization of interest on unpaid debt, and overexposure were aggravated by banks' large open positions in foreign exchange. The Bank of Latvia (BoL) reacted immediately by implementing tighter prudential regulations, stepped-up monitoring of banks through more frequent on-site inspections and the requirements of external audits, the creation of "core banks,"[2] and rapid closure of banks which are not in compliance with prudential standards. The aftermath of the banking crisis was a severe decline in the level of loans extended and low consumer confidence in the banking system.

14. Aside from anecdotal evidence, signs of increased confidence in the banking system during 1997 are proxied by the 18 percent decline in velocity during 1997 (compared to a 6 percent decline during 1996), and close to a 15 percent decline in the currency/deposit ratio during 1997 (compared to a 0.4 percent rise in 1996).

15. Additionally, the number and level of activities of NBFIs appears to be growing (see below). Currently, NBFIs are mainly insurance companies and leasing firms. But as of July 1, 1998, when the new investment law takes effect, it is expected that investment banks and funds will enter the market. It is expected that by mid-1999, these firms will be a powerful force in the financial market.

The banking sector

Overview

16. As in other countries with universal banking systems, Latvia's financial sector centers around banks, which provide primary financial instruments (loans and deposits) and which own approximately half of the NBFIs. As of December 1997, there were 33 banks (including one foreign), out of which 19 had core status. Of the remaining non-core banks, 7 were finance companies (usually associated with one firm), 6 were small "niche banks" (with limited services and activities primarily in a specific sector), and one was a foreign bank with limited services. Although the number of banks has fallen since the banking crisis (down from 44) and the smaller banks do not appear to be problematic at present, it is likely that there are still too many operating banks, given the size of the Latvian market. Approximately 80 percent of all lending activities are carried out by the top 4 banks, and about 70 percent of deposits are with these same banks. Many of the small banks have remained profitable by holding CIS-country government securities, whereas the largest banks are turning increasingly to domestic loans to the private sector.

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[2]Core banks are the only institutions allowed to take household deposits.

17. It is possible that as margins on foreign securities decline, banks which do not have a significant loan-based portfolio might be forced out of business. Until that time the main source of pressure for bank consolidation will be competition among banks for new clients in order to maintain levels of profitability, especially if lending margins fall, which should intensify in the next two years as banks turn increasingly toward the domestic market for profit earnings.

18. Although minimum capital requirements are to be raised in April 1998 to the equivalent of ECU 5 million, this requirement only applies to new banks (of which there are none), and the extension of the requirement to all banks is not due until January 2000. However, the BoL requires that at a minimum, all core banks meet the ECU 5 million level now.

19. The sectoral distribution of credit has shifted since 1995 (see Statistical Appendix Table 43), with the share of total domestic currency credits of agriculture dropping from 7.1 percent at the end of 1995 to 5.2 percent in December 1997, while the share of credits to the financial sector rose sharply from 1.2 percent to 13.9 percent of the total over the same period. The largest share of both domestic and foreign currency credits is to the trade sector (34.9 percent and 53.4 percent, respectively, in December 1997), and the share has been approximately unchanged since 1995.

20. The maturity structure of loans has gradually lengthened, with 14.8 percent of bank assets held in long-term maturity instruments[3] in December 1995 growing to 44.9 percent in December 1997. On the deposit side, however, the percentage of long-term maturities has fallen from 6 percent in December 1995 to around 4.5 percent at the end of 1997. Bankers suggest that the maturity mismatch is due to the previously negative real rates of return on deposits (though deposits are growing rapidly) and the introduction of alternative financial instruments. At the same time, the fact that deposits are growing is an indication of increased confidence in the banking sector, which combined with increasingly positive real interest rates on a forward-looking basis is likely to result in lengthening maturities and a reduction in the maturity mismatch.

21. Privatization and the growth of activity on the Riga Stock Exchange (RSE) has allowed banks to diversify their portfolios to include equity holdings. The aggregate amount of equity holdings as a percentage of total assets has grown from 1 percent in 1996 to 3 percent in 1997. This growth of share holdings by banks is currently not covered by prudential regulations, but will be corrected when a market risk component is added to the capital adequacy requirement (not expected to be operational until 1999), at which time banks will have to factor equity holdings in their calculation of risk.

[3]Long-term in this case is defined as greater than one year.

22. Finally, a new area of growth for banks is trust operations—banks acting as agents to broker the purchase and sale of foreign securities. These activities constitute approximately LVL 50 million in terms of float and are a major source of bank profits. Although trust operations are currently unregulated, the BoL plans to set guidelines for these activities during 1998.

Banking supervision and prudential regulation

23. Banking supervision and prudential regulations in Latvia continue to strengthen and are among the most stringent in transition economies. All requirements are compatible with the Basle Committee recommendations (with the exception of the market risk component of capital adequacy which is expected to become operational in early 1999), and all are consistent with EU best practices.[4] In addition, banks are inspected on-site six times per year (four times by the BoL, twice by international auditors).

24. As of end-December 1997, all banks were in compliance with prudential regulations (capital adequacy and minimum capital requirements), though 14 banks are operating with some restrictions and thus are not considered "core banks." Table 2 presents selected banking sector "soundness" variables. In particular, all banks met the 10 percent capital adequacy requirement.[5] Second, the level of loan-loss provisioning has declined as a percent of total loans, to about 11 percent of total loans. This ratio has declined because not only has the total loan pool grown, but also because the level of nonperforming loans has declined. It is notable that most nonperforming loans were contracted before the banking crisis. In addition, the definition of nonperforming loans has widened.

25. In the aggregate, banks continue to hold excess reserves. The end-December figure was an excess of LVL 15 million, the highest in the past year. However, this figure is partly due to the shifting of government deposits out of the BoL into the commercial banks, although banks have been holding, on average, between LVL 7–10 million in excess reserves since 1996.

26. With the bulk of the institutional and legal framework for banking sector regulations in place, the BoL is focusing on strengthening procedures and refining requirements to match the needs of the evolving sector. Each of these changes will be monitored by supervisors during their six yearly on-site inspections. In 1998, the BoL plans the following changes. First, as of April 1998, a new system of commercial bank internal control is required by the BoL. The new procedure will allow the BoL to standardize data regarding governance practices, risk evaluation, management information systems, and general accounting practices. Second, to

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[4]Table 1 summarizes basic prudential regulations and compares them to EU standards.

[5]Capital adequacy ratios for the largest four banks (which constitute more than 80 percent of bank assets) was approximately 11 percent at the end of December.

combat money laundering, the BoL has instituted a new disclosure requirement which gives it the right to revoke the core status of any bank which cannot produce a comprehensive list of its actual shareholders.Third, the BoL strengthened the capital adequacy requirement on bank activities in "zone b" countries (CIS), by changing the weighting of these assets from 80 percent to 100 percent.[6] This change effectively makes holding these assets more expensive for banks. Fourth, the loan-loss provisioning schedule has been made more stringent by categorizing any loan in which interest payments are overdue by over 90 days as nonperforming instead of substandard.

27. Perhaps the most important change this year is the move toward monitoring banks on a consolidated basis. The goal is to capture bank activities with its subsidiaries (NBFIs) under the bank balance sheets. The legal foundations for the extension of the supervisory net are in process, involving adoption of amendments to the Credit Institutions Act. The current plan is to require banks to recalculate current prudential ratios using input from all operations. Bank monitoring on a consolidated basis is expected to begin on January 1, 1999.

28. Thus far, the soundness of Latvia's banking sectors appears to be improving in parallel with the pace of financial deepening.[7] At the same time, as the banking sector becomes more dynamic and more developed, it becomes more important to assess continually the quality of loan portfolios, as proxied by indicators such as capital adequacy adherence, loan-loss provisioning levels, and the ratio of nonperforming loans/total assets.

Nonbank financial institutions

29. In addition to the financial deepening occurring in the banking sector, the number and size of new financial institutions and instruments has increased during 1997. In a universal banking system, NBFIs are usually associated with banks, which serve as the most likely source of investment capital. Unlike most countries with universal banking systems, however, only 50 percent of NBFIs in Latvia are bank subsidiaries (as of December 1997). At the same time, it appears some institutions, such as leasing companies, are owned by banks, whereas others, such as insurance companies, are independent.

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[6]Capital adequacy ratios are calculated by weighting each asset according to its level of risk on a scale of 0–100 percent, multiplying the value of the asset by its weight, adding all of the risk-weighted assets together, then multiplying the sum by the required ratio, which currently is 10 percent in Latvia. The significance of a reported ratio well above the minimum is difficult to assess. On one hand, it could signify that a bank's asset portfolio is excessively risky (and that it is properly accounting for the risk in the capital adequacy calculation); or, it could signify that a bank is being cautious and holding capital adequacy amounts over the required risk-weighted minimum.

[7]Again, see Table 2 for a time-series of selected banking sector soundness variables.

Overview

30. The most active NBFIs are the 15 leasing companies in operation as of end-December 1997. Total leasing company assets grew from approximately 1 percent of total financial assets of Latvia at the end of 1996 to 3.5 percent in December 1997. Until mid-1997, the main leasing operations were on movable assets, such as cars, furniture, and equipment. However, the five largest leasing companies (which comprise over 85 percent of total leasing operations) are now turning into financial intermediaries, as they begin to provide direct financing for companies.

31. Insurance companies are growing quickly, and as of January 1998, there were ten active nonlife companies in Latvia. Though currently, total assets of insurance companies are only 2.4 percent of total financial assets, the role of these firms is expected to grow sharply as private pensions schemes develop further.

32. The equity market in Latvia grew dramatically during 1997. Although it was founded in July 1995, the Riga Stock Exchange (RSE) did not begin rapid expansion until 1997. Market capitalization grew from about LVL 83 million in January 1997 to LVL 200.54 million in December (from 2.7 to 6.3 percent of GDP). Turnover grew by 100 percent in 1997, reaching about LVL 1 million in December, with 28 members firms on the primary list, up from 3 at the beginning of the year. Unlike in most transition economies the RSE is comprised mainly of private enterprises, with only 2 banks now listed. Because of the rapid pace of privatization of the economy, it is possible that capitalization of the RSE could grow to LVL 1 billion by the end of 1998, as most of the newly privatized large enterprises expect to list shares during 1998.

33. The extent to which foreign investors participate in the RSE is not known, though it is likely that Estonian investors take advantage of the "border-free" movement of capital (mainly through the banking system and leasing companies) allowed between all three Baltic countries. The RSE tends to react to movements in the Tallinn Stock Exchange, suggesting that Estonian investors manage liquidity by moving in and out of the RSE.[8]

34. Associated with the rapid pace of privatization, the adoption of an investment funds law, and a securities market law in 1997, investment funds are beginning to operate in Latvia. Though the number and activity is small, it is expected to accelerate by mid-1998.

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[8]Perhaps the best example of the co-movements of the Tallinn and Riga exchanges is the fact that the summer run-up and September/October drop in the Tallinn Exchange was mirrored (with a few days lag) by the RSE, though the magnitudes were much smaller in Riga.

Supervision of NBFIs

35. Currently many NBFIs are weakly regulated, with the exception of the insurance industry and most recently, the securities market. Leasing companies, the main nonbank financial intermediators, are wholly self-policing. When BoL consolidated supervision begins, approximately 50 percent of all NBFIs will be covered under the supervisory net because these firms are bank subsidiaries. Institutions covered under consolidated supervision will effectively be monitored by two different sources: by BoL banking supervision and by the regulatory agency which covers that institution.

36. Securities market regulation was adopted in 1997 (fully consistent with EU best practices) and is currently being carried out by the Securities Market Commission (SMC), an independent agency, overseen by the Ministry of Finance. The commission which began operation on January 1, 1998, is built on the Danish model. The chairman is proposed by the Ministry of Finance (MOF) and the BoL and ratified by the parliament.[9] The SMC is empowered to require disclosure of information by any equity market actor at any time and has the authority to revoke licenses, impose fines, and refer cases to the civil courts.

37. Investment firm and insurance company supervision is done by independent agencies associated with the Ministry of Finance. On-site inspection of investment firms, funds, and insurance companies is expected to take place at least one time a year. Those securities which are associated with banks will be subject to both BoL banking supervision visits and monitoring in addition to that of the SMC. The same is true for other NBFIs which are bank owned.

38. NBFI regulation, for those institutions and instruments which are not covered under separate legislation such as leasing companies, is now being created in the context of amendments to the Law on Credit Institutions, the laws on investment funds and pensions, and in the context of existing regulations.[10]

39. Finally, an inter-agency working group on financial market supervision, formally chaired by the minister of finance and composed of members of the MOF, BoL banking supervision staff, insurance representatives, and representatives from the SMC are considering the creation of a "super-regulatory" agency which could house all financial sector supervision groups and is a wholly independent entity.

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[9]The SMC signed a protocol of intent to coordinate securities market supervision among all three Baltic supervisory agencies, with the goal of harmonizing regulations. This is being done in anticipation of the proposed consolidation of all three stock exchanges into a pan-Baltic stock market.

[10]That is, the existing connected lending and credit concentration limitations as a part of the existing bank prudential regulations apply to NBFIs.

B. Literature Review and Indicators of Financial Sector Development

The process of financial development

40. Financial sector development has been studied extensively in the literature. Much of the literature (for example see, Bisat et. al. (1992), Galbis (1994), Bisat (1996), and Jbili et.al. (1997)) attempts to schematize the process of financial sector development in middle-income countries (such as the Mahgreb, East Asian "tigers", Argentina, and Brazil). All of these studies assume that financial sector development begins when prices and interest rates are liberalized, banking and financial sector deregulation takes place (especially when directed credits are eliminated), and perhaps the capital account liberalization is implemented. One problem is that the literature concentrates on the banking sector and not on other intermediaries and instruments.[11]

41. A second problem is that studies tend to concentrate on the quantitative aspects of growth of the financial sector and not on the issue of quality of the assets (including loan portfolios) and building sound financial systems. Sundararajan (1996) touches on this issue in assessing the changing role of prudential regulations in the process of financial sector growth.

42. Finally, with respect to transition economies, the beginning of financial sector development has generally been marked by tangible changes—the establishment of institutions and legislation—and intangible changes—the establishment of confidence in the banking and nonbank financial sector, rather than simply liberalizating markets (where most developing countries mark the beginning of financial development). In many cases, such as in Latvia and to a greater extent Estonia, prices, interest rates, and capital flows were free well before the financial sector began to develop rapidly, and the "take-off" point was not reached until confidence in the banking sector was restored and economic growth had begun such that there was a demand for financial services. Thus, defining a standard path of financial sector development may be less straightforward in the case of transition economies.

Indicators of financial market development

43. Most authors have relied on a limited set of variables to proxy for three main aspects of financial sector development: the volume of intermediation, financial sector efficiency, and the relationship between financial sector growth and macroeconomic growth. The majority judge the degree of financial sector development by looking at a single variable, usually the ***ratio of credit to GDP,*** or sometimes broad money to GDP. Some of the recent studies [such as Roubini and Sala-I-Martin (1992)] add the real interest rate as a variable and also a proxy for financial repression.

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[11]Johnston and Pazarbasioglu (1995) briefly discuss the narrow focus of most measures of financial sector development.

44. The degree of financial intermediation is traditionally proxied by the ratio of domestic credit (in relevant cases, to the private sector) to GDP. De Gregorio and Guidotti (1992), using a panel data set including 12 countries, separate credit-to-GDP ratios into central bank credit and commercial bank components, in order to assess the degree to which credit is "directed" or market-based.[12] They show that the greater the concentration of credit from the central bank, the lower the contribution of the financial sector to economic growth. That is, the greater the amount of directed credits, the lower the economic efficiency.

45. More recent studies [see Bisat (1996)] have expanded both the number and scope of indicators to include the degree of monetization of the economy (M1/M2 and currency/deposit ratios) and interest rate spreads, and in a few cases, equity market capitalization. Levine (1996, 1997b) includes additional measures of equity market development, value-traded ratio and turnover ratios, to assess the relative size of stock markets to GDP and the level of activity of the stock market to GDP respectively.

46. It should be noted that in response to the recent market turbulence in Southeast Asia, and to a lesser extent in advanced transition economies, a new literature on financial vulnerability is being developed. Some of the issues being discussed include the characteristics of financial systems which are at risk to crises, monitoring a set of early warning indicators, and determining a set of financial sector policies which could dampen the impact of adverse shocks to the financial system.

47. The appendix presents a summary of the main indicators found most commonly in past literature. Though the list is by no means exhaustive it represents those indicators which have been found empirically to be the most representative and perhaps most widely available such that cross-country analyses can be made.

C. Indicators of Financial Sector Development in Latvia and Cross-Country Comparisons[13]

48. Most studies involving financial sector development indicators broadly concentrate on the growth of the banking sector. Specifically, these measures attempt to capture the impact of credit expansion on economic growth, efficiency of the banking system to mobilize funds, and degree to which the supply and demand for bank resources respond to market signals. The list of indicators presented in Table 3, though by no means exhaustive, gives a range of

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[12]Additionally Odedokun (1992), in an 81-country pooled time-series/cross section data set from 1961–90, concludes that the stock of credit to GDP is consistently the best proxy for financial depth compared with other measures (such as liquid liabilities to GDP and other measures involving the real interest rate).

[13]Due to data constraints, there are only five indicators for which there are cross-country comparisons.

variables for assessing the breadth and depth of Latvia's financial sector development. When placed in a comparative context, Latvia's financial sector at end-1997 appear to be at an early stage, relative to many other countries in transition (see Table 4).[14] One interpretation is that Latvia's acceleration of financial sector development was in part a function of general economic growth as well as a "catching up" with other developing economies. The remainder of this section presents indicators of Latvia's financial sector development and selected countries for comparison.

Indicators of recourse mobilization and proxies of financial deepening

49. The two main indicators of the banking system's ability to mobilize deposits are the ratio of credit to nongovernment-to-GDP and M1/M2. First, because it is usually calculated as the sum of credit from all financial intermediaries (including NBFIs), **credit to nongovernment-to-GDP** is the most commonly used indicator of financial depth and width. In Latvia, the stock of credit to nongovernment as a percent of GDP changed dramatically from 7.6 percent in December 1995 down to 6.5 percent in December 1996 and up sharply to 10.1 by December 1997. Since credit to government-owned enterprises is less than 7 percent of total credit to nongovernment in Latvia, credit to nongovernment roughly represents credit to the private sector. Although the rate of growth has been rapid, the stock is still well below most transition and developing economies (see Tables 3 and 4 and discussion below) and thus the figure could indicate a "catching up" of credit growth in an economy in which private sector development is beginning to take off.

50. In Estonia, by comparison, the credit-to-GDP ratio rose to over 32 percent by end-1997. Although that figure is still about half that of the Czech Republic and Finland and one-third that of Germany, it is comparable to the ratios in Central European transition economies (Poland and Slovenia) and is converging to the levels found in middle-income countries such as Chile and Tunisia. One reason underlying Estonia's rapid expansion of the financial sector is the combination of completely open capital markets and the currency-board peg to the deutsche mark. In Lithuania, credit-to-GDP ratios have remained broadly constant since 1995.

51. Second ,**M1/M2** represents the degree to which an economy's banking system is able to mobilize long-term liabilities. Over time, this ratio should decline as depositors and lenders commit to longer-term maturities, which is a proxy for increased confidence in the banking system. The M1/M2 ratio in Latvia declined slightly from 67.5 percent in December 1995 to 66.2 percent in December 1997. Although this decline is not striking, at a minimum, the direction of change is consistent with the rapid growth of credit to nongovernment.

52. By comparison, Estonia's M1/M2 ratio fell consistently from 1995 to 1997 (79.6 percent down to 66.5 percent), with an acceleration of the decline taking place in 1997

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[14]The availability of data for the three Baltic countries allows for more comparisons between Latvia and its neighbors than with the other countries included in Table 4.

during the period of greatest credit expansion. In Lithuania, the M1/M2 ratio remained roughly constant in 1997 after a rise in 1996.

53. Third, Latvia's **M2/GDP**, another measure of financial depth and ability to mobilize longer-term resources, grew by 25 percent in nominal terms from December 1995 to December 1997, compared to 24 percent in Estonia and 7 percent in Lithuania over the same period. Despite this accelerated growth, M2/GDP in Latvia is currently about one-half the level of many central European transition countries, middle-income economies, and OECD economies. A better time-series would be **M3/GDP** as it captures long term maturities and credit in general, but for some countries, such as Latvia, this is difficult to calculate and is not yet officially reported.

Indicators of confidence in the banking system

54. Increased confidence in the banking sector is most easily detected by the increased demand for loans and increased willingness of banks to lend. One indicator of this process is the narrowing of **lending-deposit spreads**. Persistently wide or increasing spreads could be a warning signal that banks perceive the risk to lending to be high, which is then interpreted as low confidence in the banking system. On the other hand, a narrowing of spreads could represent a reduction in the risk premium and thus is indicative of confidence in the banking sector. Ultimately, spreads should converge to developed financial sector levels. In Latvia, nominal interest rate spreads have only begun to narrow consistently since June 1997 and were around 7 percent on average at the end of 1997. Currently, spreads in Latvia are about 4 percentage points wider than in OECD and many middle-income countries.

55. By comparison, nominal interest rate spreads in Estonia narrowed in 1997 to approximately 5 percent, which is roughly comparable to spreads found in EU countries (again, see Table 4). This positive result suggests that there is both strong confidence in the banking sector and the belief that the risk premium on loans in Estonian kroon is low relative to foreign currency denominated loans. In Lithuania, nominal interest rate spreads as of December 1997 were comparable to those of Estonia.

56. A second indicator of increased confidence is the decline in **the currency-deposit ratio**. However, caution should be used in interpreting low currency-deposit ratios, as it might also be a sign of currency substitution. One way of confirming that a decline in the ratio reflects a growing confidence in the financial system is to check for growth in **loan-deposit ratios**. In Latvia, the currency deposit ratio fell by almost 15 percent in 1997, while the loan-deposit ratio rose 15 percent during the same period. Finally, declines in **velocity** and increases in **money multiplier** are also *ex post* indicators of increased confidence. During 1997, velocity in Latvia fell by 15 percent and the money multiplier grew by almost 7 percent.

57. By comparison, the rapid decline in the currency/deposit ratio (from 0.43 in December 1996 to 0.31 at end-December 1997) in Estonia is also a confirmation of increased confidence

in the banking system. However, in Lithuania the currency/deposit ratio has been relatively stable (from 0.51 in December 1995 to 0.5 in December 1997, without much change in between). OECD country currency deposit ratios are in the range of 0.10 to 0.12 .

Real interest rate movements

58. A financially deep or developed market is typically characterized by positive **real rates of interest**. Thus, a situation where real interest rates are negative and there is an excessive growth of credit may signal a problem.[15] On the other hand, positive real rates should facilitate a growth in deposits, providing favorable conditions for financial deepening and widening. Thus over time, as an economy stabilizes and develops financially, real interest rates should converge to world market levels. Average real lending rates in Latvia have declined steadily since end-1995 to December 1997 from 11.3 percent (annualized, forward-looking basis) to 3.8 percent. Average real deposit rates have risen over the same period (from -10.5 percent to around zero). In January 1998, they turned positive on a forward-looking basis.

59. By comparison, real lending rates in Estonia were negative until November 1997, when tightened liquidity conditions resulted in a sharp rise in both nominal and real interest rates. Since then, real lending rates have remained positive, both on forward and backward looking bases. In Lithuania, real lending rates have steadily risen and are now positive. Though real deposit rates are still negative, they have been moving higher rapidly (from -31.5 in December 1995 to -2.8 in December 1997). Both real rates are roughly comparable to those in Latvia. Finally, real lending rates in Latvia are still higher than in OECD countries by about 2 percentage points, although real deposit rates in Latvia are 1–3 percentage points below OECD countries.

Equity market capitalization as a percentage of GDP

60. The most common (and tractable) indicator of nonbank financial market widening is a measure of the size and importance (relative to GDP) of the equity market. In many cases this ratio increases over time because the growth of the stock market should outpace the growth of GDP in developing economies. Market capitalization, relative to GDP, in Latvia has risen sharply from 2.7 percent in January 1997 to 6.3 percent at the end of December 1997 (the peak before the small stock-market correction was about 8 percent in September).

61. By contrast, capitalization of the Tallinn Stock Exchange in Estonia began 1997 at 18 percent of GDP, reached a peak of around 30 percent in September, and declined to approximately 26 percent by year-end. Estonia's level of stock market capitalization is higher than all other transition economies and comparable to developed economies with universal banking systems. Compared with other countries, capitalization of the RSE is on the same

[15]That is, negative real rates of interest should stimulate a demand for credit and deter deposits. This situation is unsustainable and poses risks to developing economies.

order of magnitude as Lithuania and Slovenia, slightly below that of Poland, but well below the Czech Republic, as well as many middle-income countries and OECD countries (again, see Table 4).

62. As regards nonbank financial institutions and instruments, Latvia lags behind other transition economies. In fact many NBFIs in Latvia are subsidiaries of Estonian financial institutions. The securities market in Latvia, in particular, has been slow to develop. But unlike in Estonia, the shares offered are from a diverse group of banks and firms, instead of being dominated by banks. This solid foundation bodes well for an even expansion of the securities market in Latvia in the future as privatization of large enterprises is completed.

D. Summary and Conclusions

63. The development of the financial sector in Latvia accelerated in 1997, following the slow recovery from the banking crisis during 1995 and 1996, although it remains at low levels compared to other economies in transition. Financial deepening in the banking sector has been closely monitored by the central bank's supervisory agency which during 1997 adapted existing legislation and adopted new regulations to stay ahead of the rapidly expanding types of instruments and institutions. Thus as loan portfolios have expanded, bank supervisors have paid increasing attention to the quality both of the portfolios and of the banks' resources which could be mobilized in the case of a problem.

64. The rapid growth of the financial sector can be attributed to the take-off of the private sector, a credible exchange rate peg, tight fiscal policy, and an increase of collateralizable assets. However, continued growth at the current rate could have some negative effects. First, as credit expands rapidly, a major risk is that the quality of loans could decline, threatening the soundness of the banking system. Second, as competition for good clients increases, banks might resort to lending less prudently, either to more risky clients (who do not have clear credit histories), or to clients with less secure collateral (such as bank securities traded on the stock market), or by introducing riskier instruments. While neither of these risks alone may be enough to precipitate a crisis in itself, the combination of risks warrants the higher provisioning and closer monitoring that has been seen and requires continued vigilance and forward progress on supervision.

65. Financial widening is occurring, albeit at a slower rate than financial deepening. In 1997, NBFIs in Latvia—especially leasing operations—offered alternatives to traditional banking services. The combination of increased demand for financial instruments (due to the growth of the private sector) and the adoption of regulations suggest that NBFIs will play a greater role in the financial sector in the coming years. In an effort to widen the supervisory net, the BoL plans to implement bank supervision on a consolidated basis by January 1999 as a way to capture bank-owned subsidiary activities. For those NBFIs associated with banks, supervision will occur both from the top-down (from the banks) as well as by the specific regulatory agency. Further, possible merging of supervisory agencies is being considered, though no timetable is set. Thus the main task for the regulatory agencies is to keep both

reporting requirements and education of supervisors ahead of the proliferation of new instruments.

66. When set into a wider international comparative context, Latvia's financial sector development during 1997 was impressive, although its level still falls below other countries. First, monetization of the economy appears to be occurring slowly, and credit-to-GDP ratios remain between one-half and one-sixth of many other transition economies—some of which may have less solid macroeconomic fundamentals. Second, confidence in the banking sector, both from the bank and the consumer side, is rising, but not as quickly as in central European countries. Finally, the importance of nonbank financial markets, such as equity markets, relative to GDP is quite small in Latvia—about one-fourth of that of Estonia, one-ninth of the Czech Republic which is typical of other middle-income developing countries.

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Table 1. Latvia: Regulatory Framework for Commercial Banks

Type		Prudential Regulation	Comparison With EU Standards 1/
Basic Requirements			
Capital adequacy ratio		10 % (risk-weighted)	8% (risk weighted)
Liquidity indicator		Maintain liquid assets not below 30 % of total current liabilities	No liquidity indicator
Limits on lending (as % of own capital)			
Credit concentration per client (group of connected clients)		25 % (from Jan. 1, 1996)	25%
Insider lending (aggregate)		15 % (from Jan. 1, 1996)	20%
Limits on foreign exchange exposure (as % of own capital)			
From January 1, 1996		20 % (overall) 10 % (any one currency)	>2%, excess multiplied by 8 to get capital adequacy
Loan classification Provisioning	As of 1996:	10 % for close watch, 30 % for substandard, 60 % for doubtful. 100 % for bad loans.	No EU-wide standards, but Latvian regulations are more strict than most individual EU countries.
Licensing requirements			
Minimum capital requirement		LVL 1 million from April 1996 LVL 2 million from April 1998 ECU 5 million from January 2000	ECU 5 million
Minimum registered capital (for new banks)		ECU 5 million (shall be paid in lats in the amount equivalent to ECU 5 million)	ECU 5 million
Competence of bank management		(See articles 24 and 25 of the law "On Credit Institutions")	
Other requirements			
Audited annual reports		By international audit companies approved by the Bank of Latvia	External comprehensive audits
Quarterly balance-sheet publication		Required for "core" banks accepting household deposits	No explicit rules obligating banks to submit quarterly balance sheets, but most do.

Sources: Data provided by the Bank of Latvia and Fund staff.

1/ EU regulations reported are the minimum standards.

Table 2. Latvia: Banking Sector Soundness Variables, 1995-97
(in percent unless otherwise indicated)

Variable	Dec 1995	Mar 1996	Jun 1996	Sep 1996	Dec 1996	Mar 1997	Jun 1997	Sep 1997	Dec 1997
Loans/deposits	49.2	53.9	42.2	37.7	40.2	42.3	45.1	49.0	46.4
Loans/total assets	29.7	31.9	24.9	22.9	23.7	24.5	25.9	26.2	29.7
Liquidity Test 1/	63.6	54.5	69.5	57.1	69.7	64.0	59.9	55.9	77.0
Capital Adequacy	22.9	26.5	28.1	27.7	24.5	31.1	24.3	22.4	21.0
Loan-loss provisioning 2/	23.7	26.5	27.9	29.3	25.1	23.2	17.0	14.4	11.0
Return on equity 3/	34.0	41.0	30.0	21.0	24.0	24.0	26.0	29.0	26.0
Net portfolio investments/GDP 4/	4.7	8.4	8.4	17.4	16.0	21.6	18.7	27.8	22.9
Net position w/ foreign credit instit. 5/	209.7	179.3	263.4	263.1	349.3	290.2	298.6	292.9	310.5

Sources: Bank of Latvia and Fund staff estimates.
1/ Liquidity Test is defined as cash + claims on the central bank + claims on other credit institutions and fixed-income government bonds- liabilities to the central bank - liabilities to other credit institutions/deposits.
2/ Expressed as a percentage of gross loans.
3/ Return on equity (ROE) is defined as the ratio of the value of bank-issued equity over profits.
4/ Portfolio investment is defined as holdings less than or equal to 10 percent of total assets.
5/ Net foreign asset position vis-à-vis foreign credit institutions, in LVL millions.

Table 3. Latvia: Financial Sector Development Measures, 1995-97
(in percent)

Ratio	Dec 1995	Mar 1996	Jun 1996	Sep 1996	Dec 1996	Mar 1997	Jun 1997	Sep 1997	Dec 1997
M1/M2	67.5	67.8	66.7	63.0	66.9	65.4	65.3	63.5	66.2
M2/GDP	19.4	18.7	18.9	19.7	19.9	22.0	22.1	23.3	24.3
Credit to non-gov/GDP 1/	7.6	7.3	6.7	6.3	6.5	7.3	7.8	8.5	10.1
Credit to state ents/total credit	12.1	11.7	10.7	7.6	8.2	7.5	7.9	7.1	5.9
BOL/Total Bank Credit 2/	17.5	19.2	17.3	13.8	4.6	11.5	2.4	0.4	2.1
Nominal interest rate spreads 3/	13.9	20.4	12.4	15.8	11.9	9.0	10.6	7.5	7.0
Real interest rate--lending 4/	11.3	17.5	6.1	4.1	6.5	11.6	4.9	3.5	3.8
Real interest rate--deposits 4/	-10.5	-2.3	-6.4	-7.4	-2.5	-2.6	-1.3	-2.4	-2.0
Currency/Deposit	0.666	0.722	0.733	0.684	0.725	0.72	0.654	0.606	0.618
Market Cap/GDP	0.4	0.6	1.2	2.0	2.7	5.9	5.5	8.0	6.3

Sources: Bank of Latvia, Riga Stock Exchange, and Fund staff estimates
1/ GDP is calculated using annualized quarterly data.
2/ Excludes credit to government
3/ Lending-deposit spreads are a centered 3 month moving average for 3-6 month maturities using end-of period data.
4/ 3-6 month maturities, backward-looking, using twelve month inflation rate

Table 4. Financial Sector Development Indicators in Selected Transition and EU Countries, 1995-97
(end-of-period, in percent)

Country	Credit to non-government/GDP 1/			Nominal interest rate spreads 2/			M2/GDP 3/			Stock market cap/GDP 4/		
	1995	1996	1997	1995	1996	1997	1995	1996	1997	1995	1996	1997
Estonia	17.0	22.3	32.3	8.7	8.5	5.4	22.8	24.3	28.3	...	18.9	26.0
Latvia	7.6	6.5	10.1	13.9	11.9	7.0	19.4	19.9	24.3	0.4	2.7	6.3
Lithuania	11.4	10.5	11.4	17.0	7.4	5.8	17.3	16.8	18.5	2.7	5.7	6.0
Czech Republic	64.0	82.8	67.4	5.8	5.3	5.5	81.1	75.8	72.3	31.1	50	...
Poland	12.8	23.3	24.5	6.0	7.0	5.0	34.5	39.8	40.0	3.7	6.1	6.9
Slovenia	26.7	35.8	38.1	9.5	8.7	8.1	27.2	29.7	31.5	6.6		
Thailand	98.0	109.4	...	7.25	7.0	...	79.2	81.1	...	85.3	...	...
Malaysia	94.7	107.0	123	2.6	2.8	3.0	90.5	91.2	99.1	258.6	...	...
Tunisia	54.5	49.4	51.9	8.8	7.0	...	45.9	46.6	42.2	22.3	...	...
Chile	50.3	54.2	54.3	4.4	3.9	3.6	37.8	40.1	40.1	109.7	...	...
Mexico	30.5	18.1	13.7	5.9	5.6	4.0	30.5	27.9	24.7	37.6	...	...
Finland	64.2	61.2	57.1	4.4	3.6	3.2	58.6	54.5	51.9	35.3	...	...
Germany	102.1	106.5	104.8	7.1	6.9	6.4	34.8	34.6	34.7	21.0	...	...
Japan	116.5	114.5	109.7	2.5	2.4	-0.64	113.7	112.2	111.9	75.3	...	...

Sources: National authorities; IFC (1996); Fund staff estimates

1/ Annualized QIV GDP figures used for 1995 and 1996; 1997 figure using QIV GDP projections.
2/ Average lending/deposit rates (under 1 year maturity), 1997 figure estimated fourth quarter.
3/ Using end-of-period figures.
4/ Capitalization /GDP ratios for 1997 are end-December figures, except for Poland which reports end-June.

III. Pension Reform in Latvia

67. Latvia was the first transition country to introduce a systemic reform of its public pension system. It was also the first transition country to implement the "notional defined contribution" (NDC) approach to pension reform, in which benefits are linked to individual contributions and to the retirement age. The new NDC system, adopted in late 1995, is already in place, as the first of the three-pillar structure that will constitute the reformed Latvian pension system. The adoption of a NDC system as the first pillar and the gradual introduction of funded pillars will avoid the high transactions costs typically incurred in the move to a funded pension system.

A. Background

68. Upon regaining independence, Latvia inherited the Soviet public welfare system, which was designed to provide "cradle-to-grave" protection to the population, including health care, education, various transfers and allowances, and guaranteed employment. As part of this "social package", the pension system provided virtually universal coverage from age 55 for women and 60 for men. The system was run on a pay-as-you-go (PAYG) basis, with current pensions financed by current payroll contributions, and suffered from a number of shortcomings common to other large PAYG pension systems[16]. In 1992 there were attempts to reform the inherited public welfare system as part of an effort to strengthen the social safety net during the transition period. However, since these early reforms failed to address the main deficiencies of the existing public welfare system, the financial burden of social protection continued to increase significantly in the next few years.

69. The sharp growth in pension expenditures was the main factor behind the increasing fiscal burden of social security outlays during the transition period. Between 1985 and 1996, pension expenditures almost doubled as a percentage of GDP. They peaked in 1996, reaching almost 11 percent of GDP and 29 percent of total general government expenditure—the highest ratio among BRO countries. A small decline was already noticeable in 1997, as a result of the introduction of the new NDC pension system (Figure 1).

70. Part of the financial stress in the social budget during the transition period reflected the burden of a relatively old population, which translated into a high demographic dependency ratio (the number of individuals above the working age divided by the working age population). More importantly, the large share of pensioners in the population (about 25 percent) was due also to the overly generous early retirement policies included in the Latvian pension system, which allowed a significant increase in the number of pensioners at the beginning of the 1990s. Pension expenditures were also increased by attempts to protect

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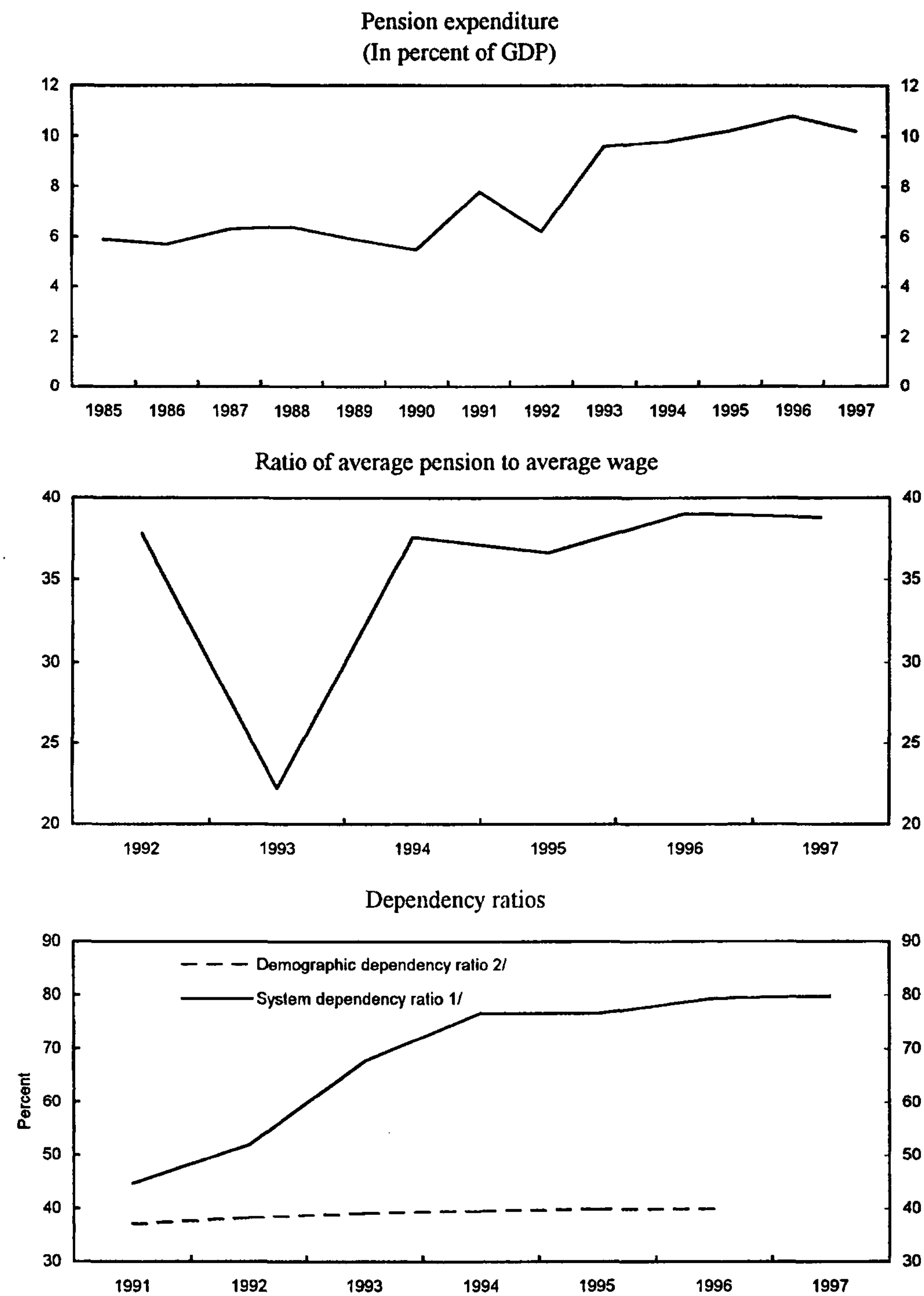
[16]For a description of the pension systems of BRO countries and the various attemps to deal with their problems, see WP/98/11, "Pension Reform in the Baltics, Russia, and other countries of the Former Soviet Union (BRO), by Marta de Castelle-Branco.

Figure 1. Latvia: Pension System Indicators



Sources: Latvian authorities; and IMF staff estimates.

1/ Ratio of number of all pensioners to number of contributors.

2/ Ratio of number of persons above working age to number of persons of working age.

the real value of benefits during the early phase of transition. A new pension formula was introduced in late 1993, providing for a base pension of 30 percent of the average wage, with an increase of 0.4 percent of the average wage for each year of work history up to a maximum of 38 years. Although the growth in pension expenditures was contained by low indexation, there was a sharp increase in the ratio of the average pension to the average wage in 1994 (Figure 1).

71. On the revenue side, the key problems were the shrinking contribution base and—until recently—a weak tax administration. The marked increase in the ratio of pensioners to contributors (the system dependency ratio) during the transition years was mainly due to a sharp decline in the number of contributors, reflecting the incentives for early retirement. High payroll taxes,[17] coupled with a weak link between benefits and contributions, encouraged tax evasion and the development of underground activities.

72. By the end of 1994 it was clear that the pension system, in its current form, was not affordable in the short run, while its long-run sustainability was threatened by an aging population. The various distortions of the Latvian PAYG system were clearly visible in the high and rising system dependency ratio and the large gap between the system dependency ratio and the demographic dependency ratio (Figure 1). Furthermore, despite the heavy fiscal burden, the system provided inadequate social protection, since although pension levels were handed out to a large segment of the population, their level was very low.

73. As in other transition countries, the various shortcomings of the Latvian public pension system were compounded by certain specific circumstances of the transition process, including:

- low tax enforcement capabilities
- large informal sector
- large expenditure needs related to the transition process
- need to cushion the effects of transition on the poor
- high expectations regarding social security — a legacy of the Soviet period

[17] The total payroll tax until 1996 was 38 percent; the system did not include a separately identified pension contribution rate.

B. The 1995 Reform

74. In view of the drawbacks of the PAYG system and the prospects for a rapidly aging population, pension reform was placed on the agenda in Latvia in the mid-1990s. A new pension law was introduced in November 1995, together with several pieces of legislation aimed at a major restructuring of the Latvian social security system.[18] The main objectives of these reforms were to ensure the affordability and efficiency of the Latvian welfare system, while reducing the labor market distortions inherent to the old defined-benefit system.[19] After a careful review of the possible options for pension reform, it was decided that a mixed model, combining elements of PAYG and funded systems, would be the most appropriate route for Latvia. Given Latvia's demography, some funding of the system was needed to reduce the burden on future generations. However, the cost of switching to a fully funded system was considered too high.

75. The new pension law, effective from January 1996 for all those retiring after 1995 (leaving current pensioners unaffected), envisaged the gradual introduction of a multi-pillar system in Latvia. The first step in the implementation of the new system was the introduction of a **mandatory** first pillar consisting of a modified PAYG system that combined a benefit structure based on ***notional defined-contribution accounts*** (explained below) with a minimum guaranteed pension.[20] This scheme was to be supplemented at a later stage by two funded pillars, one mandatory and one voluntary.

76. The new NDC system introduced strong incentives for individuals to work longer and pay contributions.[21] Instead of raising the mandatory retirement age for men, actuarial provisions are used in the calculation of the pension formula in order to encourage individuals to continue working past the minimum retirement age (to be gradually unified at 60 for both men and women). The system is also more robust to demographic changes, since the pension formula ensures that benefits adjust to changes in life expectancy. To reduce the excessive tax burden under the old system, a five percent cut in the social insurance contribution was to

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[18] On that occasion, parliament approved seven new laws covering old-age pensions, sickness, disability, maternity, unemployment and funeral benefits.

[19] In **defined-benefit plans**, contributors receive an "entitlement" to pre-determined benefits, usually linked to age, years of contribution/employment, and past earnings. **Defined-contribution** schemes, by contrast, specify in advance the contribution, but not the benefit, which depends on the accumulated contributions and the rates of return on investments.

[20] The minimum pension was set at the level of the *social pension*, granted to those who reach the age of 60 and have not met the minimum contribution period (ten years).

[21] Transition rules provided compensation for acquired rights to early retirement age, even though no further accumulation of these rights was allowed in the new system.

have been implemented gradually until the contribution rate reached 33 percent in 2001. This schedule has not been implemented, however, as the authorities plan to cut the rate to 33 percent in one step in 2002. On the other hand, the employees' share is being gradually increased until 2002, when the social insurance contribution will be split equally between employer and employee.

77. By correcting some of the distortions of the existing PAYG system, the new NDC system is expected to lead over time to lower expenditures and increased revenues. On the expenditure side, savings should result from the move from wage indexation to price indexation, and the reduction of benefits to early retirees (most categories have been phased out and the benefits of the remaining ones are adjusted according to actuarial criteria). On the revenue side, improvements should follow from increased incentives to report income, participate in the formal sector and postpone retirement, as well as from improved tax administration. One important measure taken to strengthen tax administration was the consolidation of social tax collection with other tax collection under the State Revenue Service in January 1998.

The NDC system (first pillar)

78. The basic element of the 1995 reform was the establishment of a stronger link between benefits and contributions, which is expected to result over time in increased compliance and coverage. This is to be achieved through the implementation of a system of *notional* accounts within the first pillar. In this system, a record is made of contributions (up to a ceiling) paid by employee/employer into the individual notional accounts, but in contrast to funded schemes, no *real* funds are accumulated into the accounts, only "notional capital." The main characteristics of the new NDC system are:

- the existing generation of pensioners continues to be supported by payroll contributions.
- the pension benefit is calculated by dividing the total funds "accumulated" in each individual account (the "notional capital") by the post-retirement average life expectancy of the individual's cohort.
- the "rate of return" on the notional capital is given by the rate of growth of the sum of wages on which contributions are collected (the contribution wage base).
- benefits will be indexed according to changes in consumer prices until the year 2000, and after that based on both wage and price changes.
- noncontributory benefits were shifted to the state budget, eliminating cross-subsidization of benefits.

Funded pillars

79. The introduction of privately managed funded pillars will take place in two stages, the first comprising the development of the regulatory and institutional framework for the voluntary (third) pillar, and the second involving the introduction of the mandatory second pillar, using the reserve funds accumulated with the operation of the new NDC system (first pillar). Legislation for the operation of private pension funds was passed in July 1997 and these funds are now in the process of receiving licenses. Contributions to the funds will be exempt from income tax. [22] The third pillar will be intended essentially for those wishing to save for higher retirement income.

80. The second pillar (initially conceived as a mandatory funded pillar based on privately managed savings accounts) will be the last one to be introduced. Originally envisaged for 1998, it is now scheduled for 1999–2001, to allow time for the establishment of an appropriate regulatory framework,[23] the development of capital markets, and the accumulation of savings from the reforms implemented in the first pillar—to avoid increasing the payroll tax or resorting to debt financing. The choice between voluntary and mandatory participation in the second pillar is still under debate, although the original concept suggested mandatory participation. It is expected that for those joining the labor force today, roughly one third of their total pension will come from the funded pillar.

C. Evaluation of the First Phase of the Reform

Advantages of the NDC system

81. The creation of the new, defined-contribution pension system is a major achievement. Compared with the old system, the NDC system should be more affordable, equitable and transparent. Moreover, by linking benefits more closely to contributions, the system will encourage compliance with tax legislation, while by encouraging the development of capital markets, it should contribute to a more efficient resource allocation and enhance growth.

Affordability

82. The reduction in entitlement, combined with postponed retirement, will allow pension expenditures to fall steadily as a percentage of the contribution base over the ten-year period following the introduction of the new system (Table 5). The projected expenditures on old-age pension benefits under the new system will yield savings of roughly 10 percent compared to the old system. Furthermore, the system dependency ratio, an indicator of affordability, is

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[22] Pension benefits became taxable under the 1996 tax law.

[23] The relevant legislation is under preparation and it is expected to be passed by the end of 1998.

projected to fall steadily to below 50 percent by the end of the ten-year period (Figure 2). Provided Latvia continues to grow, even modestly, the affordability of the system should be achieved—but at a cost. Since the old system allowed too many people to retire too early, the new system will still have to rely on relatively high payroll taxes to finance transfers over the medium term. Major cost reductions at this point could only be achieved by cutting back pensions already granted. Nonetheless, by the year 2002 Latvia's payroll tax, at 33 percent, will be one of the lowest in the region.

83. The new system has two built-in stabilizers to help insure long-term financial sustainability. The first is the automatic adjustment to changing demographics provided in the pension formula. One of the largest threats to the stability of public pension systems in OECD countries has been the slow political response to increasing life expectancy. In transition countries, where current high mortality rates for men over 50 are not expected to continue into the next century, this threat is even greater. By introducing actuarial criteria in the calculation of pension benefits, the new system avoids the acrimonious debate over retirement age that has plagued other transition countries. The second automatic stabilizer is the indexation of contributions in the "notional" account. While formulas based, for example, on the German "points" system, index contributions to *average* wages, the Latvian formula indexes contributions to the *contribution wage base*. As a result, system liabilities grow at the same rate as revenues.

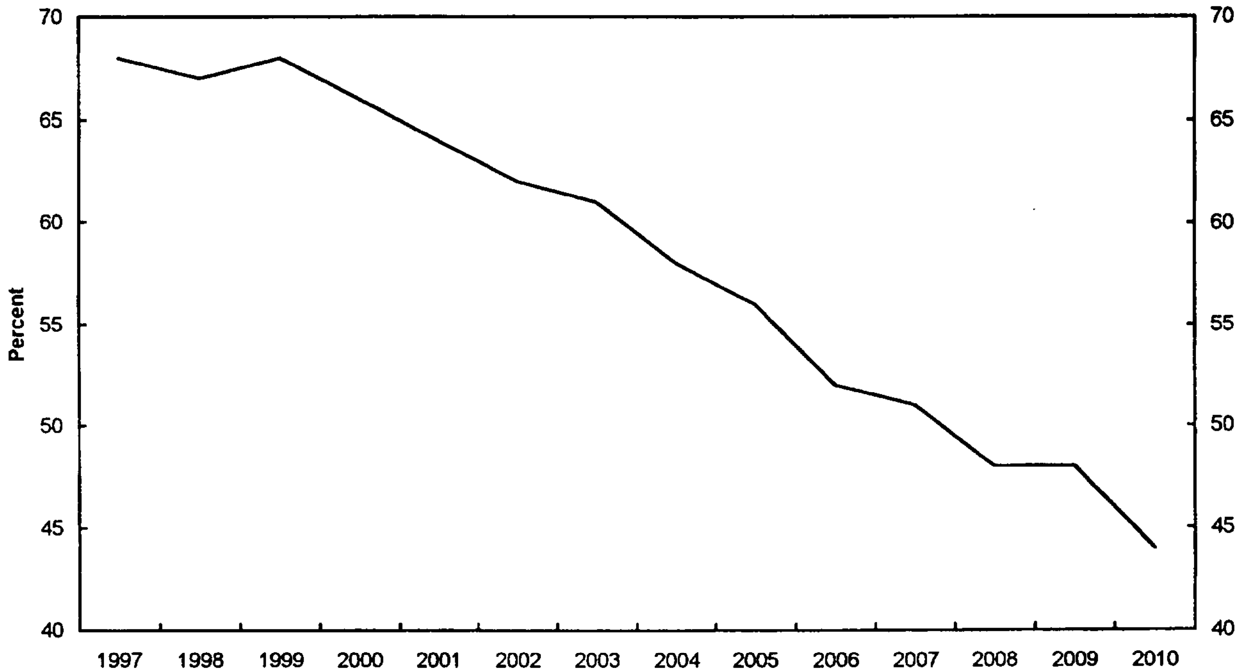
Efficiency

84. As benefits are completely and fully dependent on contributions in the new system, a large part of the disincentive effect (dead weight loss) of a traditional social insurance tax disappears. This effect will be stronger after 2002, reflecting the decline in the old pension liabilities and the payroll tax. Despite continued high payroll taxes, the significant reduction in the micro-economic distortions present under the old system should raise incentives for increased labor supply and participation in the formal sector. This would lead to higher compliance rates and reduced tax administration costs. Indeed, after two years of implementation of the new system, social tax collections have already increased, although such increase may also reflect improved tax administration. Depending on the burden of the overall tax system and the credibility of the government in promoting the reform, implementation of the new system could lead to increased revenue across the board, owing to the higher incentives to participate in the formal sector.

Equity and transparency

85. One of the major advantages of the new system is that everyone is treated the same way—pensions are based solely on what individuals contributed. Under the previous system, redistributions could occur simply by adding favorable treatment for one group into the pension law, without any analysis of the implied costs to other pensioners or to future contributors. As a result, such redistributions occurred often under the old system, including, for example, (a) early retirement for special groups (which encouraged retirement at the

Figure 2. Latvia: System Dependency Ratio: Projection until Year 2010 1/



Sources: Latvian authorities; and World Bank staff estimates.

1/ Ratio of old age pensioners to number of contributors.

earliest possible date); and (b) pension credit for noncontributory periods, such as maternity leave or military service. In all of these cases, the favored group received more benefits than other pensioners for the same contribution.

86. Under the new system, noninsurance redistributions, such as subsidies for maternity leave, require explicit contributions into an "account" (e.g. into the Social Insurance Fund or the second pillar), making the new system much more transparent than the previous defined-benefit one. In case a redistribution is considered, not only does the requirement for a contribution place a political "brake" on special interest redistribution, but it also encourages consideration of its the true financial cost.

Social protection

87. Although Latvia's new pension system is not very redistributive, significant social insurance elements should protect against old-age poverty—one of the main goals of any public pension system. Pension credits for time spent raising children and for periods of covered unemployment (two factors that can lead to inadequate pensions in a private system) can help ensure that the lifetime poor will nonetheless receive an adequate pension from the system. The minimum pension also provides protection for the lifetime poor.

88. The new system also allows a wider range of options for older workers. Anyone over the age of 60 can take a pension if so desired. Or they can continue working and get a higher pension later. Or they can stop working for a while, and then start up again. These options can be especially important for women, who tend to have greater responsibility for taking care of dependent family members, and those whose health may be weakening, but still wish to work part time and require limited income support.

Smooth transition into the second pillar

89. Grafting a defined contribution scheme onto a defined benefit scheme can be expensive because of the need to compensate those already covered by the existing scheme. Often, these workers assert their acquired rights to a benefit level that they legally can not be forced to give up. This is especially true for those who have participated in the old pension scheme for some time. However, allowing the choice of scheme may prove expensive if the existing scheme has a high minimum benefit for few years of service. If participation is voluntary, system switching points must be tightly constrained to avoid moral hazard problems (participants switch when they can get the most out of both systems). These problems do not arise with the notional defined contribution system. Benefits in both the NDC pillar and the funded pillars depend solely on contributions and can be allocated into the second pillar either on a mandatory or voluntary basis without creating any moral hazard problems.

Potential drawbacks of the system

90. No pension scheme is perfect, especially a public pension system forged in the fire of political compromises required in more open political systems. Both the NDC concept and Latvia's implementation of this concept have some drawbacks that need to be considered. Implementation problems in Latvia emerged in part owing to the speed of reform: the pension law was adopted in November 1995, and the introduction of the three pillars was to take effect by January 1998. Two major issues were not addressed adequately in the initial period of the reform: public information and central agency development. Other implementation problems have been caused by the failure to raise the minimum retirement age for women.

Public information

91. A major reform such as the Latvian one requires an extensive information campaign to communicate its basic characteristics to the population. For example, the incentives to work longer will not be effective if those making the retirement decisions do not understand them. A political backlash can occur if too many people quit work and choose low pensions, not realizing the choices they had. In the first year of implementation, Latvia's public information system was inadequate. Office staff were not adequately trained nor given materials to explain the system to beneficiaries. This provoked frequent criticism of the new system in the press, especially by formerly favored groups who lost their privileges. Those who gained under the system also did not understand their gains, so could not provide a counterweight.

92. Beginning in late 1996, the central social insurance agency (now called Social Security Insurance Agency—SSIA) began an intensive public relations effort, using the media to explain the system. Materials were developed for office staff and classes were held in the spring of 1997. In the summer of 1997 all Latvians of working age received statements showing their contribution to the system and their expected pension based on these contributions. Partly as a result of these efforts, the average expected retirement age has begun to increase slightly.

Central Agency Development

93. Although the NDC is based on a simple formula, it still requires sophisticated information systems to calculate pension benefits. Computer models are useful to help individuals calculate their pension options, but in 1996 only a 1960s mainframe system with a poorly functioning database management was available. A new, state-of-the-art system, is expected to come on line in mid-1999. Until then, however, the administrative burden of the new system will continue to be overwhelming, delaying pension payments. Implementation of other key parts of the system, such as the ceiling on contributions, will have to be delayed also until the new computer system is in place.

94. Furthermore, the SSIA was created only in 1995, and at that time lacked both the infrastructure and the staff skills to manage a major reform. In order to improve its

implementation capacity, the agency was restructured in 1996. Levels of hierarchy have been eliminated, new office procedures have been put in place, staff have been trained, and in the Riga office, a new management team has been in place since 1997.[24]

Minimum guarantee and protection of the poor

95. A pure defined contribution approach may not offer sufficient income guarantees for the lifetime poor. The new system includes a minimum guaranteed pension for all those over 60 who have contributed to the system for at least five years. The purpose of this guarantee is to transfer some of the cost of supporting the lifetime elderly poor from the social assistance system (and the state budget) to the pension fund. The size of the transfer will depend on the level of the guarantee. At its current level (equal to the social pension), few individuals with over 25 years of service should be in need of the guarantee. However, if the guarantee level is increased in real terms (or informal sector expansion raises the number of noncontributors for a long time), the guarantee would become more costly. In this case, it would violate the key principle of the new scheme, i.e., a contributor should only receive a benefit related to his/her contribution.

96. There has been pressure on this guarantee already, from women who retired before the age of 60. Allowing this early retirement was a political compromise reached at the time the new pension law was adopted, but it included the proviso that these early retirees would not receive a guaranteed minimum pension. However, in 1997, a number of women who were receiving very small pensions (owing to their small contribution period and to having only reached the age of 55) demonstrated at parliament and received substantial press coverage. As a result, parliament promptly changed the legislation to guarantee all women who retire at 55 the minimum pension, thus reducing the incentives for women, especially low income ones, to postpone retirement.

97. Should the guarantee be maintained? This is a complicated question. From an administrative point of view, the guarantee may be cost-effective, as it saves the social assistance system from constantly means-testing someone who would normally not be expected to return to work. However, it may not be a well targeted social expenditure, since it does not depend on the income of the consumption unit (e.g. whether the pensioner lives with a working spouse or adult children, how many income-earning assets they own, etc.). Since most pensioners in Latvia do not live alone, the potential for leakage to higher income households is high. This is the argument for reliance on the social assistance system for poverty alleviation, including for the elderly. A balance might be struck by maintaining the guarantee at about the current level in real terms. In the medium term, once the fiscal situation has stabilized, a budget transfer to cover the difference between the pension

[24] Development of the central social insurance agency, including the purchase and installation of a new information management system, has been supported by the World Bank-financed Latvian Welfare Reform project, approved in May 1997.

entitlement and the guarantee could be instituted to preserve the integrity of the contribution-based system.

D. Lessons for Other Transition Economies

98. Is the Latvian NDC reform a model for other transition economies? Certainly it is worthy of consideration, as the early indications are that it is working well. Poland has decided to implement a similar model. Based on the Latvian's experience, the NDC approach seems a good model for middle-income transition economies with mature systems. This is because the NDC concept fundamentally changes the tone of the debate about pension reform. It establishes the principle that everyone's benefit is dependent on their contribution—a major break from the Soviet PAYG system. The concept thus facilitates a fundamental restructuring of the old system, partially neutralizing the efforts of those who try to maintain their privileges. With the cost of special privileges more explicit, these become harder to maintain.

99. Countries with younger systems may not find the NDC reform the best model for them. The Latvian model still includes a large PAYG pillar, with all the limitations of this type of financing. However, moving toward full funding would have been difficult, if not impossible, in a country where 10 percent of GDP was already being spent on pensions—the transition costs would have been too high. On the other hand, countries with younger systems would have a smaller implicit debt and thus lower transition costs. Therefore, these countries could consider a much smaller PAYG system (or even phasing it out entirely, as envisaged in Kazakhstan), combined with a funded system.

100. In considering the various options for pension reform, countries should be aware of the potential implementation problems of the NDC system, as well as the cost implications of allowing exceptions to the system's rules. Most important for the successful implementation of the reform is the provision of adequate information to the public and the development of an appropriate institutional infrastructure and efficient information systems. Finally, a lead time to set up an implementation system longer than the one month allowed in the Latvian case (the new NDC pillar became effective in January 1996, one month after the adoption of the new pension law) is clearly desirable.

Latvia. Table 5. Actual and Projected Social Insurance Budget, 1993-2005
(Percentage of total contribution base)

	1993	1994	1995	1996	1997 1/	1998	1999	2000	2001	2002	2003	2004	2005
Revenues													
Social tax	33.3	34.4	35.6	36.3	38.2	35.3	35.3	35.4	35.3	31.4	31.5	31.5	31.5
State budget transfers to pension fund	...	...	...	...	0.3	0.4	0.4	0.4	0.4	0.4	0.5	0.5	0.5
Other transfers, penalties, interest, etc.	...	...	...	0.3	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Total revenues	33.3	34.4	35.6	36.6	39.0	36.3	36.4	36.4	36.3	32.5	32.5	32.5	32.5
Expenditures													
Pensions	27.9	29.2	29.3	33.4	34.0	30.3	29.1	28.7	28.0	27.2	27.2	26.6	25.8
Old age	17.8	21.9	22.2	25.8	26.6	25.9	24.8	24.3	23.6	22.9	22.9	22.2	21.5
Disability	3.9	5.1	5.3	5.4	5.3	2.4	2.4	2.5	2.5	2.6	2.6	2.7	2.7
Survivors	1.1	1.2	1.3	1.4	1.4	1.2	1.2	1.1	1.1	1.1	1.0	1.0	0.9
Other	5.1	0.9	0.4	0.8	0.7	0.8	0.8	0.8	0.8	0.7	0.7	0.7	0.7
Sickness benefits	1.5	1.7	1.8	1.5	0.3	0.3	0.4	0.5	0.5	0.6	0.6	0.7	0.8
Maternity benefits	0.4	0.3	0.3	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Funeral benefits	0.2	0.3	0.3	0.2	0.2	0.2	0.3	0.3	0.3	0.2	0.2	0.2	0.2
Unemployment benefits	1.5	1.4	1.2	1.3	1.4	1.7	1.8	1.9	1.9	1.8	1.7	1.6	1.5
Work injury benefits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other benefits	7.4	5.3	0.0	0.0	...	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Administration	0.9	0.7	0.7	0.8	0.9	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Total expenditures	39.9	38.9	33.6	37.6	37.1	34.2	33.2	32.9	32.4	31.6	31.6	30.8	30.1
Cash surplus	-6.6	-4.5	2.0	-1.0	1.9	2.1	3.2	3.5	4.0	0.8	0.9	1.7	2.4
Accumulated cash surplus					2.6	4.5	7.5	10.6	14.0	13.9	14.1	14.9	16.4

Source: World Bank.

1/ Estimates.

IV. External Sector Developments and Prospects

A. Introduction

101. Latvia's economic transformation has been manifested in several external sector developments which resulted in a much more open economy, a reorientation of trade towards western markets, and a significantly more liberal trade regime. This has occurred in the context of a fixed exchange regime with the lats pegged to the SDR since February 1994, a substantial decline in inflation—albeit this still remains above that in most of the European trading partners—substantial privatization, and an accelerating recovery since 1995. These generally favorable developments, have, as in other advanced transition economies, led to a sharp swing in the current account position from a rough balance in 1994 to an estimated deficit of 7 percent of GDP in 1997 (Table 6). Though this was more than fully financed by net foreign investment, the high level and sharp increase of this deficit merit close attention to its nature and future prospects.

102. While data limitations limit in-depth analysis of relevant external sector developments, many of the commonly used indicators of competitiveness can be calculated. Several of these are discussed in the next section, while section C describes the evidence on export market penetration. Section D, following recent work on indicators of current account vulnerability [25] assesses available data which may throw light on the prospects of current account sustainability. Section E summarizes the analysis, and Annex 1 describes still existing data shortcomings which, however, would not appear to affect the essential conclusions.

B. External Competitiveness

103. This section examines the recent trends in available indicators of Latvia's competitiveness, emphasizing the trends relative to EU markets, and comparing with the more advanced transition economies. The indicators include the real effective exchange rate, dollar wages and the unit labor cost in the manufacturing sector. The analysis suggests that while Latvia's recent competitiveness may have declined as indicated by a moderate overall appreciation of CPI-based real effective exchange rate against all trading partners, the movement relative to specific partners and competitors has varied widely. While some appreciation from probably undervalued levels early in the transition is to be expected, unfortunately the lack of productivity data limits full analysis of this phenomenon. However, wage indicators suggest that Latvia has maintained its competitiveness relative to other transition economies.

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[25] For example, Milesi-Ferreti and Razin (1996) and Roubini and Wachtel (1997).

Trends in the real effective exchange rate

104. The real exchange rate is one of the most frequently used indicators of the evolution of the economy's external competitiveness.[26] An index of the real effective exchange rate (REER) can be readily calculated but its interpretation is tempered by difficulties in distinguishing between the impact of negative factors such as a misalignment in the nominal exchange rate that yields a REER appreciation and a loss of competitiveness, and that of favorable factors such as productivity gains or improvements in the external terms of trade that would also lead to a REER appreciation. Though a theoretical delineation of these factors is straightforward, the latter representing movements of the equilibrium exchange rate while the former represents deviations from it,[27] the issue is especially problematic in the transition economies, where large productivity gains are to be expected as resources are reallocated. The traditional empirical research has proceeded by relating recent trends to a historical period in which the REER is viewed to have been in equilibrium. Another strand in the literature attempts to estimate the equilibrium exchange rate which is then compared to the actual.[28] This section primarily follows the first approach, through some evidence based on the second approach is available from one recent study.

105. Empirical analysis is also complicated by the multiplicity of available price indices; here the CPI-based REER is calculated using the IMF's Information Notice System (INS). Improvements made on the INS database in October 1996 enlarged the set of countries that are covered and introduced revised weights based on more recent trading patterns. In the case of Latvia, these weights are based on the trading pattern in 1995.[29]

106. The first panel of Figure 3 shows the evolution from June 1992 to November 1997 of Latvia's REER and the nominal effective exchange rate (NEER) against all trading partners. As had been noted in previous analysis,[30] from June 1992 to February 1994 when the peg of the lats to the SDR was introduced, Latvia's NEER and REER appreciated dramatically, by

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[26]Overviews of various competitiveness indicators are presented in Lipshitz and McDonald (1991), Turner and Van 't dack (1993) and Marsh and Tokarick (1994). World Economic Forum (1997) presents other broad indicators.

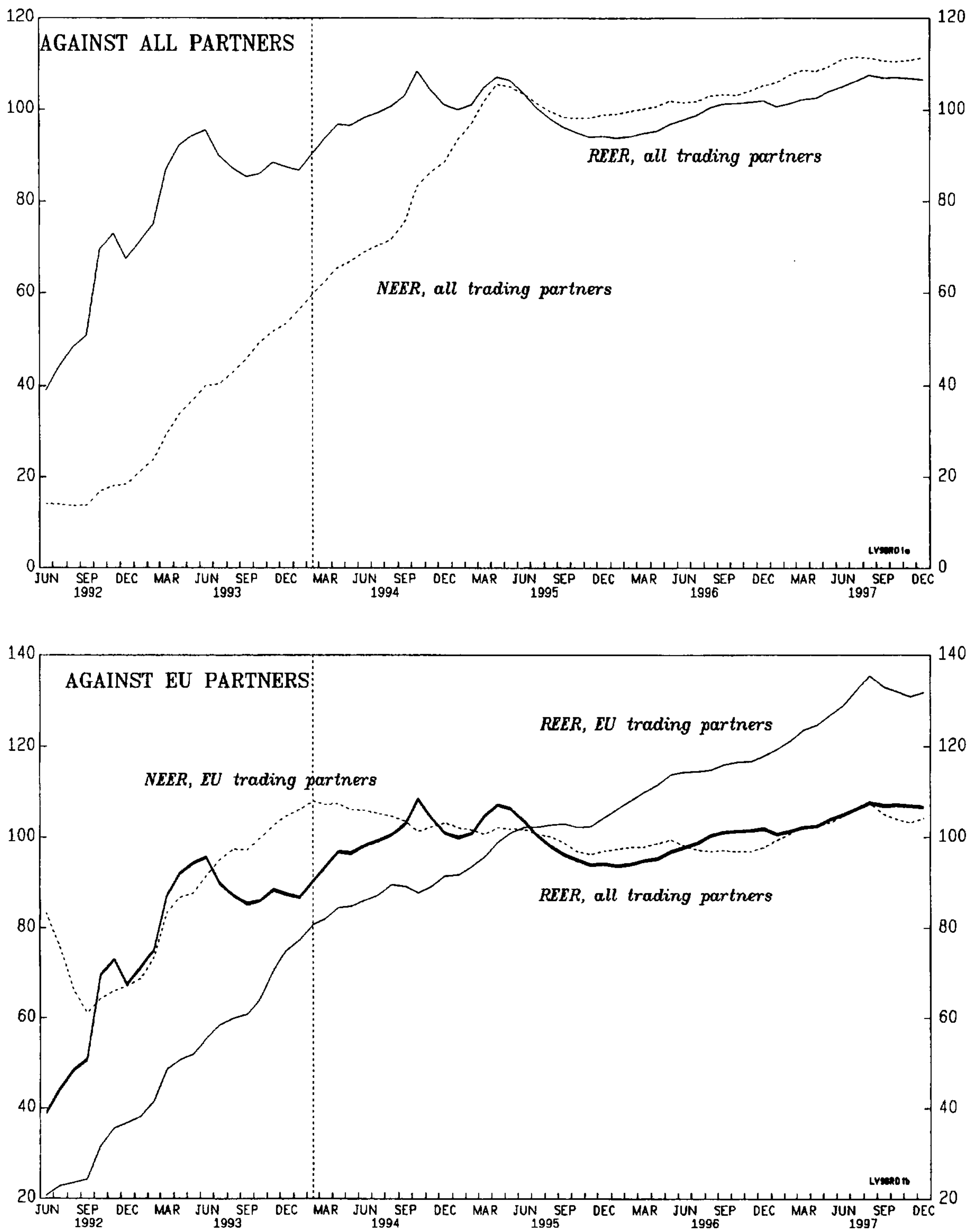
[27]The theoretical underpinnings of such analysis are rooted in purchasing power parity (PPP) doctrine. Froot and Rogoff (1995) reviews issues in the PPP literature and real exchange rates.

[28]This literature is discussed in Williamson (1994) and Hinkle and Montiel (1997). In a later section we discuss the equilibrium wage rate estimates by Krajnyak and Zettlemeyer (1997).

[29]See Zanello and Desruelle (1997) for a detailed description of the INS.

[30]Chapter IV of the background paper (SM/96/287, 11/13/96).

Figure 3. Latvia: Effective Exchange Rates 1/
(Index 1995 = 100)



Source: IFS, INS database.
1/ Nominal effective exchange rate (NEER) and real effective exchange rate (REER).
Increase implies an appreciation. The nominal exchange rate was pegged to the SDR in February 1994.

322 percent and 132 percent, respectively. From February 1994 to end-1995, a moderation of the appreciation in noted, with the NEER and REER appreciating by 65 percent and 4.1 percent, respectively, as a result of a better inflation performance vis-à-vis its major trading partners.[31] From end-1995 to November 1997, one sees the NEER showing a steady but moderate nominal appreciation of 12 percent for the NEER and 14 percent for the REER.

107. The second panel of Figure 3 shows for the NEER and the REER a steeper real appreciation against the EU trading partners over the entire period to November 1997. In the period June 1992 to February 1994, the REER against the EU countries appreciated by 290 percent, from February 1994 to end-1995 by 29 percent, and from end-1995 to November 1997 by 25 percent. Thus, while appreciation against EU countries was larger than against other partners, in both cases this has been much moderated in recent years.

108. An examination of the trends in the bilateral real and nominal exchange rates reveals that the recent outturn has varied quite markedly across individual trading partners and competitors. Table 7 reports the quarterly averages of the REER indices against these countries. On the one hand, from end-1995 to November 1997 the lats appreciated by 12 percent in nominal terms against the German mark as global trends depreciated the mark against the U.S. dollar and SDR.[32] The large nominal appreciation of the lats combined with the difference in inflation to yield a real appreciation of 32 percent against the mark, and fostered real appreciation against those currencies that were pegged or tied to the mark (Estonia, Finland, Hungary, Slovak Republic, and Czech Republic until June 1996). In contrast, only modest real appreciation has occurred against the U.K. pound and the U.S. dollar from end-1995 to November 1997, by 1 percent and 6 percent, respectively. Global forces acting on the dollar led to a 7 percent nominal depreciation of the lats from end-1995 to November 1997. This in turn fostered a real depreciation of the lats against currencies pegged to the U.S. dollar (Lithuania). Finally, in the case of Russia one sees a 3 percent real depreciation, and a moderated real appreciation of 18 percent against the Polish zloty.

[31]Note that these overall trends are heavily influenced by the bilateral trends against the Russian Federation and Germany, which have the largest weights (respectively, 0.297 and 0.158). The weights for other EU countries were: Sweden, Finland and the United Kingdom 0.173, 0.165, and 0.109, respectively.

[32]Chapter II of **International Capital Market**, IMF (1997), presents an overview of recent trends in the major currencies.

Measures of cost competitiveness: U.S. dollar wages and unit labor costs

Relative wages in U.S. dollars

109. Another common indicator of cost competitiveness is the average remuneration of labor in U.S. dollars. Tables 8 and 9 present cross-country comparisons of nominal wages in U.S. dollars, economy-wide (Table 8) and for the state sector (Table 9). Estonia has the highest wages in the Baltics and Russia, with wages in Latvia still behind Estonia. Further, from Table 8, we see Latvian wages have risen the least in the three Baltic states since 1994, though faster than in Russia. Reported wages in Latvia as in other transition countries probably understate total labor remuneration in view of the widespread custom of evading the social tax by minimizing declared wage payments and making additional payments not captured in the payroll.[33] Therefore, Table 9 presents wages in U.S. dollars in the state sector where it is expected wage payments are far less distorted by such side payments. This data confirms the previous conclusions on wages developments in Latvia compared to others. As a group, the Baltics and Russia have the highest wages except the Visegrad countries (Czech Republic, Hungary and Poland). Also, from the table we see that in 1995 wages in Latvia grew faster than in Poland or Czech Republic, but appreciably slower than either in 1996.

110. Table 10 presents developments in economy-wide average earnings in U.S. dollars for a selection of countries. Average earnings in the Baltic countries have increased more markedly than in the other countries, except for Russia which has also had large cumulative wage increases. Of the selected countries, wages in Latvia grew relatively weakly in 1996, by 12 percent between 1995 Q4 to 1996 Q4, about the same as in Estonia but much lower than Czech Republic, Lithuania and Russia. Only in Poland and Slovenia did wages grow more slowly (9 percent and 2 percent, respectively).

111. The data in Table 10 also suggest 1997 was a transition year in wage developments for several of these countries: Wages in U.S. dollars fell from their peak in 1996 Q4 in the Czech Republic, Slovenia and Poland (though a partial reversal of initial losses is noted for the Czech Republic and Poland) even as strong wage growth continued in the Baltics and Russia. The rate of growth of wages in Russia moderated somewhat, but has remained virtually unchanged for Latvia and Lithuania. However, the numbers for Latvia overstate real wage change, as the general wage increases awarded in Latvia in early 1997 were meant to compensate workers for increased tax liability, which resulted from the shifting of 9 percentage points of the social tax from enterprises to employees. Net of this increase, wage growth in Latvia has been much more gradual.

112. To conclude, notwithstanding data limitations, the wage data indicate that wages are higher in the Baltics than in other transition economies except the Visegrad countries, and

[33] A 37 percent social tax applies on the payroll in Latvia, a number similar to many other transition economies.

wages in Latvia are higher than in Lithuania but lower than in Estonia. Over the recent period, wages in Latvia have increased more moderately than in most other transition economies, and wage growth in 1997, net of the change in tax liabilities, has moderated substantially.

Relative unit labor cost in U.S. dollars

113. One of the preferred indicators of cost competitiveness is the relative unit labor cost (ULC) in manufacturing or industry, though it is not without drawbacks,[34] and like the price-based indicators requires the identification of a base period in which equilibrium obtains. Latvian data permit the ULC growth rates to be calculated only for 1996 and the first three quarters of 1997;[35] while similar data for industrial countries is readily available, those for the more relevant comparator, other transition countries, are not available without considerable effort. Thus the values for Latvia alone can only be used to observe trends over time but not to assess absolute levels. The percentage changes for the first three quarters of 1996 were, on the face of it, very high—but recall the qualification—with values over 60 percent. However, this moderated to 20 percent and below, as of the fourth quarter of 1996 and through the third quarter of 1997. Thus, the *trend* of wage moderation noted above is confirmed by the ULC calculation.

Convergence to equilibrium wage levels

114. Recent research by Krajnyak and Zettlemeyer (1997) builds on earlier work[36] and uses proxies for potential productivity and human capital to estimate the equilibrium wage rates for a large set of 85 countries including transition economies. They conclude that for Latvia wages in US dollars have converged rapidly to the equilibrium wage, but there is still scope for further increases since actual wages in 1995 were well below the estimated equilibrium level by a margin of 37 percent to 22 percent. This was among the smallest gaps between its actual and equilibrium levels observed in transition countries. (The study shows 53 percent to 42 percent for Estonia and 36 percent to 26 percent for Lithuania.) For Central and Eastern European countries, wages were below calculated equilibrium levels by margins of 55 percent to 44 percent. While the study's results are subject to the quality of the proxy variables

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[34]For an elaboration of some of the difficulties with ULC indicators, see for instance, Marsh and Tokarick (1994). Havlik (1996) examines the ULCs in ten central and East European transition economies, not including the Baltics.

[35]We calculated an index of the ULC in Latvia, compensation per worker divided by productivity, from the normalized result of dividing wage payments by the deflated value added in manufacturing. The GDP deflator was used.

[36]Halpern and Wyplosz (1996), and Krajnyak and Zettlemeyer (1997). These studies examine a short panel of about 80 countries that include the developed economies and a selection of transition countries. The data set and techniques employed in these studies differ.

especially that on potential productivity, it suggests nevertheless there is still some scope for catch-up wage increases in the future even without effects of productivity. Note in particular that the dollar wage increase from end-1995 to mid-1997 was 14 percent, that is below the range of 1995 undervaluation estimated by this study.

Penetration of new export markets

115. A significant redirection of Latvia's trade has taken place in recent years, away from the traditional markets of the other Baltic republics, Russia and other countries of the former Soviet Union. In 1996, 48 percent of Latvia's external trade was with countries of the European Union, compared to 27 percent in 1993. This is despite the real appreciation of the REER against these countries as a group, noted previously.[37]

116. Table 11 presents data on the recent developments in Latvia's markets and exports. Latvia's markets have grown considerably though not uniformly, as indicated by the real growth rate of imports of goods and services by these countries. A real decline in Latvia's exports of goods and services was realized in 1994, followed by modest recovery in 1995 and a sharp increase in 1996. However, 1997 estimates show a moderation of the growth in services trade in 1997, largely due to the Latvian shipping moving offshore. A significant loss in market share was experienced in 1994 and 1995, but this was reversed in 1996 and 1997 as Latvia captured an increasing share of the export market, by a cumulative 15 percent in both years. The recent gains have more than compensated for earlier losses, and over 1994 to 1997 Latvia's share in the export markets has grown by over 3 percent.

117. The trend for goods exports alone is even more dramatic: the real contraction in the export of goods was steeper in 1994 than for total goods and services, resulting in a larger loss of market share, but the rate of growth has increased steadily over 1995 to 1997, with the market share increasing in 1996 and 1997. These increases have been insufficient to reverse the early losses in market share (see column 3) which suggests that there is room for growth of its market share.

118. Table 12 presents the evolution of the market shares of various transition countries in the European Union market, defined as the value of a country's exports to the EU divided by the value of all EU imports. An alternative measure would include intra-EU imports in the concept of total EU imports. However, significant movements in relative prices would distort these value-based indicators. From the table, we see the shares of imports from these countries have grown in the recent period, dramatically in the early years of the transition, then gradually moderating. Latvia's share in EU imports from non-EU members has grown steadily, except in 1996 when it fell about 7 percent. The decline in 1996 reflects the sharp fall

[37] Havrylyshyn and Al-Atrash (1998) point to all the Baltic countries as amongst those that have experienced the strongest reorientation of trade, and as being about as open to trade (proxied by trade to GDP ratios) as similar size market economies.

in export prices of Latvian wood (a large component of Latvian exports) as the world market weakened (an average decline in the U.S. dollar average price of 7 percent over 1995). In view of the large intra-EU trade in wood which was also affected by the fall in prices in 1996, the distortion from the movement in wood prices is less severe for the measure that includes intra-EU imports in total imports. This indicates a continued increase in Latvia's market share during 1996. Further, data for 1997 Q1 indicate a strong recovery in Latvia's market share compared to 1996 Q1, faster than most of the other transition economies, probably due to the recovery of wood prices.

119. More generally, during 1995 and 1996 Latvia has increased its market share in the EU as much or better than other transition economies except for Estonia, Hungary, the Slovak Republic in 1995, and the Czech Republic in 1996. The United Nations (1997) reports growth of Latvian exports of goods to the EU in 1995, 1996, and first half of 1997 as, respectively, 34 percent, 10 percent, and 14 percent, compared to 34 percent, 3 percent, and 9 percent for all of Eastern Europe. For 1997, only Hungary, Estonia and Lithuania are higher. Thus, the analysis indicates a robust growth in exports to the EU sufficient to capture a rising share of the market, at rates that are comparable or better than other transition economies.

120. In summary, export penetration indicators clearly point to a buoyant situation, with market shares in important new markets—in the EU in particular—growing steadily and probably somewhat faster than the average for Central and Eastern Europe. The implication of a continued position of competitiveness is sustained through 1997.

C. Indicators of Current Account Sustainability

121. Following the significant widening of current account deficits in the transition economies and more recently the crises in the Czech Republic and Southeast Asia, the external vulnerability of economies, particularly the transition economies, has received renewed interest.[38] Several "early warning" indicators have been used to assess potential vulnerability, though the literature on this is still in an early stage of development. With this caveat, this section examines Latvia's position compared to a selection of countries that have faced such crises.

122. From Table 13 we see Latvia's growth rate has increased in 1997, to levels above those in most of the comparator countries. However, this by itself is not a sign of imminent overheating since the rapid growth in part reverses past declines, and with substantial underutilization of capacity it could continue. Increased new investment and considerable FDI add to these prospects. At the same time the government balance in Latvia improved by about 3 percent in 1997, compared to a worsening of the fiscal balance in most of the comparator countries.

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[38]Milesi-Ferretti and Razin (1996), Kaminsky et al (1997) and Roubini and Wachtel (1997) are some of the new examples of a fast growing literature.

123. Perhaps the single most important indicator in an analysis of external vulnerability is a persistently large current account deficit financed by short-term capital. Latvia's current account deficit as estimated and shown in the table is below that of its neighbor, Estonia, and is well below those recorded before the crises in the selected countries (except Indonesia), and it is more short-lived. Along with the probable overstatement of the current account in Latvia due to data problems (see Annex 1), two other factors should be considered. First, there is an appreciable slowdown in the volume growth of Latvia's imports, while export growth has accelerated and caught up with import growth. Second, Latvia's current account was more than fully financed by private direct investment, with a very minimal role of portfolio investments (unlike the other Baltic states and many Central European countries) or other forms of capital including short-term flows (unlike Mexico, and Thailand in 1997). Indeed, foreign direct investment as a share of GDP, at 5.7 percent, was probably higher in the first half of 1997 than in any other country in the region.[39]

124. The debt statistics reveal even wider differences. Very prudent external borrowing has kept Latvia's public external debt stock below 10 percent of GDP. Despite the patchy data on private external debt in Latvia, these are still believed to be small judging from the known practices of the large enterprises as well as banks' net creditor positions. Thus, Latvia's total external debt would be much lower than those reported for the listed countries, except for Estonia. Latvia's total debt service is well below those reported for the listed countries.

125. In sum, an examination of these data suggests that while the high current account deficit if not reduced is a potential problem, Latvia's position for other indicators such as short term liabilities, fiscal position and attraction of FDI is quite favorable. However, in view of the speed at which any crisis could emerge, close monitoring of the developments is no doubt called for.

D. Summary and Conclusions

126. This paper has examined Latvia's competitiveness against the EU and its main competitors during 1996 and 1997. An overall real appreciation is seen against all trading partners, but the bilateral real and nominal exchange rates reveal this has varied quite markedly across individual trading partners and competitors. Real appreciation was highest relative to Europe, but this has moderated since 1995, and increased penetration of EU markets suggests continued ability to compete. The wage-based indicators also suggest that Latvia has broadly maintained its competitiveness. It would therefore appear that the observed overall real appreciation of the REER is consistent with the common hypothesis in transition of early undervaluation followed by an appreciation of the REER as stabilization allows catch-up and then productivity growth reinforces the tendency.

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[39]UN (1997) shows an average of 22 percent for Eastern Europe, 3.5 percent for the Baltic, and 0.8 percent for European CIS countries (Belarus, Moldova, Russia, Ukraine).

127. We have also examined Latvia's available indicators of external vulnerability, and compared these with a selection of economies. These suggest that while Latvia is certainly facing a period of risk with a high current account deficit, the high coverage by foreign direct investment, strong credit ratings, high growth prospects, good fiscal position and very low debt levels, all mitigate vulnerability in the immediate future. Nevertheless, such a favorable position can deteriorate quickly hence close attention is clearly called for.

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DATA ISSUES

Despite continued progress in the compilation of the balance of payments statistics by the Central Statistical Bureau (CSB), weaknesses in the Latvian balance of payments calls for caution in the interpretation of the implied trends. Data estimates in the earlier period were impaired both by the lack of needed surveys and weaknesses in the techniques that were employed. Consequently, undercoverage and the misclassification of items afflicted the data on trade and capital flows but especially services, and large errors and omissions arose. However, the direction of the resultant bias on the current account balance is ambiguous. New surveys and improved methodologies have since been phased in which along with improvements in practices of some of the primary data sources has resulted in more robust estimates of most components of the balance of payments. For instance, data on merchandise trade are based primarily on customs data and improved customs practices have enhanced the reliability of the trade data. Also, concerns over the possible undervaluation of goods have lessened and will decline even further as a result of the recent implementation of regulations towards ensuring the use of transaction price valuation.

Despite the recent improvements some difficulties still remain in the estimation of services and some non-public capital flows. There is therefore a need for continued improvements in the reliability of the data, primarily by maximizing the coverage in the relevant surveys while minimizing potential underreporting. This is especially relevant in the enterprise and passenger travel surveys, which would give rise to weak estimates in the services items, and the trade credit component of short-term capital. It is believed that these weaknesses lead to the understatement of service receipts and hence the services balance, and the mis-measurement of trade credits. The improvements noted in the statistical practices, however, have introduced noteworthy breaks in the current account data, in 1993 and 1995.

In sum, published balance of payments data while still inadequate are more likely to overstate the current account deficit while some short-term capital (trade credits) may not be fully identified. The analysis in this paper also looks at data on exchange rates, prices, wages, and exports. These data series are judged to be fairly reliable and therefore may not jeopardize the conclusions.

Table 6. Latvia: Selected Indicators

	1993	1994	1995	1996	1997
Annual real GDP growth (percent)	-16.0	2.1	0.3	2.8	6.0
Annual CPI inflation (percent)	34.9	26.3	23.1	13.1	7.0
Imports (percent of GDP)	48.4	36.3	41.2	42.8	45.9
Exports (percent of GDP)	48.6	28.0	28.9	27.8	30.4
Current account balance (percent of GDP)	14.5	-0.2	-3.4	-4.1	-6.9

Source: Authorities and staff estimates

Table 7. Latvia: Real Effective Exchange Rate Indices
(Quarterly average, 1995=100)

	All trading partners	EU	Germany	Sweden	United Kingdom	Finland	United States	Russia	Lithuania	Estonia	Czech Republic	Hungary	Poland	Slovenia	Slovak Republic
1993															
Q1	77.8	42.8	43.3	39.9	41.0	48.4	38.1	142.5	153.6	86.0	48.8	39.7	45.2	44.1	46.9
Q2	93.9	52.8	53.7	49.5	49.5	58.7	47.9	169.9	138.1	100.8	59.8	50.5	55.6	57.4	56.6
Q3	87.5	59.8	59.9	57.8	54.4	66.7	51.7	114.3	103.1	107.3	64.6	55.5	63.7	64.4	65.1
Q4	87.3	70.0	69.9	68.8	63.7	77.3	59.9	91.0	103.7	115.1	73.1	64.4	75.0	75.2	73.5
1994															
Q1	90.2	80.1	81.6	76.7	73.1	86.4	68.5	93.0	103.4	116.1	84.3	74.5	84.6	89.2	85.1
Q2	97.1	85.1	86.2	82.0	79.2	92.1	75.1	97.1	105.5	110.2	89.3	79.5	89.8	92.6	89.3
Q3	100.9	88.6	88.7	88.0	84.1	94.0	81.9	104.6	107.6	108.2	91.5	84.6	94.4	93.1	91.6
Q4	104.4	89.4	90.9	87.8	85.0	91.0	84.9	117.9	102.9	105.9	92.1	85.7	94.1	93.2	91.6
1995															
Q1	101.9	93.7	93.7	94.1	90.8	94.8	91.0	112.7	98.2	101.4	95.1	90.0	96.0	94.7	94.8
Q2	105.6	100.7	99.3	104.2	100.7	100.1	101.8	115.4	105.0	101.8	100.4	102.1	100.5	99.0	101.4
Q3	98.2	102.6	102.9	103.5	102.9	101.7	102.7	89.8	101.4	100.6	102.3	103.4	102.2	101.0	101.5
Q4	94.3	103.0	104.1	98.2	105.6	103.4	104.5	82.1	95.4	96.1	102.2	104.5	101.4	105.3	102.3
1996															
Q1	94.1	108.0	109.7	101.9	109.4	111.7	106.0	79.2	89.6	93.8	104.5	107.5	100.1	113.4	105.7
Q2	96.6	113.2	116.4	104.1	112.5	119.3	108.0	80.0	88.4	95.4	107.0	110.1	102.8	117.6	109.1
Q3	100.1	115.1	118.6	106.9	114.0	119.2	111.6	86.0	91.4	96.5	105.4	112.8	107.5	117.3	111.4
Q4	101.6	117.0	122.3	109.3	108.7	121.9	112.2	88.0	91.4	98.5	106.8	115.2	108.0	121.8	113.8
1997															
Q1	101.1	121.5	127.7	116.9	104.9	127.0	108.0	83.4	85.0	100.8	106.8	114.8	105.7	125.7	113.8
Q2	103.8	126.9	133.6	123.2	105.8	133.5	109.3	83.5	85.3	100.9	116.9	118.9	110.1	127.5	115.3
Q3	106.8	133.6	142.6	126.7	107.0	141.8	110.8	84.3	85.4	106.2	123.3	125.0	119.8	134.8	119.8

Source: Information Notice System database, IMF

Table 8. Latvia: Economy–wide Nominal Wages 1994–97

(In U.S. dollars)

	Estonia	Russia	Latvia	Lithuania
1994				
Q1	102	93	113	83
Q2	131	100	132	87
Q3	140	110	144	92
Q4	169	94	167	105
1995				
Q1	176	77	168	109
Q2	214	87	192	125
Q3	206	118	187	132
Q4	237	143	197	151
1996				
Q1	226	146	181	163
Q2	247	158	198	167
Q3	250	160	203	173
Q4	269	164	218	185
1997				
Q1	236	150	211	187
Q2	263	160	225	205

Sources: International Financial Statistics, and Fund staff estimates; SM/97/277

Table 9. Latvia: Average Dollar Wages in the State Sector 1994–96 1/

(In U.S. dollars)

Country	1994	1995	1996
Armenia	6.32	15.09	19.60
Azerbaijan	12.20	13.31	17.32
Belarus	23.91	65.11	88.90
Estonia	131.45	206.11	261.00
Georgia	3.30	7.68	14.10
Kazakhstan	42.78	82.58	94.48
Kyrgyz Republic	21.72	36.04	39.21
Latvia	139.56	186.12	189.78
Lithuania	91.48	129.00	165.13
Moldova	26.08	31.23	36.56
Russia	98.87	106.52	152.04
Tajikistan	17.68	8.51	6.68
Turkmenistan	83.68	29.43	10.53
Ukraine	27.25	48.50	68.63
Uzbekistan	42.90	35.45	47.80
Bulgaria	85.00	108.63	118.91
Czech Republic	240.00	228.00	328.51
Hungary	240.00	311.96	310.81
Poland	213.66	328.11	340.74
Romania	84.14	105.00	97.00

Source: Staff estimates, SM/96/287.

1/ Average dollar wages computed using average wage in the state sector and converted to dollars using the period average exchange rate. The relative size of the state sector in the economy varies from country–to–country and, therefore, cross–country analysis may not be strictly accurate.

Table 10. Economy-wide Average Earnings in Selected Countries
(Quarterly average index, 1994 = 100)

	Latvia	Estonia	Lithuania	Czech	Slovenia	Poland	Russia	US
1994								
Q1	79.0	73.5	85.5	83.5	88.1	97.7	94.1	97.6
Q2	100.0	99.7	97.4	96.4	93.8	98.7	101.6	99.3
Q3	108.0	106.5	101.2	102.1	104.2	100.3	108.6	100.6
Q4	112.9	120.3	116.0	118.0	113.9	103.2	95.7	102.5
1995								
Q1	120.5	124.7	117.6	0.0	121.0	117.6	87.3	103.9
Q2	134.4	162.9	134.3	0.0	131.7	131.1	98.8	104.3
Q3	135.3	159.3	142.8	0.0	130.4	131.8	132.6	105.5
Q4	137.1	180.2	162.3	0.0	131.4	149.6	148.7	105.8
1996								
Q1	132.0	171.7	184.7	0.0	124.1	144.0	161.7	106.3
Q2	144.1	187.7	184.7	0.0	124.9	147.5	171.2	108.3
Q3	152.2	190.2	199.4	0.0	133.4	147.1	175.2	109.2
Q4	153.3	202.1	210.2	0.0	134.3	163.0	176.7	110.3
1997								
Q1	152.8	179.6	215.8	0.0	124.2	147.1	171.7	111.7
Q2	165.7	200.2	238.7	0.0	123.5	150.1	183.8	112.9
Q3	171.3	...	256.1	129.2	117.7	141.3	195.0	114.5
Q4	...	...	...	130.0	...	155.9	...	116.6

Source: IFS and EU2 database; and staff estimates

Table 11. Latvia: Analysis of Export Market Share
(Percentage change)

	1992	1993	1994	1995	1996	1997	Cumulated growth 1993-94	1994-95	1996-1997	1994-97
Goods and services:										
Market growth 1/	5.0	16.2	5.7	11.9	3.9	8.3	22.8	18.3	12.5	33.1
Growth of Latvia's exports	...	37.0	-0.6	7.2	26.2	2.3	36.2	6.6	29.1	37.6
Change in Latvia's market share	...	17.9	-6.0	-4.2	21.5	-5.5	10.9	-9.9	14.7	3.4
Goods:										
Market growth 1/	4.6	14.6	5.4	12.2	6.0	8.3	20.8	18.3	14.8	35.8
Growth of Latvia's exports	...	9.5	-28.9	6.8	8.9	13.4	-22.1	-24.1	23.5	-6.2
Change in Latvia's market share	...	-4.5	-32.5	-4.8	2.7	4.7	-35.5	-35.8	7.6	-30.9

Source: WEO database and staff estimates

Table 12. Selected Country's Share in Total EU Imports
(in percent)

	1992	1993	1994	1995	1996	1997 Jan-Mar 1/
	Within imports from non-EU and other EU countries					
Latvia	0.029	0.063	0.079	0.087	0.094	...
Estonia	0.001	0.026	0.047	0.068	0.080	...
Lithuania	0.038	0.061	0.066	0.072	0.077	...
Czech Republic	0.000	0.465	0.518	0.555	0.644	...
Hungary	0.390	0.412	0.459	0.526	0.560	...
Poland	0.593	0.718	0.770	0.846	0.807	...
Slovenia	0.000	0.267	0.284	0.295	0.283	...
Slovak Republic	0.000	0.118	0.167	0.212	0.217	...
Russia	0.274	1.461	1.584	1.581	1.513	...
	Within imports from non-EU countries					
Latvia	0.057	0.063	0.115	0.163	0.187	0.230
Estonia	0.107	0.149	0.163	0.178	0.187	0.209
Lithuania	0.000	1.199	1.423	1.650	1.680	0.203
Czech Republic	1.082	1.037	1.169	1.397	1.517	1.635
Hungary	1.725	1.799	1.953	2.249	2.109	1.622
Poland	0.397	0.676	0.732	0.779	0.735	2.107
Slovenia	0.000	0.301	0.432	0.567	0.589	0.690
Slovak Republic	2.325	3.634	4.146	3.941	4.000	0.583
Russia	0.000	0.000	0.000	0.000	0.000	4.335

Source: Direction of Trade Statistics and Eurostat

1/ Share during 1997 Q1 compared to share in 1996 Q1.

Table 13. Latvia: Indicators of External Vulnerability
(in percent of GDP unless otherwise stated)

	Latvia		Estonia		Czech Rep.		Thailand		Indonesia		Mexicio	
	1996	1997	1996	1997	1996	1997	1996	1997	1996	1997	1993	1994
Real GDP growth (percent)	2.8	6.0	4.0	7.0	4.1	1.2	6.4	0.6	8.0	5.0	0.6	3.5
General government balance	-1.3	1.3	-1.5	0.4	-1.2	-2.1	1.6	-0.4	1.4	2.0	0.7	-0.1
Gross domestic investment	20.7	23.1	27.5	28.7	33.0	30.7	40.8	35.8	28.1	26.5	22.0	22.2
Current account balance	-4.1	-6.9	-10.2	-12.2	-7.6	-6.3	-7.9	-3.9	-3.3	-2.9	-6.5	-7.9
Merchandise export growth (percent) 1/	8.9	13.4	5.4	31.6	0.0	13.9	-0.4	...	8.7	...	13.6	12.4
Merchandise imports (percent) 1/	22.7	13.1	10.8	29.7	11.1	6.0	2.9	...	9.0	...	3.0	19.4
Gross reserves (months of goods imports)	4.1	3.8	2.5	2.0	5.4	4.4	6.6	5.0	4.7	49.7	6.2	1.3
Total external debt stock	...	...	...	...	37.7	43.1	48.9	59.3	52.9.	...	35.2	36.8
Public external debt stock	8.1	7.3	6.9	6.8	...	...	9.2	...	31.6	36.4	23.1	24.1
Total debt service	1.8	2.0	...	...	5.7	6.8	5.4	7.1	9.0	10.5	20.7	21.1
Public debt service (percent of exports) 2/	4.4	7.4	...	...	...	...	2.6	...	18.6	18.0	32.0	33.4
Net private capital flows	...	...	...	...	...	...	9.3	-10.9	6.3	1.6	5.6	2.9
Net direct investment	7.0	7.2	2.2	3.7	2.5	1.8	0.9	1.3	2.8	2.0	1.1	2.6
Net portfolio investment	0.0	0.0	3.2	3.6	1.3	0.6	0.6	0.4	0.8	-0.4	...	...
Other private net invstment	...	...	...	...	...	...	7.7	-12.6	2.7	0.1	...	...
Net Portfolio investment (percent of reserves)	0.3	0.1	22.2	23.3	5.9	3.0	2.9	...	8.8	...	112.1	115.9
Change in reserves (- indicates increase)	-3.5	-1.0	-1.3	-1.1	1.5	3.8	-1.2	9.7	-2.3	1.8	-1.5	4.5
Gross reserves (percent of broad money)	68.4	56.2	65.7	46.0	30.6	28.1	26.6	...	32.1	...	54.6	23.4
Sovereign credit rating (Moody's)	...	Baa2	...	Baal	...	Baa	A2	Bal	...	Bal	...	...
Sovereign credit rating (S&P)	...	BBB	...	BBB+	...	A	A	BBB	BBB	BBB-	...	BB+

Sources; IFS, WEO and various country papers and reports.
1/ For Estonia goods and non-factor services, for Indonesia non-oil exports or imports.
2/ For Thailand, Indonesia and Mexicio goods and non-factor services.

V. Labor Market Issues in Latvia

A. Introduction

128. The Latvian economy is in the midst of a transition to a market economy. Among the important elements of this transition has been a freeing of virtually all prices, the liberalization of trade, and enterprise privatization. These steps are contributing to restructuring of the economy and increased productivity and economic growth. However, the extent to which these reforms increase economic efficiency, as well as the degree to which the economic gains are broadly shared among the population, will depend in part on the functioning of the labor market. In addition, given that Latvia has chosen to peg its exchange rate to the SDR, it is particularly important that the domestic labor market be flexible, to help ensure that Latvia remains competitive on world markets.

129. Official unemployment in Latvia increased from virtually zero at the beginning of transition to about 7½ percent in early 1997 (Table 14), before declining to its present level of 6.7 percent. A number of factors suggest, however, that unemployment is a serious problem. First, official unemployment rates underestimate actual unemployment, with broader measures suggesting unemployment rates approaching 20 percent. Second, a growing share of the unemployed are long-term unemployed; besides the obvious impact on the well-being of the population, significant long-term unemployment could threaten political support for economic reforms more generally. Long-term unemployment may also lead to an erosion of work skills and result in a higher natural rate of unemployment. Third, unemployment is geographically concentrated, with a number of rural regions experiencing official unemployment as high as 30 percent, and labor mobility is apparently quite limited. Finally, despite the recent decline in unemployment, reflecting strong economic growth, an acceleration in the privatization process in 1997–98 and further restructuring over the medium term may lead to increases in unemployment.

130. It was inevitable that unemployment would rise during the restructuring of Latvia's economy.[40] During a transition, as individuals are released from public enterprises and productivity rises following privatization and other structural reforms, laid-off workers typically do not immediately find new jobs. In fact, some frictional unemployment may well be optimal, as individuals search for the jobs for which they are best matched, and employers search for the right workers. However, longer-term unemployment can be brought about by wage rigidities, lack of labor mobility, or a mismatch between newly desired skills (such as computer literacy of foreign language skills) and those skills possessed by the unemployed. Policies aimed specifically at preventing unemployment may, however, prove counterproductive in limiting the extent of economic restructuring and, therefore, the benefits

[40]For discussions of unemployment experiences in transition economies see, e.g., Allison and Ringold (1996) and Commander and Coricelli (1995).

of transition. Authorities may face a trade-off between the speed of transition and the transitional costs imposed on unemployed workers.

131. This note traces developments in the labor market in Latvia, including labor force participation, employment, unemployment, and wages since the beginning of the transition. Labor market outcomes are related to institutional features of the Latvian labor market and to government policies pursued during transition, and potential policy implications are briefly discussed.

B. Analytical Framework

132. Labor market developments in transition economies can be examined in the context of a "matching model."[41] The public sector sheds labor during transition, both because some or all public enterprises are privatized and because rationalization and associated layoffs are taking place within the state sector. At the same time, job creation is taking place in the private sector, again reflecting privatization but also the creation of new private sector firms and employment. However, such private sector job creation takes time, because the private sector does not develop instantaneously, and because matching individuals and jobs can be costly; as a result, there must be unemployment.

133. Individuals whose public sector jobs have been eliminated may meet one of a number of possible fates in the labor market. First, they may find employment in the private sector, either by maintaining their position in an enterprise post-privatization or by finding employment in the newly emerging private sector. Second, they may leave the labor force, for example, by opting for early retirement or emigrating out of the country; both of these have been an important phenomenon in Latvia and other transition economies. Third, they may move into the informal sector; while these individuals may continue to be measured as officially unemployed or out of the labor force they are, in fact, employed, although perhaps at very low wages. Finally, they may become unemployed. Thus, unemployment during transition can be seen as depending on the speed at which public sector jobs are being shed, the rate of private sector job creation, and the extent of exit from the labor force including through movement to the informal sector and migration.

134. Given the rate at which transition takes place (proxied by the speed at which public sector jobs are being eliminated) labor market institutions and government policies can influence the extent and duration of unemployment. A high minimum wage relative to the average wage in the economy will imply wage rigidities for a large number of workers, tending to slow job creation in the private sector, in particular for low-skilled jobs, increase unemployment but cushion the fall in real wages. Insufficient unemployment insurance (UI) may retard the restructuring process by encouraging workers to remain in an underemployed state rather than searching for new employment, or accepting jobs for which they are poor matches, while overly generous UI may encourage individuals to remain unemployed for a

[41]See, e.g., Pissarides (1990).

longer-than-optimal time, while imposing a large fiscal burden on the government. The public sector may hire laid-off individuals, acting as an "employer of last resort" and slowing the restructuring process. Training or other active labor market policies may speed the movement of the unemployed back to the workforce or may simply represent an inefficient use of public resources.

135. The matching model can be extended to account for the fact that the speed at which state-owned enterprises are privatized or closed down, and so at which public sector jobs are eliminated, is itself endogenous.[42] In this context, government labor policies can have additional impact, in effect by influencing the rate at which transition takes place. In particular, the existence of an adequate safety net, including unemployment benefits, may encourage government decision-makers to close state enterprises, speeding transition, while increasing unemployment and dampening wage reductions. The existence of a minimum wage would, similarly, tend to lead to a more rapid elimination of public sector jobs, and so speed the transition, although unemployment would tend to be higher.

Labor market data

136. Labor market data, in Latvia as in many other countries, are far from perfect and interpretation of these data must be undertaken cautiously.[43] In particular, the official definition of unemployment is more narrow than would be theoretically most desirable, as it focuses on those individuals that officially register as unemployed at the State Employment Service (SES), thereby omitting a large number of jobseekers or underemployed individuals.

137. There are several sources of labor market data in Latvia: administrative data from the SES and the Social Insurance Fund (SIF); data collected by the Central Statistical Bureau (CSB); and data from the labor market survey (LMS). The SES generates data on nonworking individuals that register with the agency and, within this group, identifies those who are officially unemployed. Unemployed individuals are identified by their characteristics, including sex and age, locality of residence and duration of unemployment. The SIF collects statistics on the number of individuals actually receiving benefits; this figure differs substantially from the number of unemployed, as a sizable share of unemployed are ineligible for benefits, e.g. the long-term unemployed who have used up their eligibility, or recent school graduates without a work history. The CSB collects and publishes the administrative data and collects its own labor force data, e.g. on labor force participation and wages. The LMS has been conducted twice a year since November 1995, and is based on a national sample of the population age 15 to 69, with a sample size of 6,000 households.

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[42]For an example of a theoretical analysis utilizing such a model, which takes the decision to close down state enterprises as endogenous, see Garibaldi and Brixiova (1997).

[43]For a detailed description of labor data in Latvia, see Loza, Caunitis, and Barfub (1997)

138. Each of these data sources has its advantages and shortcomings. Administrative data have been collected for a number of years, and so are useful in examining developments since the beginning of transition. These data also allow a regional disaggregation, which is useful for policy analysis. However, the narrow administrative definition of unemployment provides only a very partial picture of the labor market situation. The LMS data allow for a much more complete characterization of labor market status, but there have been only a small number of such surveys. Therefore the analysis that follows utilizes both main sets of data.

C. Labor Market Participation and Employment

Labor market participation[44]

139. Labor market participation has declined by more than 10 percent in Latvia, from 1.42 million in 1990 to 1.26 million in 1996 (Table 14). The participation rate of 50.5 percent is low by international standards, partly reflecting the large number of pensioners. The decline in the participation rate has had several causes. First, the size of the working age population has declined by about 7 percent during 1990–97, reflecting trends in mortality as well as migration. Second, some individuals have become discouraged in their attempts to find a job, and have dropped out of the labor force altogether; according to labor force survey data, this reduced participation by about 45 thousand, or 4 percentage points, in 1997 (Table 15). Finally, some of the decline may reflect an attempt to acquire new skills needed in a market economy. In this regard, it is interesting to note that enrollment in higher education has increased significantly over the last several years. This is consistent with findings from a number of transition economies in Central and Eastern Europe (CEE), that returns to higher education have increased sharply.[45]

Trends in employment

140. Employment has declined steadily during the course of transition in Latvia, as has been the experience in transition economies in general. The number of officially employed individuals has declined by about 240 thousand, or 17 percent, from 1990–97. More than half of that decline took place prior to the end of 1993, i.e. in the very early stages of transition; employment has fallen by just 2 percent since end-1995, and was essentially unchanged in 1997. Employment in the public sector has declined quite rapidly, falling by more than half since 1992.[46] In total, some 450 thousand public sector jobs have been lost since 1992, either through privatization or actual labor shedding (just over 400 thousand such jobs remain) and 270 thousand private sector jobs created, either through privatization or the formation of new

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[44]An individual is participating in the labor market if he or she is either employed or out of work and actively seeking a job.

[45]See Rutkowski (1996) for a review of studies in this area.

[46]Data by sector are available only since 1992.

private firms. The share of employment in the private sector has increased from just over one-third in 1992 to two-thirds in mid-1997.This proportion of private sector employment is similar to a number of CEE countries, such as Hungary, the Czech Republic and Poland, and substantially higher than Russia or Ukraine.[47]

141. It should be noted that the level of employment implied by the labor market survey data is lower than the official level, but the gap has declined over time (Table 15). According to the survey, in May 1996, employment stood at 960 thousand compared with the official data of 1,170 thousand, a difference of some 18 percent. By June 1997, however, this difference was just 4 percent, with survey results indicating a sharp growth in employment during 1997. The differences in results arise, in part, from the fact that official data are primarily based on enterprise data, adjusted for estimates of the number of individuals reported as employed in small businesses (self-employed population) and employers while, in the LMS data, employment status is self-reported. It is possible that the declining difference between the two estimates of employment reflects a reduction in employment in the informal sector. The LMS also indicates that there is a substantial amount of underemployment, not reflected in the official data. About 7 percent of the labor force are involuntarily working part-time and 0.4 percent of the labor force were involuntarily absent from work during 1997, taking either paid or unpaid leave. In particular, some state enterprises approaching privatization or liquidation have slowed or stopped production, while maintaining their employees on the payroll.

142. One interesting issue is how much of the switch from public to private sector employment simply reflects privatization as opposed to labor-shedding in the public sector and private job creation. While it is difficult to make a precise estimate, it is interesting to at least note that half of the public sector jobs lost were eliminated during 1992–93, well before the privatization process took off. This suggests that a sizable share of the loss in public sector jobs reflects labor-shedding rather than simply a shift of enterprises form the public to private sector. Similarly, nearly half of the new private sector jobs were created during 1992–93.

Trends in output, employment and productivity

143. While employment fell rapidly in the initial stages of transition, it did not fall nearly as rapidly as output. While employment fell by 12 percent during 1990–93, output fell by half. Many state-owned enterprises maintained their workforces, although a significant number of workers were sent home for a time without pay and without being registered as unemployed. As a result, labor productivity, measured by output per official worker, declined by 44 percent in constant (1993) lats during 1990–93 (Table 16), and real wages declined more or less in line (see section E). In the last several years, however, as the transition has begun to accelerate and as privatization has picked up, labor productivity has gradually increased, rising by about 9 percent over the three years, 1994–96, and by an estimated additional 6 percent in

[47]Comparisons with Ukraine and Russia, here and below, are from Garibaldi and Brixiova (1997).

1997. Output per official worker remains, however, well below the levels of 1990–91. This suggests that the transition process still has some way to go before completion, and that further substantial restructuring on both the macroeconomic and enterprise levels, and significant layoffs, may be in the offing.

144. Trends in employment by sector shed additional light on the functioning of the labor market during the transition. The sectoral composition of output has changed dramatically, with the share of manufacturing in GDP cut from 37 percent to 19 percent since 1991, and the share of services increasing from 33 percent to 58 percent over the same period. With respect to employment, significant but smaller changes have taken place. The share of manufacturing employment in total employment fell from 26 to 18 percent during 1991-95, while the share of services rose from 46 percent to 56 percent (Table 17). In those industries declining most sharply, output per worker fell sharply as well, suggesting that labor remained in those sectors longer than optimal. In particular, output per worker in agriculture and manufacturing were about half of their 1990 levels in 1996, while in construction output per worker had declined to about one-third its 1990 level. Only in the service sector, in particular wholesale and retail trade, hotels and restaurants, and transportation and communications did labor productivity increase during the transition as a whole. In 1996, however, a number of sectors experienced increases in productivity, including manufacturing, energy and water, construction and most services, and this trend continued in 1997.

145. Significant gains in employment during the transition have been made in just three sectors—wholesale and retail trade (47 percent from 1990–96); financial intermediation (157 percent); and public administration and defense (209 percent). The last figure suggests that the public sector (including local governments) may have been operating as an "employer of last resort," cushioning the fall in employment elsewhere, and perhaps slowing the restructuring of the economy.[48] This points to the importance of a broad civil service reform, at all levels of the public sector.

D. Developments in Unemployment

146. Official unemployment in Latvia stands at just under 7 percent of the economically active population. The unemployment rate increased gradually from virtually zero prior to transition to 2.3 percent in 1992 to 7.7 percent in mid-1997, but has recently declined slightly. It is questionable, however, how relevant the official unemployment figure is for policymakers, since it includes only those who register with the State Employment Service (SES).[49] Jobseekers may fail to register for a number of reasons, including ineligibility for benefits, a low level of benefits relative to travel cost, and the stigma cost of having to register

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[48]Employment in education, health and social work was maintained at pre-transition levels, implying a significant increase in the share of total employment in these sectors.

[49]On the other hand, some of those registered as unemployed do work in the informal sector.

and make follow-up visits to the SES.[50] The official concept of unemployment can be broadened in a number of ways. These various measures paint a very different picture of the significance of unemployment as a problem, but overall point to a decline in unemployment during 1997.

147. Hidden unemployment, measured by the official estimate of full-time work equivalent of reduced work hours and unpaid leave, was particularly important in the early years of transition; in 1992, for example, it was significantly larger than official unemployment (Table 18). Including this hidden unemployment in a broader measure indicates that unemployment was fairly steady at around 7–7½ percent during 1993–96, increasing to 8.4 percent by mid-1997 before declining to 7.4 percent by end-year.

148. A still broader measure of unemployment, the number of nonworking job seekers, was estimated by the LMS at 18–19 percent during the period November 1995–November 1996; in the most recent survey, for June 1997, this rate has declined to below 16 percent.[51] This implies that well more than half of nonworking job seekers have failed to registered at the SES. The category of jobseekers includes individuals beyond retirement age who are nevertheless looking for work, and a large number of young people without jobs, but who have never been part of the labor force. This last group is particularly important; in fact, one-quarter of all jobseekers are below 24 years of age. The lack of employment for these individuals is an important social issue in Latvia, and has fostered increases in crime, alcoholism, and drug abuse.

149. Measures of unemployment can be expanded to include discouraged workers or underemployed individuals. If we add to jobseekers those individuals who are on involuntary leave or are discouraged jobseekers who have dropped out of the labor force, the resulting measure of unemployment during 1995–96 was approximately 22 percent, declining to 20 percent by mid-1997. Finally, there are a significant number of individuals who are involuntarily working part-time; including them in a broad measure of unemployed or underemployed brings the rate to over 28 percent for 1995–96, declining to 26.7 percent by June 1997.

150. While there are a number of possible measures of unemployment, it appears that even the substantial unemployment in Latvia is fairly low in comparison with CEE countries, where at end-1996, official unemployment ranged from 10 percent to 18 percent (except for the Czech Republic and Romania, where rates were lower) but considerably higher than in Russia or many other BRO countries. While there has been a substantial restructuring of the Latvian economy during the course of the transition, in particular on a macro level, relatively little restructuring within firms has yet taken place. Many firms still employ too many people,

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[50]Unemployment insurance has been reformed in part to deal with these problems (see below).

[51]This broader measure of the unemployment rate is consistent with the ILO measure of unemployment

productivity has yet to significantly rise, and many people continue to work in less productive jobs in the public sector. As the privatization process accelerates, new technologies are introduced, civil service reform proceeds, and job guarantees associated with privatized firms lapse, the unemployment rate could increase significantly, unless new private sector job creation accelerates.

151. It is useful to note that all privatization agreements in Latvia include employment guarantees, usually for two to three years, but sometimes for as long as five years. The guarantees are unique for each privatized enterprise, but are typically structured such that if the privatized company reduces employment below some agreed upon level, they must make a contribution of some amount per employee, half of which goes for training programs, and the other half for payment of unemployment insurance. These agreements have tended to reduce the short-term impact on unemployment of privatization and perhaps to slow somewhat the transition process. However, the impact of these agreements has probably not been great, since penalties for reducing the number of workers below agreed levels are fairly low; a figure cited as typical was LVL 310 per employee.

Unemployment insurance

152. An adequate system of UI can be a significant element of the social safety net and, if properly designed, can help move forward the process of economic restructuring. Without such a scheme in place, governments will be less willing to undertake reforms which might cause transitory unemployment and workers might be more willing to remain in less productive sectors, perhaps in part-time work. At the same time, overly generous benefit levels or duration, or eligibility requirements, may encourage unemployment beyond the optimal level and impose substantial fiscal costs.

153. The SES is charged with registering and providing services to the unemployed, providing information on vacancies and qualifications of registered unemployed, and arranging for temporary public sector jobs. It is organized into local offices, which report to a central office in Riga. There has been a steady decline in the share of officially unemployed who receive benefits, from 81 percent in 1992 to 34 percent in mid-1997 to 28 percent by end-1997. This decline initially reflected relatively stringent eligibility requirements and the low level of benefits, set at 90 percent of the minimum wage, which reduced incentives to register. *More recently, the sharp increase in number of long-term unemployed, whose benefits have* lapsed, has accelerated the decline in the share of unemployed receiving benefits. Those individuals no longer receiving UI are reliant on locally-administered socially assistance programs. This may be inadequate, especially in regions of high unemployment, which often cannot afford significant expenditures on such programs.

154. Unemployment insurance in Latvia was reformed in 1996, with the "Law on Compulsory Social Unemployment Insurance," and these changes came into effect on June 1, 1997. The primary goals of the reform were the strengthening the link between contributions and benefits, and the introduction of phased benefit reductions to increase the incentive for job

search.[52] In order to be eligible for benefits, an applicant must be actively searching for a job and must report to an employment office once per month. In addition, eligibility now requires that an individual has made social tax payments in 9 of the previous 12 months, as opposed to 6 of 12 months under the previous scheme. An individual may receive benefits for 9 months in any 12-month period, and 6 months for a training grant. Unemployed individuals with 1–5 years of work service receive 50 percent of their average salary of the last 6 months, with the replacement rate rising stepwise to 65 percent for those with 25 or more years of service. Full benefits are paid for the first 3 months, 80 percent for 3–6 months, 60 percent for 6–9 months. The benefit level may not, however, fall below 90 percent of the minimum wage. This compares to a flat benefit equal to 90 percent of the minimum wage under the previous system, with no reduction in benefits over time. It was expected that benefit levels would, on average, increase by around 75 percent in comparison with the old law; however early indications are that the average increase has been much smaller.

155. Unemployment benefits in Latvia are more generous than those in Russia and Ukraine, and broadly similar to those of CEE countries. In Russia, for example, unemployment benefits (UB) are less than 20 percent of average wage,[53] while in CEE they tend to be around 40 percent. This may help to explain the fact that official unemployment is substantially higher in Latvia than Russia or Ukraine and illustrates the point that lower unemployment is not necessarily desirable during transition. As indicated in Table 19, the basic parameters of the UB system in Latvia are quite similar to those in a number of CEE countries. One potentially important characteristic of the Latvian system, however, is the relatively low coverage rate (i.e. the percent of registered unemployed receiving benefits) which, in turn, reflects the high rate of long-term unemployment in Latvia.

From employment to unemployment and back

156. Additional light can be shed on the impact of the transition on the labor market by examining what has happened to those who have lost their public sector jobs. As indicated in Table 20, in each year 1993–97, the reduction in public sector employment (including state enterprises) has been far greater than the increase in official unemployment. In 1993, for example, some 17 percent of the labor force lost state employment. Of these lost jobs, more than half (9 percent of the labor force) were replaced by jobs in the private sector, and about 20 percent (3.4 percent of the labor force) generated official unemployment.[54] The remainder of the affected workers left the labor force, became employed in the informal sector, or are otherwise ineligible for official unemployment status. In 1996, 60 percent of jobs lost in the

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[52]See Fox, Palmer and McIsaac (1996).

[53]See Garibaldi and Brixiova (1997).

[54]These date tell us about jobs gained or lost, but not whether the same individuals that lost jobs in a given year found new ones.

public sector were replaced by private sector jobs, and in the third quarter of 1997, the number of new private sector jobs exceeded the number of jobs lost in the public sector.

157. While private sector job creation is taking place, those that do become unemployed tend to stay unemployed; this is a key finding for virtually all transition economies. In Latvia, the proportion of long-term unemployed[55] has been rising over time, from 12 percent of all registered unemployed in 1992 to 50 percent in June 1995 to 60.5 percent in September 1997. The share of persons who had been unemployed for more than one year continues to increase as well, and now accounts for about 60 percent of all long-term unemployed, or 37 percent of all unemployed, compared with 26 percent of all unemployed at end-1995. This reflects, in part, the inability of individuals to adapt their skills to those required in the post-transition economy, and the resulting segmentation of the labor market. The substantial and growing share of the unemployed who have been without jobs for more than a year are without unemployment benefits, which lapse after nine months.

Active labor market programs

158. Active labor market programs in Latvia have been limited in scope. In response to the rise in long-term unemployment, the public works program in Latvia was expanded in 1994. Some 21,000 unemployed individuals (compared with a total of 36,000 long-term unemployed) participated in pubic works programs, for an average of 2½ months, contributing to the maintenance of cities, villages, schools, hospitals, parks and roads, as well as providing assistance to ill pensioners and the disabled. In 1996, however, only some 10,000 unemployed individuals (compared with 50,000 long-term unemployed) took part in public works programs, although three times as many unemployed applied for such work. The government has added several new programs, in 1998, aimed at the long-term and youth unemployed. A temporary public works program provides jobs for some 1,100 people in social work and forestry, and another 3,000 jobs in public works, administered by the local governments. In addition, in-service training is provided for young people, including through apprenticeships with the chamber of crafts (the goal is to reach 2,500 individuals) and other employees (about 500 positions).

159. The Latvian government has a number of training programs for the unemployed.[56] However, these programs have met with only limited success; only about one-fourth of the unemployed find jobs after having completed training courses. The Latvian authorities hope to improve this performance by ensuring that training is better aimed at market requirements. However, this task may be particularly difficult in a transition economy, owing to the fact that the ongoing restructuring process likely makes it may be more difficult to predict which skills will be required by private enterprises in the future. In addition, unemployed individuals in Latvia often do not know what training programs are available, and transportation to SES

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[55]Defined as those unemployed for more than six months consecutively.

[56]See Latvia Ministry of Welfare (May 1997).

offices can be a problem in rural areas. The SES is undergoing an administrative reform aimed at addressing these issues. The Latvian government is also attempting to improve the effectiveness of the SES through the creation of a computer system to provide accurate and up-to-date information on the unemployed as well as available vacancies. In 1995, jobs were found for some 19,000 unemployed with the help of the SES. The authorities have also expressed a desire to improve the work procedures and professionalism of the staff of the SES.

Regional variations in unemployment

160. The situation in Latvia is characterized by large regional differences in unemployment rates. The closing of a number of large enterprises in "one company towns" as well as the decline in agriculture have led to high unemployment rates in rural areas, in particular in the Latgale region, in the eastern part of Latvia. In some districts, official unemployment is as high as 30 percent, while in Riga and Ventspils, by contrast, the unemployment rate is only around 3 percent. One particularly worrying point is that those regions with the highest unemployment rates have continued to see increases in unemployment. In the Rezekne district, for example, unemployment rose from 29.5 percent at the end of the first quarter of 1997 to 32 percent at the end of the second quarter. In Riga, on the other hand, unemployment declined over the same period from 3.7 percent to 3.4 percent. In addition, in many of those cities and districts with high unemployment, as many as three-fourths of the unemployed are long-term unemployed.

161. One question is why there has not been more movement of the population from high unemployment areas to low unemployment regions, such as Riga. There has been significant net emigration from Latvia as a whole since the beginning of the transition, of about 125,000 people, or some 5 percent of the population. Some of this may have been a response to worsening economic conditions. However, a large proportion of individuals emigrated to other BRO countries, as a large number of individuals returned to their countries of origin. The pattern of internal migration shows no evidence of migration from high unemployment to low unemployment regions; in fact, Riga appears to have experienced a net out-migration in recent years. The lack of labor mobility may well reflect a social norm developed during years of central planning, and might be expected to increase over the long term. Labor mobility is also constrained, however, by the poor available housing stock, and very limited turnover, in particular in Riga. This points to the importance of moving ahead with apartment privatization as well as the further development of the capital market to support mortgages and other credit for housing. Finally, the SES is currently unable to provide information regarding job opportunities, as their information system is still in an early stage of development.

E. Wage Developments

162. All transition economies have experienced substantial declines in real wages, at least initially, in line with the sharp contraction in output and, in many cases, extremely high inflation. This has also been the case in Latvia, where real wage decline has been more akin to

the experience of CEE countries than to the dramatic declines experienced, e.g., in Russia or Ukraine.[57]

163. Real gross wages in the public sector declined sharply during 1990–92, falling by 44 percent, but recovered about one-third of the initial fall by September 1997 (Table 21). Since 1993, the first year for which wage data for the national economy are available, real wage growth in the public sector and the economy as a whole have been nearly identical, at about 15 percent. These wage data likely overstate wage growth, however, especially in the most recent period, as the share of the social insurance contribution (social tax) paid by employees has increased from zero to 9 percentage points (out of 37 percent), with offsetting gross wage increases.[58] Adjusting for this factor implies minimal real net wage growth in the national economy of about 4 percent since 1993, and actually a decline since 1995 on the order of 7 percent.

164. It appears that, during the initial phase of transition, 1990–92, real (gross) wages declined more or less in line with productivity, measured by output per official worker, with both falling by 40 percent.[59] During the period 1993–95, however, real (gross) wage increases appear to have preceded gains in productivity; real wages nationwide rose by 11 percent while productivity increased by just 4 percent. It may be that these real wage increases limited employment gains. In 1996, by contrast, when productivity rose by nearly 5 percent, real wages declined. Most recently, in 1997, net-of-tax wages increased by 8 percent in U.S. dollar terms, slightly higher than estimated GDP growth.

165. There has been a consistent relationship over time in the relative wages of different sectors of the economy. Wages in the public sector have been higher, on average, than the private sector, owing to public enterprises wages, and the extent to which this is the case has broadly unchanged. The ratio of public sector to national wages has remained at about 1.1 since 1993, the first year for which data are available, while the ratio of wages in budgetary institutions to national wages has remained at about 0.88. These data may reflect

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[57]The longest time series on wages in Latvia is for gross public sector wages, for which information is available for 1990–97. These data have several shortcomings: (1) they do not cover the entire economy; (2) they are measured as wage payments divided by employees, and so are distorted by seasonality in wage payments (e.g. salary advances to teachers prior to summer vacation); and (3) they do not reflect the fact that the portion of social tax paid by employees has increased from zero to 9 percentage points since 1996, with an offsetting increase to the gross wage.

[58]This can be seen by the fact that the difference between gross and net wages has risen from 16 percent to 26 percent during 1994–97.

[59]Wage data are available for the public sector only prior to 1993. We assume that the ratio between national and public sector wages in 1992 was similar to 1993–97.

both the relatively large size of the public sector as well as its role in influencing wages throughout the economy via its own wage policy.

Minimum wage

166. The government does not directly intervene in wage determination, except to set the minimum wage. The minimum wage is determined by a consultative council of three members, one of which is a representative of the labor unions.[60] The minimum wage declined more sharply than other wages in the early years of transition, falling by almost half during 1992, but increased by 41 percent from 1993–97, and has remained fairly constant as a share of public sector or national wages, at around 30 percent since 1992. The minimum wage was increased by 10 percent, from LVL 38 to LVL 42 per month, on January 1, 1998. The minimum wage in Latvia is relatively generous compared with those of other BRO countries; in both Russia and Ukraine, for example, the minimum wage is less than 10 percent of the average wage, and there has been a tendency in many transition economies for the minimum wage to decline relative to the average wage in the economy over time.

167. One issue is whether the legal minimum wage is at a sufficiently high level to have an important impact on employment. Evidence of the impact of minimum wages on employment of low-skilled workers is mixed; several studies in developing countries (Mexico, India, Chile) see little impact, either because the minimum wage is set at or below market wage rates, or because the legal minimum wage is easily circumvented by employees, while other studies (e.g. Zimbabwe) indicate that significant effects do exist.[61] It should be noted, in this context, that in the November 1996 survey, only 6 percent of all public sector employees were earning less than LVL 40 per month.

F. Conclusions and Policy Implications

168. Official unemployment in Latvia, at below 7 percent, is moderate and declining. However, survey data indicate that actual unemployment is substantially higher. In addition, long-term unemployment is growing rapidly as a share of total unemployment, and large regional disparities in unemployment remain, with no indication of significant geographic labor mobility. Over the medium term, there may be a tendency toward higher unemployment, as privatization moves to completion and restructuring on both the macro and enterprise levels continues. Thus, it is important that Latvia pursue policies to address these issues. A reasonable approach would aim at supporting the market mechanisms that lead to restructuring, while providing an adequate and well-targeted safety net for those made worse off, at least temporarily, by the transition.

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[60]Unions are organized by industry, but currently only about 30 percent of all workers are union members.

[61]For a summary, see Freeman (1993)

169. With respect to supporting transition, it appears to be particularly important that Latvia take steps to enhance labor mobility by improving the housing stock, in particular in Riga. This could be accomplished by advancing its program of apartment privatization—currently about 20 percent of previously government-owned apartments are privatized nationwide, but less in Riga. Similarly, development of a mortgage market would contribute to increasing housing opportunities for those wishing to move for employment purposes. In addition, there appears to be a lack of information regarding job opportunities, which the SES is seeking to correct. Training programs can also be of value in speeding transition and reducing unemployment. However, the experience of Latvia in this area has been mixed, in particular in preparing individuals for employment in a rapidly changing economic environment. One possibility for improving the flexibility of training programs would be to support unemployed individuals' training in the private sector, e.g. through a system of vouchers.

170. The experience of Latvia to date also points up the importance of civil service reform. Evidence suggests that government, including at the national level, has played the role of employer of last resort, increasing its employment in response to job loss, in particular in the public enterprise sector. This may have slowed down the restructuring of the economy somewhat, and suggests that there is room for reductions in the size of the civil service. Limiting public expenditure would also allow a reduction in tax burdens, potentially stimulating employment. It would appear that one of the more important constraints to employment growth in Latvia is the high payroll tax rate, currently 37 percent. The authorities had initially planned to reduce this rate gradually over time, but have delayed their plan in order to accumulate a surplus to finance the costs of pension reform.

171. In part to address the problem of very high regional unemployment, the Latvian government has recently begun to introduce regional tax exemptions. This is likely to prove to be an inefficient and costly means of job creation. However, other means of encouraging development in high unemployment regions may be more desirable, including increased public investment to provide the needed economic infrastructure. But such policies should be seen as complementary to, rather than substitutes for, measures to enhance labor mobility.

172. Finally, the basis of a safety net for the unemployed is the system of unemployment insurance. The new system in Latvia is an important improvement over the previous one. However, a large and increasing share of the unemployed have already exhausted their benefits, and are reliant on local governments for income support. Temporary paid public sector employment can be part of a well-targeted safety net program, if wages are kept sufficiently low and administrative costs are reasonable.

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Table 14. Latvia: Summary of Labor Market Trends, 1990-97
(In thousands, except where indicated)

	1990	1991	1992	1993	1994	1995	1996	1997 1/
Population	2,670	2,662	2,632	2,586	2,547	2,516	2,501	2,464
Labor force participation	1,416	1,405	1,447	1,320	1,300	1,276	1,263	...
Participation rate	53.0	52.8	55.0	51.1	51.0	50.7	50.5	...
Employment	1,409	1,397	1,345	1,245	1,205	1,189	1,168	1,165
Percent in private sector	...	...	37.6	50.5	58.1	61.0	64.8	66.0
Registered unemployment	...	...	31.3	76.7	83.9	83.2	90.8	84.9
Unemployment rate	...	...	2.2	5.8	6.5	6.5	7.2	6.7
Long-term unemployed	...	...	3.7	25.3	36.1	37.5	49.5	52.7
As percent of total unemployed	...	...	11.8	33.0	43.0	45.1	54.5	62.0
Wages (lats per month):								
Gross monthly wage (public sector)	1.45	2.80	24.13	51.78	77.39	98.20	110.50	132.22
Net monthly wage (public sector)	...	...	...	...	64.56	80.21	86.96	97.52
Net monthly wage (economy-wide)	...	...	...	...	60.33	73.54	78.65	89.93
Real wage index:								
Public sector	165.88	120.67	92.85	100.00	109.98	111.93	106.37	114.93
National economy	...	...	...	100.00	111.99	111.54	104.60	115.06

Source: Central Statistics Bureau of Latvia.

1/ Most recent data available.

Table 15. Latvia: Labor Market Survey Results, 1995-97

	1995	1996	1997
	Nov.	Nov.	June
Economically active population			
(in thousands)	1,200	1,182	1,197
As percent of population 15-69 yrs.	68	67	68
Employed (in thousands)	973	965	1,007
Of which:			
On involuntary unpaid leave	4.3	3.6	2.6
Involuntary paid leave	0.4	0.4	0.9
Involunary part time work	73.8	77.7	79.5
Jobseekers (in thousands)	227	217	190
As percent of economically active	19	18	16
Economically inactive population			
(in thousands)	576	796	791
Of which:			
Discouraged	37	37	46
Memorandum items:			
Characteristics of jobseekers			
Percent under 24 years	23.6	28.3	24.6
Percent over 60 years	7.1	8.1	5.2
Percent male	55.7	54.4	53.2
Percent urban	81.3	83.7	86

Source: Central Statistics Bureau of Latvia, "Labour in Latvia: Labour Force Survey Data," various issues.

Table 16. Latvia: Output Per Worker by Sector, 1990-97
(In thousands of 1993 lats)

	1990	1991	1992	1993	1994	1995	1996	1997
Total	1,917.0	1,719.0	1,155.6	1,069.7	1,113.8	1,111.7	1,163.3	1,236.3
Agriculture	1,191.1	1,151.9	735.7	662.3	585.2	600.2	555.4	...
Fishing	291.7	282.8	245.2	170.3	163.4	236.4	259.0	...
Mining and quarrying	1,874.0	1,649.0	1,124.4	1,049.6	1,134.7	850.9	1,269.6	...
Manufacturing	2,364.8	2,487.9	1,415.1	1,142.9	1,184.0	1,222.4	1,263.9	...
Energy and water	13,048.4	16,137.0	7,858.1	6,110.1	5,613.5	5,703.2	6,113.0	...
Construction	3,384.6	2,103.3	1,255.6	831.2	1,011.4	1,039.4	1,207.0	...
Services	1,393.2	1,208.2	1,028.1	1,095.8	1,170.7	1,139.6	1,224.2	...
Wholesale and retail trade	...	...	687.1	734.8	810.8	766.5	756.1	...
Hotels and restaurants	...	...	445.5	448.5	531.6	663.7	780.4	...
Transport and communications	...	...	2,735.1	2,853.9	3,292.9	3,337.3	3,854.2	...
Financial intermediation	...	...	5,509.8	5,509.8	4,643.6	2,699.5	2,866.7	...
Real estate	...	...	730.8	826.0	722.1	761.0	794.6	...
Public administration and defense	...	...	928.6	928.6	876.0	906.8	788.9	...
Education	...	...	616.1	617.3	643.8	569.4	581.2	...
Health and social work	...	...	488.5	504.6	505.8	456.1	486.5	...
Other community, social and personal services	...	...	431.2	460.8	436.1	461.9	544.8	...

Sources: Central Statistics Bureau of Latvia; and Fund staff estimates.

Table 17. Latvia: Share of Employment by Industry, 1990-96
(In percent of total employment)

	1990	1991	1992	1993	1994	1995	1996
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture	16.5	16.9	19.5	18.9	18.6	18.0	17.8
Fishing	0.9	0.9	0.5	0.6	0.6	0.5	0.5
Mining and quarrying	0.3	0.3	0.2	0.2	0.2	0.3	0.3
Manufacturing	26.5	25.5	23.9	21.6	19.3	17.5	17.7
Energy and water	1.0	0.8	1.2	1.3	1.5	1.4	1.4
Construction	9.7	9.3	6.6	5.5	5.2	6.0	5.5
Services	45.2	46.4	48.1	51.9	54.6	56.4	56.8
Wholesale and retail trade	7.7	8.5	10.3	12.4	13.4	13.8	13.8
Hotels and restaurants	4.3	4.2	3.7	2.6	3.0	2.2	2.1
Transport and communications	7.5	7.7	7.8	8.7	8.8	8.8	8.8
Financial intermediation	0.5	0.5	0.7	0.8	1.0	1.7	1.5
Real estate	5.7	5.6	4.9	4.9	5.1	4.8	5.0
Public administration and defens	1.5	1.7	2.8	3.5	4.1	4.7	5.6
Education	7.2	6.7	7.5	7.6	7.6	8.8	8.9
Health and social work	4.8	4.7	5.2	6.4	6.1	6.2	6.1
Other community, social and personal services	5.9	6.7	5.3	5.1	5.4	5.3	5.0

Sources: Central Statistics Bureau of Latvia; and Fund staff estimates.

Table 18. Latvia: Alternative Measures of Unemployment and Underemployment, 1992-97

(in percent)

	1992	1993	1994	1995	1996	1997 1/
From SES data:						
Official unemployment	2.3	5.8	6.5	6.6	7.2	6.7
Official "broad" unemployment 2/	5.2	6.9	7.1	7.2	7.7	7.4
From labor survey data:						
Job seekers	...	...	...	18.9	18.4	15.9
Plus involuntary leave	...	...	...	19.3	18.7	16.2
Plus discouraged workers	...	...	...	22.4	21.8	20.0
Plus involuntary part-time workers	...	...	...	28.5	28.4	26.7

Sources: Central Statistics Bureau of Latvia;and Fund staff estimates.

1/ Most recent data.

2/ Includes full-time work equivalent of time reported lost from reduced hours and unpaid leave.

Table 19. Comparison of Unemployment Benefit Systems in Transition Economies 1/

	Maximum Duration In months	Minimum Benefit % of minimum wage	Maximum Benefit % of minimum wage	Gross Replacement Rate First 3 months	Gross Replacement Rate First year	Coverage 2/
Latvia	9	90	none	65	39	28
Bulgaria	12	90	140	60	60	33
Czech Republic	6	none	150	60	30	48
Hungary	12	70	150	58	51	40
Poland	12	none	none	45	45	55
Slovak Republic	6	none	150	60	30	27

Sources: Boeri and Edwards, "Labour-Market Reforms in Transition Economies," **Oxford Review of Economic Policies**, 13(2), 1997; and data provided by the Latvian authorities.

1/ For countries other than Latvia, figures are as of December 1995; for Latvia they are as of end-1997.
2/ Unemployment benefit recipients as percent of registered unemployed.

Table 20. Latvia: Employment and Unemployment Changes, 1992-97 1/

(In percent of labor force, except where noted)

	1993	1994	1995	1996	Sept. 1997
Change in employment	-7.57	-3.10	-1.26	-1.67	0.72
Change in state employment	-16.87	-8.61	-3.22	-4.21	-0.48
Change in private employment	9.31	5.51	1.97	2.54	1.20
Change in unemployment	3.44	0.56	-0.06	0.60	-0.53
Change unemployment as percent of change employment	-0.45	-0.18	0.04	-0.36	-0.75
Change unemploment as percent of change public employment	-0.20	-0.06	0.02	-0.14	1.12

Sources: Central Statistics Bureau of Latvia; and Fund staff estimates.

Table 21. Latvia: Wage Data, 1990-97

	1990	1991	1992	1993	1994	1995	1996	1997 1/
Average monthly wage in national economy								
Gross (in LVL)	...	...	...	47.23	71.87	89.35	98.73	122.34
Net (in LVL	...	...	...	...	60.33	73.54	78.65	89.93
Gross (in US$)	...	...	...	70.07	128.34	169.47	179.18	208.77
Net (in US$)	...	...	...	...	107.73	139.47	141.97	153.46
Average monthly wage in public sector								
Gross (in LVL)	1.45	2.80	24.13	51.78	77.39	98.20	110.50	144.47
Net (in LVL)	...	...	...	...	64.56	80.21	86.96	97.52
Gross (in US$)	...	...	30.00	76.82	138.20	186.23	199.56	227.66
Net (in US$)	...	...	...	...	115.29	152.12	158.46	166.42
Average monthly wage in budgetary organizations								
Gross (in LVL)	1.10	2.08	19.63	41.42	61.56	80.20	88.87	106.35
Average monthly wage in state enterprises								
Gross (in LVL)	1.55	2.45	26.15	57.28	90.98	111.76	129.30	158.23
Ratio of public to national wage								
Gross	...	...	...	1.10	1.08	1.10	1.12	1.09
Net	...	...	...	...	1.07	1.09	1.11	1.08
Ratio of public enterprise to national wage								
Gross	...	...	...	1.21	1.27	1.25	1.31	1.29
Ratio of budgetary organizations to national wage	...	...	...	0.88	0.86	0.90	0.90	0.87
Real wage index (1993=100)								
National	...	...	...	100.00	111.99	111.54	104.60	115.06
Public	165.88	120.67	92.85	100.00	109.98	111.93	106.37	114.93
Budgetary	152.94	128.00	97.68	100.00	105.66	113.26	106.26	114.34
State enterprises	158.82	111.78	88.68	100.00	113.18	113.67	111.45	121.47
Minimum wage	...	186.67	98.58	100.00	129.51	131.84	142.14	141.26
Minimum wage	...	1	8	15	22	28	36	38
As % of average national wage	...	...	...	31.8	30.6	31.3	36.0	31.1
As % of public sector wage	...	40.2	33.8	29.0	28.4	28.5	32.1	26.3

Sources: Central Statistical Bureau of Latvia; and Fund staff estimates.

1/ Most recent data.

VI. Latvia and European Union Accession

A. Introduction

173. In recent years, the relationship between the European Union (EU) and Latvia has deepened through a variety of agreements aimed at further developing economic and political relations and, ultimately, integration with the EU. The most important agreements to date have been the 1993 Agreement on Trade and Commercial and Economic Cooperation; the Free Trade Agreement, effective on January 1, 1995; and the Association, or Europe Agreement, signed in June 1995 and ratified in February 1998. By signing this Agreement, Latvia asserted its intention to become fully integrated with the EU and, in the fall of 1995, the country formally applied for EU membership.

174. The purpose of this Chapter is twofold: to portray the process facing Latvia in undertaking to integrate with Europe and become a member of the EU and to analyze the challenges and opportunities implied by Latvia's potential membership in the EU. Section II reviews the EU's general pre-accession strategy for the associated countries of central and eastern Europe and its implications for Latvia. A tentative timetable for EU accession is also discussed. The EU accession criteria and their implications for domestic economic, structural, social, and legal policies are examined, as well as the EU's specific support to ease the process of accession for the associated member countries; the section ends with a general discussion of accession strategies. Section III examines the opportunities provided by EU accession, including the beneficial impact on investment, trade, and growth from closer integration with western Europe; political considerations; domestic priorities concerning the implementation of required reforms; and the size and direction of the expected net cash flows between Latvia and the EU under different assumptions regarding EU's future agricultural and structural subsidy policies.

B. The European Union's General Pre-Accession Strategy for the Associated Countries of Central and Eastern Europe—the Case of Latvia

175. At the Copenhagen summit in 1993, it was decided that "the associated countries of central Europe that so desire shall become members of the European Union as soon as they are able to assume obligations of membership."[62] At the same time, the economic and political membership criteria were also defined. The following year, at the Essen summit in December 1994, it was confirmed that the countries of central Europe could become members in the EU, and the Union's policy was refocused toward these countries in light of their future accession. In particular, a "pre-accession strategy" was determined, outlining the means through which the Union will assist the associated countries in their integration process. This strategy, tailored to meet the needs of those countries with which Europe Agreements were concluded or would be concluded in the near future, encompassed: the Association Agreements, whereby

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[62] See Commission of European Communities (1994a, 1994b, 1995b, and 1996e).

the EU offers the associated countries the trade concessions and other benefits normally affiliated with full membership; the creation of a "structured dialogue," providing a framework through which the associated countries and member states can discuss issues of common concern; financial grants, policy advice, and training through the Phare Program; and a White Paper on "legislation harmonization." While last year's EU Luxembourg summit decided to only include five of the ten central and eastern European (CEE) applicant countries in the first wave of accession talks, preparatory talks will begin simultaneously with the other associated countries, including Latvia; through further domestic progress and regular reviews by the EU, the door to EU membership has been left open also for these countries. This section will review the pre-accession strategy and the implications for Latvia. A possible timetable will be discussed and the accession conditions for EU membership will be examined. In particular, Latvia's progress in terms of the EBRD transition indicators, the Maastricht macroeconomic convergence criteria, and according to the European Commission's *avis* will be discussed. The section ends with a more general discussion of EU enlargement strategies.

Pre-accession strategy: EU support

Association (Europe) agreements

176. The Association, or Europe, Agreements are the most wide-ranging agreements that the EU has ever entered into, covering political dialogue and economic integration as well as cultural and financial cooperation and they are concluded for unlimited periods (Table 22 provides a list of the bilateral Association Agreements signed between the EU and CEE countries and the submission of formal membership applications).[63] These agreements acquired greater political significance following the 1993 Copenhagen summit where EU membership of the associated countries was recognized as an objective shared by the EU.[64] A key element of the Europe Agreements is the series of bilateral meetings between the EU and each of the partner countries, concerning, inter alia, the implementation of the pre-accession strategy and intra-regional cooperation. The pre-accession strategy also introduces a number of measures to promote trade for the partner countries, and the Europe Agreements aim at gradually establishing free trade in industrial products over the transition period on an asymmetric basis: the EU, as the stronger economic partner, opens it markets more rapidly than the associated country.

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[63] As noted in Table 22, the Association Agreement of Slovenia, the last one to be signed, is still in the process of being ratified.

[64] Apart from the Association Agreements signed between the EU and the ten countries of central and eastern Europe in the 1990s, Association Agreements between the EU and Malta and Cyprus came into force already in 1971 and 1973, respectively; see Commission of the European Communities (1993a and 1993b).

177. The Europe Agreement signed between the EU and Latvia in June 1995 finally entered into force in February 1998. This agreement now fully supplants the previous trade and cooperation agreement while also providing for a political dialogue between the EU and Latvia and includes provisions on matters such as the establishment of firms, movement of workers and capital, supply of services, economic, cultural, and financial cooperation, and cooperation on prevention of illegal activities.

178. Latvia enjoys a transitional period, ending December 31, 1999, in the areas of trade liberalization and competition.[65] It has been agreed to gradually establish a free trade area with the EU over a transitional period starting on January 1, 1995, and lasting a maximum of four years. The governing principles are those of the Association Agreement as well as those of the World Trade Organization (WTO) and the "New" General Agreements of Tariffs and Trade (GATT) of 1994. Remaining exports tariffs are to be abolished by the end of 1998 at the latest. All quantitative restrictions on imports and exports vis-à-vis the EU were abolished on January 1, 1995, and the EU and Latvia have both declared their readiness to reduce custom duties more rapidly if the economic situation so permits.

Structured dialogue

179. At the Copenhagen summit, the EU agreed on a multilateral framework of regular joint meetings at ministerial level between the Union and the associated countries. The structured dialogue provides a framework for the discussion of issues of common concern, including the Common Foreign and Security Policy and justice and interior issues, and familiarizes prospective member countries with the EU's decision-making process and institutional setup. Since 1995, government leaders and EU ministers have been meeting their counterparts from the associated countries, including Latvia, at regular intervals. Twice a year, heads of state and governments have met during the European Council; foreign affairs ministers and ministers responsible for justice and interior affairs also convened twice a year. Latvia, which has been particularly active in the political dialogue, in March 1997 proposed the development of an individualized political dialogue.

Phare program

180. The Phare Program, initially developed as an immediate response to the structural challenges facing CEE countries, has become one of the cornerstones of the pre-accession strategy.[66] The program provides grants as well as policy advice and training to support its partner countries through the process of economic transformation and strengthening of democracy. The program has been implemented in cooperation with other international

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[65]See Pautola (1996).

[66]PHARE, which now encompasses all the CEE associated member countries, is an acronym for "Poland and Hungary: Aid for Restructuring of Economies."

institutions to ensure consistency in policy and sector strategy and to avoid duplication of efforts. The Phare budget is determined by the European Parliament and the Council of the EU and in the first six years of operation (1990-95), a total of ECU 5.4 billion were made available to 11 partner countries.[67] [68]

181. Latvia has been part of the Phare Program since 1992 and has received assistance through both national and multi-country programs. During the 1992-97 period, the Phare program allocated ECU 162 million to Latvia.[69] Phare assistance to Latvia has focused on the provision of know-how, in particular in the areas of public administration, privatization, the development of small and medium-sized firms, and the improvement of the banking, agriculture, telecommunications, energy, transport, health, and higher education sectors. In 1995, a Multi-Annual Indicative Program (MIP) covering the 1996-99 period was signed for Latvia. The MIPs are more concentrated in character and focus on pre-accession preparations (including the implementation of the Free Trade and Europe Agreements and the adoption of the internal market's *acquis communautaire*); medium-term restructuring (post-stabilization economic development); infrastructure investment; and regional cooperation. In particular, the Latvian MIP focuses on private sector development, institutional integration, human resources, social sector reform, and infrastructure development.

White Paper on approximation of laws

182. Within the framework of the Europe Agreements, the associated countries have begun harmonizing their legislative frameworks to move toward the economic freedoms which constitute the basis of the EU's internal market. Given the magnitude and complexity of this task, the European Council endorsed a White Paper in Cannes in June 1995 to help the countries prepare as rapidly and efficiently as possible.[70] The White Paper sets out the body of essential internal market legislation divided into 23 sectors. These sectors cover, inter alia, the free movement of capital and persons, competition policy, social policy, agriculture, transportation, the environment, telecommunications, direct and indirect taxation, public procurement, financial services, energy, and consumer protection.

183. As a response to the White Paper and as part of the general strategy for the pre-accession phase, the Latvian government in December 1996 adopted a National Program for

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[67]In addition to the ten CEE applicant countries, the Phare Program also includes Albania.

[68]See the Commission of the European Communities (1996c and 1996d).

[69]In 1991, funds were channeled through the Tacis ("Technical Assistance to the Commonwealth of Independent States") program, designed to promote the development of the newly independent states of the former Soviet Union.

[70]See Commission of the European Communities (1995a).

EU Integration, including timetables and responsibilities for each legislative field. The program was subsequently approved in the parliament's committee for European Affairs. The legislative program has so far mainly focussed on the implementation of the single market (Stage I measures); until now, legislation harmonization has been achieved in the areas of company law, customs legislation, free movement of capital, indirect taxation, and procurement procedures. The scope will gradually be widened to also cover transportation, the environment, consumer protection and labor-market issues and the National Program will be updated every six months to reflect recent progress and allow for clear priorities to be set.

Timetable

184. One purpose of the Intergovernmental Conference (IGC), a conference of representatives of the governments of the EU member states which got underway in March of 1996, was to decide on the eastern enlargement of the EU. The IGC was concluded at the June 1997 Amsterdam summit, subsequent to which the European Commission presented a package known as 'Agenda 2000,' comprising four key sets of documents on enlargement setting out: (1) the Commission's view on individual countries' applications; (2) an evaluation of the impact of enlargement on EU policies, notably on the Common Agricultural Policy (CAP) and the regional funds; (3) a draft budget to run from 2000 taking into account the prospect of enlargement; and (4) a composite paper bringing together the Commission's overall analysis of the applicant's readiness for membership and the likely impact on the EU. In particular, the Commission recommended that the CEE associated member countries to be included in the first wave of membership negotiations should be, in alphabetical order, the Czech Republic, Estonia, Hungary, Poland, and Slovenia.[71]

185. The final decision regarding the timetable of the eastern enlargement was taken at the EU Luxembourg summit in December 1997, indicating that while full accession talks, i.e., bilateral negotiations at the government level, will be initiated in April 1998 with the six countries suggested by the European Commission, preparatory talks will also begin at the same time with the other central and east European applicant countries, i.e., Bulgaria, Latvia, Lithuania, Romania, and Slovakia. The enlargement process will officially begin on March 30, 1998, with a meeting of foreign ministers from the 15 EU member nations and from the eleven applicant countries. All eleven countries will be offered "pre-accession partnerships," including financial aid and annual reviews to determine whether new countries should join the negotiations. The six "first wave" countries will also be invited to an intergovernmental conference, with the eventual aim of signing accession agreement; actual EU membership for the first associated member countries is, however, not expected to take place until 2002 at the earliest, and most likely not until 2004-05.[72]

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[71]It was also recommended that membership negotiations should be initiated with Cyprus.

[72]See, for example, Backé (1997) for a discussion of an eastern EU enlargement.

186. The timing of EU accession for the associated countries of central and eastern Europe will in the end depend on both the EU's willingness and capacity to absorb new members and the status of the economic, political, social, and legal reform processes in the countries. While the White Paper is encouraging in its detailed step-by-step advice, it also highlights the enormous amount of work yet to be completed. Among other things, domestic laws need to be approximated to some 80,000 pages of EU legislation and the EU legal framework needs to be translated into each country's own language. For example, some 400 directives reportedly must be introduced before the end of 1999 in order to align Latvian legislation with the EU standards. However, the White Paper should not be seen as an entry test, but rather as a tool of orientation: it has been argued that if one would take the formalism of the White Paper or the meticulousness of the EU questionnaire as a basis, no country would meet every single condition (Csaba, 1996).

Admission criteria

The Copenhagen summit

187. At the Copenhagen summit, the European Council listed the economic and political conditions that the associated countries in central and eastern Europe would have to satisfy in order to become members of the EU. These criteria were: (i) stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for the protection of minorities; (ii) the existence of a functioning market economy and the capacity to cope with competitive pressures and market forces within the EU; and (iii) the ability to take on the obligations of membership, including adherence to the aims of political, economic, and monetary union. A fourth precondition was subsequently added, stating that the EU itself should show that it had the capacity to handle new members without slowing the momentum of the European integration process.

188. The criteria set by the European Council were very general and failed to provide any concrete definitions or guidelines on what exactly would be required of the associated countries. Therefore, during the Copenhagen summit, France proposed a more detailed description of the admission criteria, known as the "French list", including: GDP per capita; the extent of privatization; the ability to deliver a quantifiable level of social protection; the control of public debt and inflation; monetary and fiscal policies, including convertibility and stability of the local currency and policies on capital movements; the proportion of external trade in GDP; the impact of the country's economy on that of the Union; the capacity of national administrations to implement domestic and EU laws; and the existence of a modern fiscal system.

189. With Latvia still in transition, and with its economic, political, and social systems still in the process of formation, the terms of admission into the EU and the problem of defining the admission criteria have become contentious issues. This section will review Latvia's progress in the last years toward meeting the EU accession criteria, both in terms of the EBRD's "transition" indicators and, although somewhat prematurely, the Maastricht EMU

convergence criteria. The last part of this section will summarize the European Commission's *avis* on Latvia, presented in July 1997, where the Commission suggested not to include Latvia in the first round of membership negotiations.

Latvia in transition: the EBRD indicators

190. Since 1994, the EBRD publishes a number of indicators of progress in market-oriented reform for a total of 25 countries, including 10 countries in central and eastern Europe, the Baltics, Russia, and the other countries of the former Soviet Union.[73] These "transition" indicators cover the areas of enterprises, markets and trade, financial institutions, and legal reform. While they do not capture all dimensions of the transition process, they represent important common features of well-functioning market economies and of effective transition and provide an overview of the relative stages of transition of the different countries. In Table 23, the 1994–97 EBRD transition indicators are summarized for Latvia; the 1997 indicators are also provided for the other CEE associated EU member countries. The numbers assigned to each indicator represent the general level of transition achieved in a certain area, as assessed by the EBRD.

191. According to EBRD estimates, the share of the private sector in Latvia ranged between 60 percent and 65 percent of GDP by mid-1997 (Table 23).[74] Small-scale privatization is now almost complete, while progress has been somewhat slower in the privatization of large-scale enterprises; also, sales of land and real estate have yet to really take off. Further improvements in corporate management and in financial discipline at the enterprise level are still needed, even though the financial discipline of enterprises has become stricter. Also, a culture of management accountability before the shareholders, in particular minority shareholders and external investors, still needs to be developed.

192. Latvia is further advanced in price, trade and foreign exchange liberalization. Few formal price controls remain: domestic agricultural prices have been liberalized, rent subsidies are being cut, and energy tariffs have moved to cost-recovery levels. Latvia's trade regime is very liberal for industrial goods while tariffs on agricultural products remain high despite reductions in the last years; also, the import licensing process has been simplified. The few remaining export and specific tariffs still need to be eliminated and converted to ad valorem tariffs, respectively. Latvia offers full current account and capital account convertibility. However, while the country has a liberal trade regime, competition policy will have to be further improved. A new Competition Act was adopted by the parliament in July 1997, and an independent Competition Board will be established to oversee its implementation.

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[73]See EBRD (1997).

[74]On average, more than 75 percent of enterprises in advanced industrial countries are private.

193. Interest rates and credit allocation have been liberalized. Banking supervision was tightened considerably following the 1995 banking crisis, progress has been made in the establishment of bank solvency requirements, and a draft deposit insurance law has been submitted to Parliament. More progress is still needed in the areas of private sector lending, including further possibilities for collateralized lending. Also, Latvia still does not provide the full range of competitive banking services available elsewhere in Europe. The regulation and supervision of non-bank financial market institutions are still being developed and the legal and regulatory framework to promote issuance and trading of securities of private enterprises needs to be further developed. Meanwhile, the development of nonbank financial institutions, in particular insurance companies and local investment funds, recently received an impetus by the adoption of laws on compulsory vehicle insurance and private pension funds.

194. Significant progress was made in 1996 to expand and enhance the effectiveness of the legal framework on investment. Legal rules do not impose major obstacles to the creation of investment opportunities or exports of profits and the law is reasonably clear in this regard, with legal advice readily available if needed. However, the judicial and administrative support of the laws is still incomplete and further efforts should also be directed at expediting the process of hearing cases and executing final judgements.

195. Latvia generally performs well relative to the other CEE applicant countries, with slightly less progress in large-scale privatization, development of securities markets and non-bank financial institutions, and reform of commercial law while somewhat further along, together with Estonia, in the area of competition policy. However, in comparison with the five "first round" associated countries with which the EU intends to initiate the membership negotiations, Latvia lags behind in most areas; only in the areas of price liberalization and competition policy does Latvia demonstrate the same level of progress as these countries.

The Maastricht criteria: the status of Latvia

196. The first step toward the EU for the associated member countries of central and eastern Europe is to meet the economic, social, and legal requirements for membership, including the existence of a functioning market economy capable of coping with competitive pressures and market forces within the Union as well as the ability to take on the obligations of membership including the adherence to the aims of EMU.[75] In case an associated member country does not meet the Maastricht criteria for EMU participation by the time of EU membership, it will adopt the general goals and provisions of the third stage of EMU as

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[75]Countries also need to decide whether or not to accede to the European Social Charter, a requirement in order to enter the Council of Europe; in May 1997, Latvia signed the Social Charter and its first two protocols.

member state with a derogation.[76] This derogation will last until the member state meets the convergence criteria, at which point, according to the EU interpretation, it is obliged to participate in the third stage of EMU encompassing the (irrevocable) fixing of parities between the currencies of the qualifying EU member states.[77]

197. Latvia's performance vis-à-vis the Maastricht criteria is mixed (Table 24). Despite the rapid decline in inflation in the last two years, Latvia's inflation rate is still significantly above the EU average, not to say above the inflation rates of the "best-performing" EU member states; meanwhile, Latvia's rate of inflation was comparable with that of the five "first round" countries in 1996 while well below their average inflation rate in 1997.[78] Also, while above the EU average, Latvia's short-term interest rates were below the average short-term rates of the five "first round" countries in 1996. In the case of long-term interest rates, the associated member countries of central and eastern Europe are still in the process of transition to market economies, with underdeveloped long-term capital markets. Ten-year bonds, the maturity considered for the convergence criterion, still do not exist in these countries; the longest maturity in Latvia is currently the two-year treasury note.[79] The development of the financial markets will be a prerequisite for assessing the interest rate performance of the associated member countries; the absence of developed financial markets in these economies can be viewed as a symptom of the prematurity of EMU participation at this stage.

198. In contrast to the situation regarding the financial variables, Latvia, as well as the five "first round" applicant countries, would have little problem qualifying today for the two fiscal convergence criteria. As a result of Latvia's prudent fiscal policy and the fact that all debt of the former Soviet Union was assigned to Russia by the time of the breakup, the ratios of the public debt and the fiscal deficit to GDP are well below the stipulated levels (Table 24).[80] Finally, as to exchange rate stability, the last Maastricht EMU criterion, Latvia's experience with a pegged exchange rate regime during its transition from a planned to a market economy

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[76]See Ilzkovitz (1996) regarding the challenges facing the associated member countries ahead of EMU participation.

[77]The derogation of a member state can be abrogated according to a procedure similar to the one employed when deciding which member countries will participate in the first round of EMU. This procedure will take place at least every two years, or at the request of the member country with a derogation.

[78]In 1997, the five "first round" countries had an average rate of inflation of 12 percent.

[79]A three-year treasury note may be issued shortly.

[80]In fact, a gradual increase in the public debt as a result of the undertaking of sound investment projects would not necessarily be an unwelcome development.

bodes well for its ability to participate in a fixed exchange-rate regime centered around the forthcoming euro.[81] [82]

199. Finally, a couple of caveats: first, it should be noted that the Maastricht convergence criteria for EMU participation have to be fulfilled not only by the time a country enters into the third stage but also subsequently on a permanent basis. Therefore, the ability to correct macroeconomic distortions by policies compatible with market economies and EU rules will be as important as the magnitude of the distortions per se.[83] Second, when deciding at which stage to adopt the EMU convergence criteria, the associated member countries should take into account the notion that a premature adoption of excessively tight convergence fiscal criteria may slow down the successful completion of necessary structural reforms.

200. While the level and rate of growth of GDP do not constitute formal EU accession or EMU convergence criteria, they capture the general state of development and potential future progress, respectively. Even though Latvia still clearly lags behind the EU as to per capita income (Table 24), the current level of income should be less of a concern ahead of membership negotiations than the country's ability to create wealth fast enough to bring it up to EU standards within some reasonable time period. To this end, strong export and investment growth and, in particular, continued strong FDI inflows will be pertinent - in 1997, FDI amounted to an estimated $415 million, or some 7.2 percent of GDP, with the FDI stock close to $520 per capita. After more moderate GDP growth rates in 1994 and 1995, economic growth started to pick up in 1996 and, in particular, in 1997.[84] However, in order to catch up with the EU average standard of living within a reasonable time period, Latvia will have to do even better and according to some estimates, the country will have to grow by some 8 percent in real terms in order to reach the per capita income level of even the least wealthy EU member states by the year 2010.[85]

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[81]According to the EC Treaty, a two-year formal membership participation in the ERM, without initiating a devaluation, is required to fulfill the exchange rate stability criterion; however, this strict interpretation is not shared by all current EU member states.

[82]The behavior of the euro is likely to be highly dominated by the current behavior of the deutsche mark, one of the five composite currencies constituting the SDR and the anchor of the Latvian fixed exchange-rate regime.

[83]In this context, it is worth noting the Bank of Latvia's current quite limited ability to conduct open market operations.

[84]Due to the banking crisis, Latvia did not grow in real terms in 1995.

[85]See Federation of Swedish Industries (1996). Estimates for more advanced transition countries such as Slovenia and the Czech Republic suggest that they would reach some 75-80

(continued...)

The European Commission's avis on Latvia

201. In July 1997, the European Commission presented its *avis*, or opinion, on the membership applications of the associated countries of central and eastern Europe. The *avis* analyzes the status of the applicant countries vis-à-vis the aforementioned membership accession criteria, listing progress achieved as well as areas where further efforts still are needed. In addition to the individual opinions, the Commission also presented separately, within the framework of the "Agenda 2000," a general assessment of the accession requests, its recommendations concerning a strategy for a successful enlargement of the Union, and an evaluation of the impact of enlargement on the Union's policies.

202. In its *avis* on Latvia, the Commission noted that in the case of the political criteria, more efforts still are needed in the workings of the judicial apparatus in order to reduce the time taken to judge cases and make the enforcement of decisions taken more efficient.[86] Also, efforts to intensify the fight against corruption should be sustained and the naturalization process of noncitizens needs to be accelerated; furthermore, efforts to ensure general equality of treatment for noncitizens and minorities should be pursued. Regarding the economic criteria, the *avis* asserted that while Latvia has made considerable progress toward the creation of a market economy, the country would still face "serious difficulties" in coping with the competitive pressures and market forces within the Union in the medium term. Not surprisingly, significant progress in establishing the legislative framework was not seen as being matched with similar progress in effective implementation. Also, all the necessary regulatory bodies are either not yet in place or not working properly, and the privatization process was considered incomplete, with the remaining state-owned companies generally in poor financial condition. Industrial and enterprise restructuring are still needed, the banking sector was deemed underdeveloped, and the agricultural sector needs to be modernized.

203. The third accession criterion refers to the ability to assume the obligations of membership, i.e., the legal and institutional framework known as the *acquis communautaire*. With the development of the Union, the *acquis* has expanded significantly over the years, and now presents a greater challenge upon accession compared with previous enlargements. In fact, as noted by the EU's *avis*, Latvia's ability to implement the *acquis* will be central to its capacity to function successfully within the Union. The areas covered in the *acquis* include the "four freedoms" and competition policy; "innovation"; economic and fiscal affairs; sectoral policies; economic and social cohesion; quality of life and environment; justice and home affairs; and external policies. The EU *avis* reviewed Latvia's progress in each of these fields,

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[85](...continued)
percent of the EU average purchasing power by 2010 if they grew 3 percent faster each year, in real terms, in the 15 preceding years (see International Policy Council, 1997).

[86]See Commission of the European Communities (1997b).

listing areas where efforts are still needed. Also, Latvia's ability in the fiscal sphere, both as to budgetary management and control systems for public expenditure, was assessed. Overall, the *avis* concluded that Latvia has made some progress in implementing the *acquis*, in particular relating to the single market, and that with "considerable" further effort, it should be able to participate fully in the single market in the medium term. However, special efforts, including investment, were seen as needed to apply the *acquis* fully in sectors such as environment and agriculture; also, a strengthening of the administrative structure was considered indispensable in order for Latvia to apply and enforce the *acquis* effectively.

Accession strategies

204. The expansion of the EU to 25 or more member states raises questions regarding the way the European Union/Community has traditionally managed the enlargement process. The "tension" between the EU's desire to widen, taking in new members, and its desire to deepen, strengthening the decision-making competence and scope of EU institutions, is likely to increase in the future. Therefore, the "traditional" integration model may no longer be appropriate. Table 25, which presents the change in the EU's population and GDP from the previous four rounds of enlargements as well as the prospective changes resulting from the current enlargement process, illustrates the greater challenge now involved. The ten CEE applicant countries would add some 29 percent to the population of the EU while increasing the EU's total GDP by only 3 percent. The 1973 and 1995 enlargements incorporated countries whose economic importance corresponded to their demographic size, and whose level of development were equivalent to that of the EU. This was not the case in the 1981 and 1986 enlargements, leading, inter alia, to the development of social and economic cohesion policies in connection with the accession of Spain and Portugal. With the accession of the CEE countries, the development differences are significantly greater, most likely resulting in a budgetary strain of additional cohesion funds.

Classical community method[87]

205. The "classical" Community method of enlargement is based on a number of more or less explicit assumptions about the rights and obligations of the existing members as well as of the applicant states. One of these assumptions is that the applicant countries accept the *acquis communautaire* in full, with no possibility of permanent opt-outs. A second principle is that formal accession negotiations focus solely on the practicalities of the applicants taking on the *acquis*, with the Community managing this process by the use of time-limited transitional periods. A third principle is that problems that may be created by the economic diversity of an enlarged Community are addressed by the creation of new policy instruments added on to the existing ones, rather than by fundamental reform of the original, inadequate instruments. Fourth, new members are integrated into the Community's institutional structure on the basis of limited incremental adaptation, facilitated by the promise of a more fundamental review

[87] This section draws heavily on Preston (1995).

after the enlargement. Finally, the Community prefers to negotiate with groups of states with close ties to each other.

206. The "classical" method established, at the outset of negotiations, the key outcomes: the integration of new members into a club with an existing and ever-expanding rule book. The major responsibility for adjustment was placed on the applicant states, providing them with a strong incentive to expedite the negotiations. While quite successful in managing the enlargement of the Community/Union from six to 15 members, the method has also had some serious weaknesses, which are likely to become more evident in the future.

Obstacles for further enlargements

207. Substantial obstacles remain before the associated member countries will be able to accede to the EU. One issue which may lead to difficulties in the future is the notion that the bulk of adjustment costs should be borne by the applicants.[88] Turning to the assumptions underlying the traditional integration method, the first principle, that the *acquis* should be accepted by the applicants with no permanent opt-outs, was restated for the current associated member countries of central and eastern Europe at the Copenhagen summit. However, these countries are seeking to join a Union substantially more integrated than ever before, following the completion of the single market and the Maastricht commitments to EMU, from a significantly lower economic base than was the case in previous enlargements. A far-ranging review of the structure of the EU budget and receipts, in particular the CAP and the Structural Funds, is unavoidable as the budgetary burdens given the current rules would be formidable. Also, decisions will need to be made regarding how far the EU expects the associated countries to accept the *acquis* in areas such as environment and social policy, where full implementation could prolong the accession process indefinitely.

208. The other three underlying assumptions are also under question. The third component of the classical method, that problems created by diversity are addressed by adding on new policy instruments to the existing ones, is likely to be severely tested. An eastern enlargement based on the current budget criteria would imply a decrease in expenditure to and an increase in revenues raised from present EU members, with current poorer beneficiaries disproportionally affected. Furthermore, the fourth principle based on limited institutional adaption also seem untenable in the case of the current eastern enlargement. While no decision was made at the 1997 Amsterdam summit, a revision of the EU's voting procedures is expected ahead of accession of the current applicants, the inclusion of which would increase the already marked bias towards small states affecting voting behavior in the Council of

[88]This expectation already led to problems in earlier enlargements, most notably in the case of the United Kingdom and Spain.

Ministers using the qualified majority voting system.[89] Finally, the fifth proposition, that the EU prefers to negotiate with a group of closely linked countries, also presents the Union with some difficult choices and may have to be abandoned altogether; in 1994, the EU itself reportedly declared that the Austrian-Nordic enlargement was the last collective entry and that a case-by-case approach would be employed in the future (Csaba, 1996).[90]

209. In addition to the challenges referring to the traditional integration method, other issues remain which will tend to make this wave of enlargement very different, and probably more problematic, than previous rounds. In particular, while the current EU members have a long tradition of good experiences of a series of national solutions, the applicant countries have fresh experiences of a supranational system within which each country had only limited powers; therefore, they all tend to be strong supporters of intergovernmental cooperation. In fact, while western Europe is reconsidering the role and global significance of nation states, the candidate countries are just in the process of creating nation states.[91]

C. EU Accession—Challenges and Opportunities

210. The admittance of the ten CEE countries to the EU entail both challenges and opportunities for the applicant countries and for the EU and its member countries, referring to issues ranging from the impact on investment, trade, and growth from closer integration between western and eastern Europe and the size and direction of expected net transfers between the applicant countries and the EU, to domestic concerns in applicant countries regarding spending scarce resources on implementing the *acquis communautaire* and political considerations. The purpose of this section is to briefly analyze the challenges and opportunities implied by the EU's eastern enlargement in general, and by Latvia's potential membership in the EU in particular.

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[89]While unanimous decisions are required on issues of great importance, such as the adoption of the EU fundamental law, enlargement, or fiscal questions, many other issues are decided with a "qualified majority": each country is assigned a certain number of votes, of which only 71 percent is needed for the winning coalition.

[90]While the EU has stated a preference for dealing with the Baltics as a single entity, the Baltic countries have been insisting on the importance of each country being dealt with on an *à la tête du client* basis, according to their own merits. In particular, during 1996 and the first half of 1997, Estonia "successfully" argued that the economic achievement of a country, and not its geopolitical aspects, must take priority in the admission of new members into the EU.

[91]See the Center for Finnish Business and Policy Studies (1997).

Economic costs and benefits

211. There are four parts to the calculation of the economic costs and benefits of admitting the ten CEE countries to the EU: the cost and benefits in the east, and the costs and benefits in the west. To date, almost all efforts have been directed to estimating the costs to the EU budget of an eastern enlargement, often with quite inconclusive results reflecting in part the uncertainty of the EU's future agricultural and structural subsidy policies. In a recent comprehensive study, Baldwin et al. (1997)[92] make an attempt at a "sober evaluation" of the literature, finding that the empirical results available so far in fact support a relatively narrow cost of estimates for the budget cost of enlargement. Moreover, the authors find that this cost is quite low compared to earlier results. In addition, Baldwin et al. also make an attempt to assess the economic benefits to the east and west. The final part of the calculus, the cost to the east, at this stage seems to defy calculation. These costs would involve estimates of the potentially slower growth and higher unemployment stemming from requiring the applicant countries to adopt the EU's body of legislation and case law—the acquis—which, after all, was designed for rich democratic societies with extensive social security systems and therefore was not to be appropriate for the poorer, but rapidly growing, eastern neighbors.

212. The authors divide the impact of trade liberalization into allocation and accumulation effects. The former refer to integration-induced changes in economic efficiency through resource and expenditure reallocation while the latter highlights the channels through which trade arrangements can alter the level of national resources, in particular capital stocks, rather than merely reallocate the existing stock of resources. Baldwin et al. estimate the long-run economic benefits and costs of an eastern enlargement under two scenarios, assuming: (i) that membership for the CEE applicant countries would only entail single market access and a common external tariff; and (ii) that membership also promotes additional investment in the applicant countries resulting from a substantial lowering of their country risk premia. Under both scenarios, the incumbent "EU15", i.e., the current EU member countries, are projected to gain about ECU 10 billion in real terms, with Germany accounting for about one third of the total gain, and France and the United Kingdom accounting for another third.[93]

213. The estimations of the budgetary costs to the EU are based in part on a survey of the existing literature on likely CAP and cohesion receipts, combined with an estimate of the applicant countries' contributions to the EU budget, yielding a consensus estimate of a net

[92]See Baldwin, François, and Portes (1997): *The Costs and Benefits of Eastern Enlargement*.

[93]Together with Italy, the four largest EU members would receive some 75 percent of the gains from an eastern enlargement. Only Portugal, one of the poorest current EU member countries, would lose in real terms.

cost to the EU budget of ECU 23 billion for a "Visegrad" enlargement in 2000.[94] Estimates are also obtained based on the notion that members' receipts are related to their voting power in the Council of Ministers while per capita national contributions are related to per capita income, providing an estimate of the EU budget cost estimate of ECU 10–18 billion.

214. In the case of the applicant countries, the authors conclude, not surprisingly, that they would benefit "enormously" from EU membership. Conservative estimates suggest an increase in real income for the "CEEC7"[95] of some ECU 2.5 billion (an increase of 1.5 percent), while less conservative results, which assume that EU membership will have an important impact on the countries' risk premia, suggest an increase of ECU 30 billion (18.8 percent increase). Including agricultural and structural funds transfers raises the long-run estimates to about ECU 23 billion and ECU 50 billion, respectively. However, these figures do not include current progress in these countries driven by the prospect of an early eastern enlargement: given the need to meet the Copenhagen Summit membership criteria and adopt the *acquis communautaire*, CEE governments have been better able to resist pressures from special interest groups and calls for irresponsible policies. In particular, Havrylyshyn (1997) and Hoekman and Djankov (1996) point to the credibility gains to applicant countries arising from anchoring economic reforms within the framework of an economic union. Enhanced credibility of present and future stabilization and structural policies resulting from EU membership may stimulate growth through increased investments, in particular foreign investment, and greater adjustment efforts. Also, through increased harmonization of regulatory regimes and administrative requirements, trade, and therefore growth, may be enhanced.

215. Other recent studies have also attempted to estimate the economic costs and benefits involved in an eastern enlargement of the EU. According to the International Policy Council (IPC) (1997), a major problem will be the budgetary strain of additional cohesion funds resulting from the accession of the ten CEE applicant countries. If the average per capita assistance which the EU now pays to its less developed members (ECU 184 per person and year to Greece, Ireland, Portugal, and Spain) would be extended to the ten applicant countries, the cost would amount to ECU 20 billion. Instead, if future transfers were based on the current transfers to the poorest member country only (ECU 240 per person and year to Greece), the cost would amount to ECU 25 billion. Such estimates suggest that this attempt at cohesion could only be undertaken following a reform of the structural fund mechanisms, in particular given the current unwillingness among EU members to increase their contributions to the EU budget. In addition to the cohesion funds, additional budgetary strain will result from the cost to the CAP of an enlargement. The IPC reports on two studies in this regard. First, according to the EU's own estimates published in 1995, the cost to the CAP would be ECU 12.2 billion by the year 2010 (the presumed completion date for all ten applicants)

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[94]The Visegrad countries are the Czech Republic, Hungary, Poland, Slovakia, and Slovenia.

[95]I.e., the Visegrad countries plus Bulgaria and Romania.

assuming that the new members would receive all the current benefits of the CAP. However, according to a study by the Observatoire Français des Conjunctures Economiques, this amount could in fact be reduced by ECU 5-10 billion if the enlargement process was less rushed, if production was reduced by an early application of supply control measures, and if the EU would refrain from extending the compensatory bonuses given to EU farmers following the fall in cereal prices in 1992 to the new members. These estimates should be compared with the projected cost of the CAP itself of ECU 43.3 billion by 1999.

216. In Stehn (1997), estimates of the costs to the EU budget of an enlargement to the "Visegrad4" countries[96] plus Bulgaria and Romania are presented; assuming that the distribution of agricultural and structural funds would stay unchanged after an EU enlargement, that the per capita incomes of the new members would double from their 1989 levels, and that the share of agriculture in total production in these countries would decline by 25 percent due to structural changes, the yearly net cost to the EU budget would amount to ECU 11 billion.

217. Finally, the 'Agenda 2000' also comprised an evaluation of the impact of enlargement on EU policies, notably on the CAP and the regional funds, and a draft budget to run from 2000 taking into account the prospect of enlargement. Overall, a total of ECU 75 billion or about 10 percent of the EU budget is proposed for the eleven applicant countries (including Cyprus) for the 2000–06 period, including ECU 16 billion in agricultural support and ECU 45 billion from the structural and cohesion funds; the projections for agricultural support are based on a radical reform of the CAP, with drastic cuts in EU-guaranteed prices of milk and cereals.[97] The level of EU spending is proposed to be maintained at 1.27 percent of the total EU GNP between 1999 and 2006 while limiting aid from structural funds to any current or future EU member to 4 percent of their GDP. The European Commission also suggested allocating some ECU 45 billion to new members as part of a regional aid budget of ECU 275 billion.

218. So far, little work has been done on the costs and benefits of EU membership on a country-by-country basis in general, or for Latvia, or the Baltics, in particular. However, some estimates are available. For example, in Baldwin et al., budget projections, based on the "power politics" view and assuming an enlargement to "EU25" in 2002, are presented for all the current applicant countries. In the case of Latvia, receipts and contributions are estimated at ECU 1.48 billion and ECU 0.22 billion, respectively, implying a net gain of ECU 1.3 billion. This should be compared with a total estimated net gain to the Baltics of ECU 3.4 billion and to the ten CEE countries of ECU 15.1 billion.

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[96]The Visegrad(5) minus Slovenia.

[97]By March 1998, the European Commission is supposed to present its proposal for the EU budget 2000–06, with expected sharp deductions in the agricultural and regional funds.

219. Furthermore, in its *avis* on Latvia, the European Commission noted that once the suggested reforms of the CAP would be fully operational, only comprising market intervention measures, Latvia's accession to the EU would give rise to only marginal additional expenditure in relation to the likely expenditure of the current 15 member states. As already mentioned, the total allocations for structural measures in Latvia would account for no more than around 4 percent of the country's GNP after a phasing-in period. Other internal Community policies would most likely involve additional expenditures in excess of Latvia's relative proportion of the Union's total GNP. Finally, given that Latvia's EU membership should not entail significant additional expenditured in the area of external action, and that, once a member, Latvia would no longer be eligible for Phare financing or other pre-accession programs, the Commission concluded that the estimated costs arising from Latvia's accession should fall in the range of ECU 0.4 billion to ECU 0.9 billion annually in 2005–06, in real (1997) prices. As to revenues to the EU budget resulting from Latvia's membership, the *avis* simply stated that given "full application of the own resources system,"[98] the new members' contributions to the Community budget should, in terms of total GNP and VAT resources (taking into account the "capping" rules applicable to VAT), be close to their proportion of the Union's total GNP, in Latvia's case less than 0.1 percent.

Political considerations

220. The estimates regarding the expected costs and benefits of an eastern enlargement suggest that the net cost to the current EU would range between zero and ECU 8 billion, which even at the upper bound would only amount to some 0.01 percent of the EU15's GDP. This estimate must be considered quite low in light of the historic nature of the challenge in central and eastern Europe. An eastern enlargement of the EU concerns much more than narrowly defined economic benefits. The EU's primary purpose is, after all, to ensure peace and stability in Europe, where economic integration is the means and not the end. This political stability aspect of EU membership is likely to be even more important to the current ten CEE applicant countries and their aspirations to become members, implying that too narrow a focus on purely economic gains from a potential membership misses an important part of the calculation. For example, Finland's rapid and strong vote for an EU membership was most likely to a large degree attributed to "geopolitical considerations." Within three months of the demise of the USSR, Finland applied to join the EU, and at a referendum in October 1994, Finland registered the strongest pro-accession vote among the three Nordic applicants.[99] [100]

[98]Commission of the European Communities (1997b), Chapter 3.9, p. 67.

[99]See Arter (1995).

[100]Of the other two applicants, Norway and Sweden, only the latter decided to join the EU.

D. Summary and Concluding Remarks

221. This chapter has examined the process facing Latvia in its current endeavor to become a member of the EU and the challenges and opportunities involved in such an undertaking. While Latvia is not considered to be part of the "first wave" to be engaged in full accession talks, the Luxembourg summit of 1997 provides an opportunity for parallel preparatory talks, assistance for the preparations, and regular reviews of possibilities to join the negotiations. Broadly, Latvia's macroeconomic conditions give it as good marks as the first wave countries. Meanwhile, for at least some elements of structural developments—large-scale privatization, securities markets, commercial law—Latvia compares less favorably. This chapter emphasized that there are both challenges and opportunities for the CEE countries arising from EU membership, relating to a range of issues such as the impact on investment, trade, and growth from closer integration, the expected net transfers from the EU budget, pressures on scarce domestic resources from implementing the *acquis*, and political considerations. Overall, assessments of economic benefits and accession costs support the view that while, not surprisingly, the CEE applicant countries would benefit substantially from EU membership, the current EU member states would also benefit from an enlarged Union, in particular when taking into account a broader, political view. Net transfers between the EU and the new members are expected to be large and will in the end depend on the future design of the EU's agricultural and structural funds.

222. While the importance of accession is not under question, it must be recognized that in the near term, preparations for accession, such as the approximation of domestic laws to the internal market's *acquis communautaire*, may absorb a large share of already scarce human resources, put strains on domestic administrative capacities, and add to fiscal pressures. Overall, measures required by the EU ahead of membership should not preclude the maintenance of the present very prudent fiscal stance, as there still exists scope both for increased revenue efficiency and in particular for expenditure rationalization and reductions. These, if judiciously implemented, will allow absorption for any added costs of the preparations for accession. Looking ahead, with Latvia largely having achieved macroeconomic stabilization and entering a period of institution building and broadening of structural reforms in the context of growing integrating with the rest of Europe, the main role *of the Fund is likely to be focussed on conducting surveillance while continuing to provide* technical assistance, though on a much reduced scale compared with recent years.

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Table 22. Association Agreements and EU Membership Applications of Central and Eastern European Countries

Country	Association Agreement signed	Association Agreement came into force	Official application for EU membership
Bulgaria	March 1993	February 1995	December 1995
Czech Republic	October 1993	February 1995	January 1996
Estonia	June 1995	February 1998	November 1995
Hungary	December 1991	February 1994	March 1994
Latvia	June 1995	February 1998	October 1995
Lithuania	June 1995	February 1998	December 1995
Poland	December 1991	February 1994	April 1994
Romania	February 1993	February 1995	June 1995
Slovakia	October 1993	February 1995	June 1995
Slovenia	June 1996	— 1/	June 1996

Source: Commission of the European Communities

1/ Still in the process of ratification.

Table 23. EBRD Transition Indicators for EU Associated Member Countries 1/

	Latvia				Estonia	Lithuania	Other Associated Countries 2/	"First Round" Associated Countries 2/
	1994	1995	1996	1997	1997	1997	1997	1997
Private sector share of GDP in percent (mid-year estimate)	55	60	60	60	70	70	65	65
Large-scale privatization	2	2	3	3	4	3	3½	4-
Small-scale privatization	3	4	4	4	4+	4	4	4+
Governance and enterprise restructuring 3/	2	2	3	3-	3	3-	3-	3
Price liberalization 4/	3	3	3	3	3	3	3	3
Trade and foreign exchange system	4	4	4	4	4	4	4+	4+
Competition policy 4/	n.a.	2	2	3-	3-	2+	2½	3-
Banking reform and interest rate liberalization 5/	3	3	3	3	3+	3	3	3+
Securities markets and non-bank financial institutions	n.a.	2	2	2+	3	2+	3-	3
Extensiveness and effectiveness of legal rules on investment 6/	n.a.	2	4	3	4	3	3½	4-

Source: EBRD Transition Reports 1994, 1995, 1996, and 1997.

1/ A "4+" rating implies standards and performance norms of advanced industrial economies.

2/ + and - are measured as +/- 0.33, respectively; averages are rounded to the nearest 5 (private sector share) or to +, 0.5, or - (other variables). "Other Associated Countries" refer to the Czech Republic, Hungary, Poland, Slovenia, Bulgaria, Romania, and the Slovak Republic, of which the first four countries, plus Estonia, constitute the "First Round."

3/ "Governance" was included starting 1997.

4/ In 1994, "price liberalization" included "competition policy."

5/ "Interest rate liberalization" was included starting 1995.

6/ In 1997, legal rules refer to pledge, bankruptcy, and company law.

Table 24. Selected Economic Indicators for Latvia, the EU, and the "First Round" 1/

Variable	Latvia 1994	Latvia 1995	Latvia 1996	Latvia 1997	EU 1994	EU 1995	EU 1996	"First Round" 1996
Inflation (in percent)								
- period average	36	25	18	8	3.1	3.1	2.4	17
Interest rates (in percent) 2/								
- 3-month	24	43	11	4	7.1	7.0	5.4	14
- 1-year	...	...	14	6	...	...	...	...
- 2-year	...	...	...	7	...	...	...	...
- long-term	...	...	...	...	8.2	8.5	7.0	...
Fiscal balance (in percent of GDP) 3/	-4.0	-3.3	-1.3	1.3	-5.1	-5.0	...	-1.7
Public debt (in percent of GDP)	14.6	15.3	14.2	11.2	60.1	64.3	...	32.5
- of which foreign debt	9.9	9.1	8.1	7.3	8.5	9.4	...	9.7
GDP per capita (in U.S. dollars)	1,430	1,880	2,145	2,325	...	...	23,436	5,093
Real GDP growth (in percent)	2.1	0.3	2.8	6.0	3.0	2.5	1.8	4.8

Sources: Eurostat; IFS; national authorities; and staff estimates.

1/ The "First Round" refers to the five CEE countries invited to the first round of EU accession talks, namely the Czech Republic, Estonia, Hungary, Poland, and Slovenia.

2/ Latvia - end-of-period t-bill rates; EU - average money market rates and long-term government bond yields (excluding Greece); "First Round" countries - deposit rates.

3/ Central government for the EU.

Table 25. Impact of EU Enlargements

Year	Composition of EU enlargement	Increase in the EU's population	Increase in the EU's GDP
		(in percent)	
1973	UK, Ireland, Denmark	33.4	32.4
1981	Greece	3.7	2.8
1986	Spain, Portugal	17.7	11.6
1995	Austria, Finland, Sweden	6.2	6.3
?	10 CEEC	29.0	3.0

Source: International Policy Council (1997).

INDICATORS OF FINANCIAL SECTOR DEVELOPMENT

1. The following list of indicators represents a summary of the most commonly used measures of financial sector development.

A. Traditional Indicators of Financial Deepening (banking sector)

Ratio of domestic credit to the non-government sector to GDP

2. This ratio is the most common "back of the envelope" calculation. It is the most used proxy for the degree of financial intermediation, and a time-series reveals the growth of stock of credit expansion. It is widely used, given the fact that data is usually available.

Ratio of total credit to the private sector (or to nongovernment) to total domestic credit

3. This measure looks at the magnitude of private sector credit vis-à-vis credit to the entire economy. The residual share of credit is assumed to be extended to government and from the central bank to commercial banks. As with the first measure, this ratio only concentrates on bank and perhaps non-bank intermediaries (leasing companies, for example) lending and does not provide an indication of the number and level of activities of other financial instruments.

Ratio of liquid liabilities of the financial system to GDP

4. This measure is more comprehensive because it captures banks, nonbank financial intermediaries, and nonintermediary financial instruments (investment funds). Liquid liabilities are defined as currency held outside of the banking system + demand and interest-bearing liabilities of banks and nonbank financial institutions (NBFIs).

Central bank credit as a percentage of total credit or GDP

5. This measure shows the degree to which central banks direct credit into the banking system. The larger this ratio, the implication is the less the ability of banks to use market incentives (interest rates) to finance loans. Thus, the ratio should drop as the banking sector develops.

M1/M2

6. This ratio represents the degree to which an economy's banking system is able to mobilize longer-term liabilities. Thus, over time, this ratio should decline as depositors and lenders commit to longer-term maturities, which is a proxy for increased confidence in the banking system.

Currency-deposit ratio

7. This ratio should fall over time, as confidence in the banking sector grows. However, caution should be used in interpreting low currency-deposit ratios, as it might be a sign of currency substitution. One way of checking to see that a decline in this ratio reflects a growing sophistication in the market is to confirm the results by looking for high loan-deposit ratios.

Time series of real interest rates

8. A financially developed market is typically characterized by positive real rates of interest both backward and forward looking. A warning signal for economies with free interest rates is the situation where real interest rates are negative and there is an excessive growth of credit.[101] On the other hand, positive real rates should facilitate a growth in deposits, providing favorable conditions for financial deepening and widening.

Interest rate spreads

9. Financial development should be characterized by narrowing lending-deposit spreads. Persistently wide or increasing spreads should be a warning signal that banks perceive the risk to lending to be high, which is then interpreted as low confidence in the banking system. On the other hand, a narrowing of spreads represents a reduction in the risk premium and thus is indicative of confidence in the banking sector. Ultimately, the spreads should converge to developed financial sector levels.

B. Stock Market Indicators and a Few Cross-Country Comparisons

10. Most countries' banking systems form the core of the financial market. This is especially true in countries with universal banking laws, where banks have the right to own and control other banks, nonbank financial institutions, and enterprises. At the same time, many countries—especially those with "Anglo-Saxon" banking laws[102]—rely on equity markets as if not the primary, at least an important secondary financial instrument. To this end, there are a number of measures of the relative size and importance of equity market.

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[101]That is, negative real rates of interest should stimulate a demand for credit and deter deposits. This situation is unsustainable and poses risks to developing economies.

[102]In "Anglo-Saxon" banking systems, banks are severely limited or prohibited from operations outside of traditional banking (i.e., deposit and lending instruments). As a result, equity markets are usually more active and have higher net values than debt markets.

Equity market capitalization as a percentage of GDP

11. This is the most common measure of the size of the equity market relative to GDP. In most cases this measure increases (because the relative size of the stock market should outpace the growth of GDP in developing economies) over time.

Value-traded ratio

12. Like market capitalization ratios, the value traded ratio is the value of shares traded divided by GDP and measures the relative size of the equity market to the size of the economy. This ratio is more precise because it measures the value of equities that are traded, whereas the market capitalization ratio measures all stocks listed (but not necessarily traded). In many developing countries, only capitalization ratios are reported.

Turnover ratio

13. The turnover ratio is the total value of shares traded on an average daily basis divided by stock market capitalization and measures the level of trading relative to the size of the market. This ratio differs from the two other equity market ratios in that it measures the level of activity on the stock exchange, instead of its size. Thus, small markets with high levels of activity can have small value traded ratios and high turnover ratios.

I. TAX SUMMARY
(as of January 1998)

A. Taxes on Income and Property

The Corporate Income Tax

Nature of the tax

1. The Law on the Corporate Income Tax replaced the Law on the Profit Tax effective April 1, 1995. Together with the Law on the Personal Income Tax, the law forms a unified system of taxation on all types of income in Latvia unless otherwise stipulated by acts of legislation. The tax applies both to residents and "permanent establishments" of nonresidents. Taxable income is defined as the profit or loss as determined by Law on Annual Reports of Enterprises, adjusted according to provisions of the Law. The annual depreciation amount for fixed assets is set at twice the depreciation rate under the law (rates between 5 percent and 25 percent) multiplied by the remaining balance: Tax losses can be carried forward for 5 years. The capitalization rules limit the amount of interest payments that can be deducted in any year, and the transfer pricing rule is applied to cross-border transactions between Latvian residents and non-residents. Amendments to the enterprise income tax law were introduced in 1997, allowing the transfer of losses between members of an enterprise group.

Tax rates

2. The standard tax rate is 25 percent. There are withholding rates of 5-25 percent on income paid to nonresidents, with a rate of 10 percent applying to dividends and interest payments. Tax credits apply to charitable deductions, small enterprises, income from agricultural activity, income of enterprises established by associations for the handicapped, charities and health foundations, and on tax paid in foreign countries. Small enterprises are defined as those satisfying requirements on the value of fixed assets, net turnover, or the number of employees.

Tax exemptions

3. Exempt entities include enterprises that use prisoners' labor and enterprises run by associations for the handicapped, charities, and health foundations. These companies pay 20 percent of the calculated corporate income tax. Amendments to the Law on Foreign Investment provide for the abolition of tax holidays for enterprises with foreign capital participation.

The Personal Income Tax (PIT)

Nature of the tax

4. The personal income tax is assessed on salary, income from self-employment, property income, as well as on all other remuneration, bonuses, compensation for unused vacation time, disability assistance payments, and all other kinds of payments which have not been exempted from the income tax. Tax levied on salaries and wages is withheld at source. Taxpayers must file an annual income declaration by April 1 of the following year for taxes owed during the previous calendar year. Persons whose only source of income is labor income and from whom income tax is withheld at the source do not submit declarations. The following do not file declarations: persons under 16 years of age; persons who have received income for fewer than 183 days during the year; and persons whose income does not exceed the yearly nontaxable income.

Tax rates

5. The tax rate is 25 percent of taxable income.

Exemptions and deductions

6. The income tax is imposed on taxpayers' income for the calendar year, except for nontaxable activities. The following are deducted from taxpayer income: (a) a nontaxable minimum (LVL 21/month effective January 1, 1997), (b) a deduction for each dependent (LVL 10.50/month effective January 1, 1997); (c) state social insurance contributions; (d) expenses for the education and health care of the taxpayer or family members; (e) donations to charity; and (f) benefits for handicapped or politically repressed persons or members of the movement of national opposition.

7. Income tax is not assessed on: agricultural income of individual farmers if it does not exceed LVL 3,000; dividends or business profits subject to the Corporate Income Tax; interest income; social benefits from the budget including unemployment compensation and social maintenance, except for temporary disability payments; scholarships; child support; alimony; worker's compensation and long-term disability payments; insurance compensation and payments; and income from the sale of private property.

Social Insurance Contributions (Social Tax)

Nature of the tax

8. The social insurance contribution (social tax) is imposed on salaries, wages, fees, other remunerations and rewards for work.

Tax rates

9. According to the provisions of the Law, On State Social Insurance, the tax rate will be 33 percent from assessable object, starting with January 1, 2002. During the transition period, the social insurance contribution rate will be 37 percent plus an additional .09 percent for insurance against job-related accidents.

10. The proportions to be paid by an employer and an employee during this transition period will be 28:9, with the exception that the rate for insurance against job-related accidents can change every year.

Exemptions

11. The social insurance contribution is not assessed on: income form property, dividends, interest payments, royalties, and other income which is not related to employment.

Real Estate Tax

Nature of the tax

12. The law On Real Estate Tax replaces the law On Land Tax in 1998. During a transition period through 2000 only land will be taxed. The tax is paid directly to the respective village, town or city budget.

Tax rates

13. The real estate tax is 1 percent of the cadastral value of real estate. During the transition period, the tax rate will be 1.5 percent of land value.

Exemptions and deductions

Exemptions

14. The following are exempt from the real estate tax:

- local government real estate used by local government and municipal enterprises in health care and social services;

♦ real estate owned by foreign countries and used as diplomatic and consular representatives;

♦ real estate of religious organizations;

♦ real estate that is a state memorial;

♦ land under newly planted forest;

♦ real estate used for sports activities.

15. Local governments may reduce the tax for the certain groups of taxpayers in accordance with their own judgments.

Property tax

Nature of the tax

16. The property tax is paid by physical persons and legal entities on fixed assets, unfinished construction, premises located in the Republic of Latvia, equipment and means of transport.

Tax rates

17. The tax imposed depends on the value of property as follows. Property worth less than LVL 1,500 is not taxed. A minimum tax of 0.5 percent is imposed on property valued at between LVL 1,500 and LVL 25,000. A maximum rate of 4 percent is applied when the value of property exceeds LVL 2.5 million. The tax is to be paid entirely to the local governments. A coefficient of 0.8 will be applied to taxes calculated in 1998.

18. If a taxpayer owns several items of property, the tax is computed for the total value of the property, and if a taxpayer's property is located in different jurisdictions, the share to be paid to the local budget is proportional to the value of taxable property in each administrative or territorial unit.

Exemptions

♦ Property of individuals, if not used for business purposes.

♦ Property used or meant to be used solely for agricultural purposes.

♦ Government property used for health care, sports, education, and cultural purposes, except for cinemas, etc.

- Roads and roadside property as well as road service facilities, bridges, and viaducts; communication lines and stretches of land beneath them; and buildings of post offices and telephone exchanges in rural areas.

- Property used for environmental protection and fire safety.

- Property of religious organizations, national culture societies, and other public organizations approved by Parliament.

- Residences and property used in municipal services.

B. Taxes on Goods and Services

Value-Added Tax

Nature of the tax

19. This is a tax on value added, which uses the credit system and is levied on goods and services at the manufacturing/import, wholesale, and retail stages. The new law became effective on May 1, 1995 and replaced the old Turnover Tax Law which had been administered as a VAT.

Tax rates

20. The standard tax rate is 18 percent of taxable value of supplies of goods (including imports), services, and supplies for internal consumption. A tax rate of zero applies to exports, international transportation, or services connected with export supplies of goods.

Exemptions

21. The VAT is not charged on: educational services; school books, scientific literature, and certain Latvian language literature; public library services; scientific research; services of nursing homes, day-care centers, and kindergartens; banking, financial and insurance services; betting, lotteries, and other types of gambling; registered mass media; real estate sales and rent payments by individuals; movies (except video), concerts, cultural, and amateur sporting events, etc.; certain approved medical services, supplies and goods; certain approved baby-foods; funerals and religious services; humanitarian aid and approved gifts; consular services; certain services provided by agricultural companies to farmers; fire-fighting services; supplies of imported goods not subject to customs duties; certain approved fixed assets; catering in penitentiaries; certain services at agricultural educational establishments; post offices; tuition for unemployed persons' professional training organized by the State Employment Service; sales of land; and works of art for museums.

Excise taxes

Nature of the tax

22. Excise taxes are payable by individuals and enterprises that produce or import the products listed below.

Tax rates

Item to be taxed	**Unit tax (LVL) or general rate (in percent of price)**
Passenger cars	10%
Alcohol or alcoholic drinks (per liter of 200-proof equivalent)	LVL 4.10
Beer between 5.5 and 7 percent alcohol (per liter of 200-proof equivalent	LVL 4.00
Beer above 7 percent alcohol (per liter of 200-proof equivalent	LVL 4.10
Champagne and wines (per liter)	LVL 0.25
Tobacco (per 100 cigarettes)	LVL 0.35
Cigarettes with filter, per one cigarette	LVL .004
Cigarettes without filter, per one cigarette	LVL .005
Cigars and cigarillos per one unit	LVL 0.01
Other tobacco products	100%
Precious metals and jewelry with precious and semi-precious stones	30%

The excise tax schedule for petrol is as follows.

- Unleaded petrol, its substitutes and components per liter:

From January 1, 1998	LVL 0.14
From January 1, 1999	LVL 0.16
From January 1, 2000	LVL 0.18
From January 1, 2001	LVL 0.20

♦ Leaded petrol, its substitutes and components per liter:

From January 1, 1998	LVL 0.16
From January 1, 1999	LVL 0.19
From January 1, 2000	LVL 0.21
From January 1, 2001	LVL 0.23

♦ Gas oil and kerosene, their substitutions and components per liter:

		For heating purpose
From January 1, 1998	LVL 0.10	
From January 1, 1999	LVL 0.13	LVL 0,013
From January 1, 2000	LVL 0.16	LVL 0.013
From January 1, 2001	LVL 0.17	LVL 0.013

♦ Fuel oil, its substitutes and components per kilogram:

From January 1, 1998	LVL 0.02	
From January 1, 1999	LVL 0.13	LVL 0.01
From January 1, 2000	LVL 0.16	LVL 0.01
From January 1, 2001	LVL 0.17	LVL 0.01

♦ Oil gases and other gaseous hydrocarbons, except natural gas, per kilogram:

From January 1, 1998	LVL 0.01
From January 1, 1999	LVL 0.03
From January 1, 2000	LVL 0.05
From January 1, 2001	LVL 0.07

Exemptions

23. Excise taxes are not imposed on exports, on ethyl alcohol used for medical, pharmaceutical and scientific purposes, and certain automobiles with small engines or more than seven years old. For agricultural producers the tax paid for consumed gas oil shall be refunded, calculated for up to 120 liters of gas oil per hectare of land used for agricultural purposes, per calender year.

Customs duties

24. A new tariff law became effective in July 1997. There are 13 ad valorem rates, ranging from 0–75 percent. The unweighted average basic rate for non-agricultural goods is 4.5 percent, with 1 percent the most common rate. For agricultural goods, the unweighted average basic rate is 19.5 percent, and the production-weighted rate 34 percent. Specific tariffs apply to certain confectionery , alcohol beverages and tobacco cigarettes. Export duties are levied on, waste and scrap metals, wood and wood products, and certain art and antiques.

C. Other Taxes

Tax on Natural Resources

Nature of the Tax

25. A new version of the law "Tax on Natural Resources" became effective on January 1, 1996. The tax is paid by all natural and legal persons who obtain natural resources in the territory of Latvia (or continental shelf), or pollute the environment, or sell self-produced or imported goods which are dangerous to the environment. In the latter case, a permit is required for such activities.

26. The tax on acquisition of natural resources and environmental pollution is calculated on a per unit basis for each unit of natural resources or pollutant. For imports of goods dangerous to the environment, the tax is calculated in lats and levied per unit or as a percentage of the total value at customs including an import duty if applicable. The tax on the sale of self-produced goods dangerous to the environment is calculated in lats and levied per unit or as a percentage of the selling price, net of excise tax and VAT.

27. The tax on natural resources is included in as a special budget of environmental protection and in special local government budgets of environmental protection in the territory from where the resource originates.

Table 26. Latvia: Savings-Investment Balance, 1995-97 1/

	1995	1996	1997
	(In percent of nominal GDP)		
Foreign savings 2/	3.4	4.1	6.9
Gross national savings	15.5	16.6	16.2
Government 3/	-1.9	0.5	3.7
Nongovernment	17.4	16.1	12.5
Gross domestic investment	18.9	20.7	23.1
Government 3/	1.9	1.9	2.3
Nongovernment	17.0	18.9	20.8
Fixed investment	18.3	19.6	22.3
Change in stocks 4/	0.6	1.2	0.8
	(Annual Percentage change)		
Memorandum item:			
Real GDP growth rate	0.3	2.8	6.0

Sources: Latvian authorities; and Fund staff estimates.

1/ Columns may not sum due to rounding.
2/ External current account deficit.
3/ From 1995 includes extrabudgetary investment in the PIP.
4/ Includes statistical discrepancy.

Table 27. Latvia: Agricultural Production, 1990-96

	1990	1991	1992	1993	1994	1995	1996
	(In thousand tons, unless otherwise specified)						
Livestock, Meat Production (index)	100	92.4	75.9	50.4	41.4	39	34
Meat, deadweight	308	296	247	193	136	123	76
(Index of Production)	(100)	(96.1)	(79.9)	(62.4)	(44.1)	(39.8)	(24.5)
Of which: private farms (percent of total)	26.8	31.7	40.1	53.4	68.7	72.6	58.5
Beef and veal	125	132	120	107	68	48	27
Cattle (thousand heads)	1,439	1,383	1,144	678	551	537	509
Pork	138	126	101	68	54	63	40
Pigs (thousand heads)	1,401	1,247	867	482	501	553	460
Poultry	40	33	21	13	11	11	9
Poultry (thousand heads)	10,321	10,395	5,438	4,124	3,700	4,198	3,791
Milk Production	1,893	1,741	1,479	1,157	1,001	948	923
(Index of Production)	(100)	(91.9)	(78.0)	(61.1)	(52.8)	(50.0)	(48.7)
Egg Production	819	761	596	389	360	421	471
(Index of Production)	(100)	(92.9)	(72.7)	(47.5)	(44.0)	(51.4)	(57.5)
Crop Production (index)	100	105.3	93.6	93.4	71.0	65.9	62
Cereals	1,622	1,336	1,152	1,235	901	694	969
(Index of Production)	(100)	(82.4)	(71.0)	(76.1)	(55.5)	(42.8)	(59.7)
Of which: private farms (percent of total)	6.7	14.1	35.1	61.7	71.5	72.1	74.8
Area sown (thousand hectares)	686	657	703	696	489	411	450
Sugarbeets	439	378	463	298	228	250	258
(Index of Production)	(100)	(86.1)	(105.5)	(67.9)	(51.9)	(56.9)	(58.8)
Area sown (thousand hectares)	15	15	25	12	12	10	10
Potatoes	1,016	944	1,167	1,272	1,045	864	1,082
(Index of Production)	(100)	(92.9)	(114.9)	(125.2)	(102.9)	(85.0)	(106.5)
Of which: private farms (percent of total)	61.9	73.8	84.8	93.0	96.5	96.2	95.8
Area sown (thousand hectares)	80	82	97	88	80	75	79
Fodder	3,307	2,891	1,662	1,339	921	611	569
(Index of Production)	(100)	(87.4)	(50.3)	(40.5)	(27.9)	(18.5)	(17.2)
Of which: private farms (percent of total)	14.9	22.2	47.7	59.4	78.9	76.4	78.3
Area sown (thousand hectares)	820	843	718	607	591	413	429
Vegetables	169	209	251	285	233	224	180
(Index of Production)	(100)	(123.7)	(148.5)	(168.6)	(137.9)	(132.5)	(106.5)
Area sown (thousand hectares)	11	13	19	19	18	17	16
Memorandum items:							
Yield per hectare for cereals (in 100 kg)							
Private farms	29	26	16	19	19	17	21
State-owned farms	23	20	17	16	18	17	22

Sources: Central Statistical Bureau; and Fund staff calculations.

Table 28. Latvia: Energy Consumption, 1990-97

	1990	1991	1992	1993	1994	1995	1996	1997 Q1-3
	(In thousand tons, unless otherwise specified)							
Coal	1,066	807	663	599	425	252	294	102
Gasoline	721	514	493	478	459	412	435	271
Diesel oil	1,419	1,069	790	722	565	502	431	370
Heavy fuel oil	1,659	1,242	1,134	1,116	1,415	1,017	1,141	592
Natural gas (million cubic meters)	2,926	2,961	2,150	1,412	1,028	1,254	1,088	861
Liquefied petroleum gas	84	76	59	61	52	34	35	26
Electricity (million kilowatt hours)	10,230	9,869	7,912	6,425	6,259	6,235	6,351	4,454

Source: Latvian authorities.

Table 29. Latvia: Labor Market Indicators, 1994-97
(In thousands)

	1994				1995				1996				1997		
	March	June	Sept.	Dec.	March	June	Sept.	Dec.	March	June	Sept.	Dec.	March	June	Sept.
Registered unemployed 1/	87.2	85.1	81.0	83.9	85.7	77.9	76.6	83.2	88.2	88.5	88.5	90.8	94.7	95.3	88.6
Of which:															
Women	45.2	43.7	42.5	43.5	43.7	39.9	40.3	43.5	45.5	45.6	47.5	49.7	52.9	55.2	52.2
Long term unemployed 2/	31.0	33.2	35.6	36.1	37.8	39.1	38.1	37.5	41.9	46.1	47.1	49.5	53.8	54.8	53.6
Benefit recipients 3/	37.4	33.7	37.9	42.7	28.8	25.8	26.1	27.5	26.5	26.2	30.1	32.2	32.1	32.8	32.4
Memorandum items:															
Hidden unemployment 4/ 5/	11.8	8.3	7.3	7.7	8.5	8.0	7.9	7.2	7.1	6.5	6.0	6.6	11.0	9.5	8.7
Total employment 6/	1,215	1,209	1,201	1,196	1,193	1,191	1,189	1,183	1,175	1,170	1,165	1,161	1,158	1,156	1,165
Unemployment rate 1/ (In percent of labor force)	6.5	6.4	6.2	6.5	6.7	6.1	6.0	6.6	7.0	7.0	7.0	7.2	7.5	7.6	7.1

Source: Central Statistical Bureau.

1/ End of the period.

2/ Persons unemployed for six months or more.

3/ Data for 1994 are end-period data; beginning 1995–average number of recipients.

4/ Defined as the full time work equivalent of working time that is reported lost due to enforced reduced hours and unpaid leave.

5/ Until December 1994—only in the mentioned month, beginning with 1995—in the period from the beginning of the year.

6/ Average quarterly.

Table 30. Latvia: Average Wages, 1993–97

	Whole Economy	State Sector	Budgetary Organizations	State Enterprises	State Sector In US$	Min. Wage In Lats
			(In LVL per month)			
1993						
Jan-March	39.82	43.47	34.45	48.41	54.75	7.50
Apr-June	45.00	47.48	41.58	50.99	71.94	12.50
July-Sep	50.51	52.30	39.47	60.94	81.97	15.00
Oct-Dec	59.24	61.32	50.18	68.76	101.36	15.00
1994						
Jan-March	61.37	63.91	54.01	73.24	110.19	15.00
Apr-June	71.84	75.16	57.45	88.31	133.03	22.50
July-Sep	75.76	78.67	57.76	96.25	143.30	22.50
Oct-Dec	80.51	89.96	74.39	106.13	165.06	28.00
1995						
Jan-March	82.35	90.24	73.54	102.46	168.36	28.00
Apr-June	89.50	98.35	80.37	111.83	192.47	28.00
July-Sep	90.27	98.34	79.23	112.65	186.60	28.00
Oct-Dec	95.29	105.86	87.65	120.11	197.50	28.00
1996						
Jan-March	89.41	98.52	79.99	113.62	180.44	28.00
Apr-June	99.21	109.68	87.55	128.66	198.34	38.00
July-Sep	102.29	111.50	88.27	131.88	202.36	38.00
Oct-Dec	107.54	122.20	99.68	143.04	220.58	38.00
1997						
Jan-March	109.87	121.03	98.66	141.73	210.85	38.00
Apr-June	118.64	129.95	104.20	154.07	224.44	38.00
July-Sep	122.34	133.41	106.35	158.23	226.50	38.00
Oct-Dec						38.00
			(Real terms, Index 1993=100)			
1990 average	n.a.	165.88	152.94	158.82	n.a.	n.a.
1991 average	n.a.	120.67	128.00	111.78	n.a.	186.67
1992 average	n.a.	92.85	97.68	88.68	n.a.	98.58
1993 average	100.00	100.00	100.00	100.00	n.a.	100.00
1994 average	111.99	109.98	105.66	113.18	n.a.	129.51
1995 average	111.54	111.93	113.26	113.67	n.a.	131.84
1996 average	104.60	106.37	106.26	111.45	n.a.	142.14
1997 average 1/	115.06	114.93	114.34	121.47	n.a.	141.26

Source: Latvian authorities.

1/ January-September.

Table 31. Latvia: Consumer Price Inflation

Year/Month	Consumer Price Index	Percentage Change Over Previous Month	Percentage change over same month last year			Annual Average Inflation	Quarterly inflation	
			All Items	Goods	Services		Over Previous Quarter	Over Previous Year
1990								
December	100.0	12.5	...	...	...	...	4.2	...
1991								
December	362.4	49.7	262.4	...	...	124.4	39.6	203.1
1992								
December	3,836.9	2.6	958.7	...	...	951.2	53.8	1,222.7
1993								
December	5,174.1	5.1	34.9	...	...	109.1	12.7	33.9
1994								
December	6,533.4	2.4	26.3	21.4	45.3	35.8	4.9	31.1
1995								
January	6,762.0	3.5	25.9	20.7	46.0	...		
February	6,975.0	3.2	25.6	20.5	45.6	...		
March	7,156.4	2.6	26.7	21.1	48.3	...	9.1	26.1
April	7,294.5	1.9	25.8	22.4	37.3	...		
May	7,396.4	1.4	27.3	22.5	42.2	...		
June	7,506.6	1.5	26.6	20.9	45.0	...	6.2	26.6
July	7,525.2	0.3	25.6	20.8	38.0	...		
August	7,504.0	-0.3	22.9	18.7	31.3	...		
September	7,640.1	1.8	23.9	20.6	29.9	...	2.1	24.1
October	7,758.5	1.6	24.2	21.2	29.9	...		
November	7,912.2	2.0	24.1	21.3	29.7	...		
December	8,045.2	1.7	23.1	20.0	30.3	25.1	4.6	23.8
1996								
January	8,327.5	3.5	23.2	18.0	36.3	...		
February	8,472.8	1.8	21.5	16.0	36.0	...		
March	8,603.3	1.5	20.2	15.7	31.6	...	7.1	21.6
April	8,646.6	0.5	18.5	14.7	27.5	...		
May	8,684.6	0.4	17.4	15.2	22.1	...		
June	8,828.5	1.7	17.6	16.6	19.2	...	3.0	17.8
July	8,858.3	0.3	17.7	17.0	19.2	...		
August	8,815.1	-0.5	17.5	16.9	19.3	...		
September	8,874.0	0.7	16.2	15.3	18.8	...	1.5	17.1
October	8,978.4	1.2	15.7	14.2	19.9	...		
November	9,048.4	0.8	14.4	12.4	19.7	...		
December	9,100.6	0.6	13.1	11.0	18.6	17.6	2.2	14.4
1997								
January	9,273.6	1.9	11.4	10.8	13.8	...		
February	9,307.9	0.4	9.9	9.1	13.0	...		
March	9,348.2	0.4	8.7	7.8	12.3	...	3.0	9.9
April	9,410.0	0.7	8.8	7.6	13.9	...		
May	9,470.4	0.6	9.0	8.0	13.2	...		
June	9,492.1	0.2	7.5	6.1	13.4	...	1.6	8.5
July	9,536.8	0.5	7.7	5.3	17.2	...		
August	9,575.6	0.4	8.6	5.6	20.7	...		
September	9,592.7	0.2	8.1	5.1	19.7	...	1.2	8.1
October	9,665.8	0.8	7.7	4.5	20.0	...		
November	9,715.7	0.5	7.4	4.6	18.3	...		
December	9,738.1	0.2	7.0	4.2	18.2	8.4	1.4	7.3
1998								
January	9,864.7	1.3	6.4	...	...	...		

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

Table 32. Latvia: Summary of General Government Operations, 1994–97

	1994	1995	1996	1997
	(In millions of lats)			
Revenue	746	884	1,084	1,330
Of which:				
Profit tax	74	48	57	79
Income and social tax	329	419	485	564
Taxes on goods and services	228	295	393	449
Privatization revenue	7	9	5	31
Expenditure	780	952	1,118	1,275
Of which:				
Wages and salaries	177	255	257	295
Transfers to households	334	399	484	476
Interest	13	30	38	31
Other current	235	247	290	407
Investment	22	22	51	67
Financial surplus(+)/deficit(-)	-35	-68	-35	55
Net lending	-48	-15	-5	-10
Fiscal surplus(+)/deficit(-)	-83	-83	-40	45
Composition of financial balance	-35	-68	-35	56
General government	-36	-78	-32	58
Central budget	n.a.	-94	-22	38
Social budget	n.a.	16	-9	20
Local governments	-6	4	-4	-2
Extrabudgetary funds	7	7	0	-1
Financing of fiscal balance	83	83	40	-45
Domestic	48	51	28	-51
Banking system	36	49	15	-45
Other domestic	12	2	13	-6
Foreign	35	32	12	6
	(In percent of GDP)			
Revenue	36.5	35.5	36.8	39.9
Of which:				
Profit tax	3.6	1.9	2.0	2.4
Income and social tax	16.1	16.8	16.5	16.9
Taxes on goods and services	11.2	11.8	13.4	13.5
Expenditure	38.2	38.2	38.0	38.2
Of which:				
Wages and salaries	8.7	10.2	8.7	8.8
Transfers to households	16.3	16.0	16.2	14.3
Interest	0.6	1.2	1.3	0.9
Other current	11.5	9.9	9.9	12.2
Investment	1.1	0.9	1.7	2.0
Financial surplus(+)/deficit(-)	-1.7	-2.7	-1.2	1.6
Net lending	-2.3	-0.6	-0.2	-0.3
Fiscal surplus(+)/deficit(-)	-4.0	-3.3	-1.3	1.3
Defense expenditure (percent of GDP)	2.5	0.8	0.7	0.7

Sources: Latvian authorities and Fund staff estimates.

Table 33. Latvia: Central Government and Social Security, 1994-97

	1994	1995	1996	1997
	(In millions of lats)			
Revenue - total	577	647	788	968
Current revenue	575	647	787	968
Taxes on income, profits and property	76	49	58	81
Tax on profits	73	48	57	79
Property tax	0	0	0	2
Social security taxes	236	291	328	381
Taxes on goods and services	227	273	347	393
Taxes on domestic transactions	203	255	328	372
Turnover/VAT	174	220	268	289
Excise	29	35	61	83
Taxes on international trade	23	18	19	22
Other taxes	23	24	14	8
Other current revenue	14	9	40	105
Transfer from priv. fund	n.a.	4	1	21
Non-budgeted revenues	...	...	18	53
Capital revenue	2	1	1	0
Expenditure - total	606	725	815	909
Current expenditure	592	714	800	878
Wages and salaries	135	180	178	155
Supplies and maintenance	86	81	94	119
Interest payments	13	30	38	31
Subsidies	5	9	9	12
Transfers	324	389	465	558
To individuals	271	334	427	453
Social budget	n.a.	275	337	361
Basic budget	n.a.	58	90	92
To local government	53	55	38	92
To extrabudgetary funds				13
Other current expenditure	22	24	16	4
Investment	14	12	15	31
Financial Surplus(+)/Deficit(-)	-29	-78	-27	58
Net lending	-48	-18	-5	-10
Fiscal Surplus(+)/Deficit(-)	-77	-96	-32	34
Basic budget	n.a.	-112	-23	28
Social budget	n.a.	16	-9	20
Financing fiscal balance	77	96	32	-34
Domestic	41	64	20	-40
Banking system	37	55	12	-36
Other domestic	4	9	8	-4
Foreign	35	32	12	6
	(In percent of GDP)			
Revenue	28.3	26.0	26.8	29.0
Of which: Basic budget	...	14.3	15.6	17.6
excl. non-budgeted revs.	...	14.3	15.0	16.0
Of which: Social budget	...	11.7	11.1	11.4
Expenditure	29.7	29.1	27.7	27.3
Financial balance	-1.4	-3.1	-0.9	1.7
Net lending	-2.3	-0.7	-0.2	-0.3
Fiscal balance	-3.7	-3.8	-1.1	1.0

Sources: Latvian authorities and Fund staff estimates.

Table 34. Latvia: Local Government Operations, 1994-97

	1994	1995	1996	1997
Revenue	179	219	238	305
Current revenue	177	218	238	305
Taxes on income, profits and property	113	153	189	163
Tax on profits	1	0	0	0
Income tax	90	127	157	126
Property tax	12	15	19	20
Land tax	10	11	13	17
Taxes on goods and services	2	0	4	4
Turnover/VAT	2	0	0	0
Other taxes	10	9	7	0
Other current revenue	54	57	38	138
Transfers from central government	53	55	38	95
Other revenue	1	2	0	0
Capital revenue	2	0	0	0
Expenditure	185	215	242	307
Economic classification:	185	215	242	307
Current expenditure	177	205	221	283
Wages and salaries	35	61	63	121
Interest payments	0	0	2	2
Supplies and maintenance	55	72	87	130
Subsidies	0	0	0	0
Transfers	63	65	50	22
To enterprises	0	0	0	0
To individuals	63	65	50	22
Other current expenditure	25	8	19	7
Capital expenditure	8	10	20	24
Investment	8	10	20	22
Fiscal Surplus(+)/Deficit(-)	-6	4	-4	-2
Revenue	8.8	8.8	8.1	9.1
Expenditure	9.1	8.6	8.2	9.2
Fiscal balance	-0.3	0.1	-0.1	-0.1

Sources: Latvian authorities and Fund staff estimates.

Table 35. Latvia: Treasury Bill Auctions, 1994-97

(In face value terms)

	Gross sales of treasury bills (LVL mn.) 1/						Outstanding stock (LVL mn., end-month) 1/					
	28 day	91 day	182 day	1 year	2 year	Total	28 day	91 day	182 day	1 year	2 year	Total
1994												
Dec.	11.2	14.1	0.0	0.0	0.0	25.3	11.2	27.8	0.0	0.0	0.0	39.0
1995												
Jan.	8.8	7.5	0.0	0.0	0.0	16.3	8.8	34.2	0.0	0.0	0.0	43.0
Feb.	12.4	21.6	0.0	0.0	0.0	34.0	12.4	44.9	0.0	0.0	0.0	57.3
Mar.	9.2	11.2	0.7	0.0	0.0	21.1	6.5	40.3	0.7	0.0	0.0	47.5
Apr.	4.7	3.0	1.2	0.0	0.0	8.9	4.7	35.8	1.9	0.0	0.0	42.4
May	12.2	3.7	2.1	0.0	0.0	18.0	11.2	15.1	4.0	0.0	0.0	30.3
June	14.1	0.9	0.1	0.0	0.0	15.2	14.1	7.6	4.1	0.0	0.0	25.9
July	17.8	0.5	0.3	0.0	0.0	18.6	17.8	5.1	4.4	0.0	0.0	27.3
Aug.	29.1	3.2	1.0	0.0	0.0	33.3	22.1	4.6	4.9	0.0	0.0	31.6
Sep.	26.1	4.3	1.4	0.0	0.0	31.8	26.1	7.9	6.2	0.0	0.0	40.2
Oct.	22.8	14.1	4.0	0.0	0.0	40.9	22.8	21.6	9.0	0.0	0.0	53.4
Nov.	25.3	19.0	9.0	0.0	0.0	53.4	19.3	37.5	15.9	0.0	0.0	72.7
Dec.	15.0	13.8	6.1	0.0	0.0	34.9	15.0	47.0	21.9	0.0	0.0	83.9
1996												
Jan.	16.0	21.9	11.1	0.0	0.0	49.0	12.0	51.5	32.6	0.0	0.0	96.1
Feb.	7.8	16.5	9.5	0.0	0.0	33.8	7.8	52.2	41.4	0.0	0.0	101.2
Mar.	7.5	14.5	10.5	0.0	0.0	32.5	7.5	52.9	50.2	0.0	0.0	110.6
Apr.	3.8	6.5	12.5	2.5	0.0	25.3	3.8	42.0	58.7	2.5	0.0	107.0
May	5.0	9.5	14.2	6.8	0.0	35.4	4.0	30.5	63.8	9.3	0.0	107.6
June	4.0	7.8	11.5	4.6	0.0	27.8	4.0	23.8	69.2	13.9	0.0	110.8
July	5.0	6.5	11.3	6.3	0.0	29.0	4.0	22.3	69.4	20.1	0.0	115.7
Aug.	4.0	4.3	9.3	3.9	0.0	21.3	4.0	18.5	69.2	24.0	0.0	115.6
Sep.	4.0	5.0	10.0	5.0	0.0	24.0	4.0	15.8	68.7	29.0	0.0	117.4
Oct.	4.3	5.6	11.4	13.7	0.0	34.9	3.4	14.8	64.4	42.7	0.0	125.2
Nov.	1.9	2.0	8.0	4.9	0.0	16.7	1.9	12.6	61.2	47.4	0.0	123.1
Dec.	4.6	5.2	6.4	10.0	0.0	25.9	4.5	12.8	56.0	57.4	0.0	130.6
1997												
Jan.	5.5	6.1	7.3	10.0	0.0	28.8	4.2	13.3	52.0	67.4	0.0	136.9
Feb.	2.6	3.8	6.0	0.0	0.0	12.3	2.5	15.0	48.7	67.4	0.0	136.9
Mar.	2.9	4.4	7.5	12.0	0.0	26.7	2.8	14.2	46.2	79.4	0.0	142.6
Apr.	3.4	6.5	7.0	0.0	17.0	33.9	2.5	14.6	42.0	75.9	17.0	153.7
May	2.0	4.0	2.0	10.0	0.0	18.0	2.0	14.8	36.0	80.2	17.0	149.9
June	2.0	3.7	4.0	0.0	0.0	9.7	2.0	14.2	33.8	75.6	17.0	142.5
July	2.1	4.3	4.0	12.0	0.0	21.7	1.9	11.2	30.5	81.3	17.0	141.9
Aug.	1.9	3.1	4.0	12.0	0.0	21.0	1.9	10.3	28.5	89.5	17.0	147.2
Sep.	2.0	2.7	4.0	10.0	0.0	18.7	2.0	9.3	25.0	94.5	17.0	147.8
Oct.	2.5	4.1	5.0	0.0	17.0	28.6	2.0	9.9	23.0	80.8	34.0	149.7
Nov.	1.8	2.3	3.7	10.0	0.0	17.8	1.8	9.1	24.7	86.0	34.0	155.6
Dec.	2.0	2.8	4.0	10.0	0.0	18.8	1.5	8.5	24.7	86.0	34.0	154.7

Sources: Latvian authorities; and Fund staff estimates.

1/ Dates refer to those of auctions rather than settlements.

Table 36. Latvia: Pension System, 1993-97

	1993	1994	1995	1996	1997
Number of recipients (thousands)	657	654	638	641	643
Old age	500	496	497	504	511
Disability	104	104	103	99	95
Survivors	26	29	30	30	29
Social	20	19	n.a	n.a	n.a
Other	7	6	8	8	9
Average benefit (lats per month)	10.5	27.0	32.7	38.5	42.4
Old age	9.9	27.3	32.6	38.3	42.6
Disability	14.0	28.3	33.9	39.2	42.8
Survivors	9.9	23.6	28.2	32.2	35.9
Social	9.3	18.4	n.a.	n.a.	n.a.
Other	n.a.	n.a.	n.a.	n.a.	n.a.
Expenditure (millions of lats) 1/	141.0	199.5	239.1	299.3	340.9
Old age	90.1	150.2	181.8	231.4	286.8
Disability	19.8	34.8	42.9	48.2	50.3
Survivors	5.5	8.4	10.4	12.4	13.5
Social	2.8	3.8	n.a.	n.a.	n.a.
Other	1.4	2.3	4.0	7.3	8.5
Heating allowance 2/	21.4	0.0	0.0	0.0	0.0
Memorandum item:					
Total expenditure (percent of GDP)	9.6	9.8	9.6	10.2	10.2

Sources: Ministry of Labor, Welfare and Health; and Fund staff estimates.

1/ From 1995, all pensions except social pension are paid by the social budget rather than by the basic budget.

2/ Heating allowance in 1993 is not included in calculation of average pensions.

Table 37. Latvia: Family Benefits, 1993-97

	1993	1994	1995	1996	1997
Number of beneficiaries (thousands)					
Birth grant	26	24	21	19	19
Maternity leave	15	11	10	...	...
Child care allowances	77	68	58	55	54
Ages 0-1.5	38	32	27	26	25
Ages 1.5-3	39	36	31	30	28
Family allowances	551	552	546	540	522
Ages 0-8	272	261	245	...	...
Ages 8-15	246	253	259	...	...
In higher education	33	38	42	...	...
Average benefit (lats per month)					
Birth grant	14.5	34.8	73.4	97.5	112.7
Maternity leave	27.9	46.4	64.0	100.5	100.5
Child care allowances	9.7	9.6	10.2	9.8	9.5
Ages 0-1.5	11.8	11.9	12.5	11.7	11.8
Ages 1.5-3	7.6	7.5	8.1	7.2	7.2
Family allowances	4.2	4.2	4.1	7.5	5.9
Ages 0-8	3.0	3.8	3.7	...	...
Ages 8-15	4.6	4.5	4.4	...	...
In higher education	4.8	4.6	4.5	...	...
Expenditure (millions of lats)	38.9	38.2	38.2	41.6	41.2
Birth grant	0.4	0.8	1.6	1.8	2.1
Maternity leave	1.7	2.0	2.4	2.6	2.9
Child care allowances	8.9	7.8	7.1	6.5	5.7
Ages 0-1.5	5.4	4.6	4.3	...	...
Ages 1.5-3	3.6	3.2	2.8	...	...
Family allowances	27.9	27.5	27.1	30.6	30.5
Ages 0-8	12.5	11.8	10.9	...	...
Ages 8-15	13.5	13.6	13.8	...	...
In higher education	1.9	2.1	2.4	...	...
Memorandum item:					
Total expenditure (percent of GDP)	2.7	1.9	1.5	1.4	1.2

Sources: Latvian Ministry of Labor, Welfare and Health; and Fund staff estimates.

Table 38 . Latvia: Reserve Money and Net Domestic Assets of the Bank of Latvia
(In millions of lats)

						New Acct. 1/			New Acct. 1/		EBS/97/174
	1994	1995		1996		1996			1997		
	Dec.	Dec.	March	June	Sept.	Dec.	March	June	Sept	Dec	Dec.
Reserve money	269.4	273.6	261.4	311.0	309.8	340.7	350.0	370.0	382.3	441.7	415.8
Currency in circulation	232.1	225.9	224.7	244.0	261.0	282.6	291.8	310.0	327.7	359.4	345.1
Bank deposits	37.3	47.7	36.8	67.0	48.7	58.1	58.2	60.0	54.7	82.4	70.7
Foreign currency deposits	--	--	--	11.6	12.5	6.8	8.3	3.1	0.1	0.1	11.3
Other	37.3	47.7	36.8	55.4	36.2	51.3	49.9	56.9	54.5	82.2	59.4
Net foreign assets 2/ 3/	249.5	220.8	242.7	280.3	304.1	349.4	357.5	391.0	426.0	433.1	416.9
Net domestic assets	19.9	52.7	18.7	30.7	5.7	-8.7	-7.5	-21.0	-43.6	8.7	-1.1
Domestic credit	60.0	100.3	73.2	86.9	62.6	43.3	52.3	47.8	30.4	83.0	67.7
Banks	54.5	43.5	46.6	40.4	30.7	10.0	28.4	6.3	1.1	7.6	16.2
BoP assistance	53.0	39.9	40.1	37.1	28.1	5.6	24.0	3.0	0.6	0.6	3.0
Refinance credits	1.4	3.5	6.5	3.3	2.6	4.3	4.4	3.3	0.5	6.9	13.2
Government,net 4/	5.5	56.9	26.6	46.5	31.9	33.3	23.9	41.5	29.3	75.5	51.5
Balance of payments assistanc	13.1	35.8	34.5	34.1	37.1	50.3	42.4	59.8	60.7	59.4	57.5
Other government,net 5/	-7.6	21.0	-7.9	12.4	-5.2	-16.9	-18.4	-18.3	-31.4	16.1	-6.0
Other items, net	-40.1	-47.6	-54.5	-56.2	-56.9	-52.0	-59.8	-68.8	-74.0	-74.4	-68.8
Memorandum items:											
					(Percentage change from the end of previous quarter)						
Reserve money	6.2	9.7	-4.4	18.9	-0.4	10.0	2.7	5.7	3.3	15.5	5.4
Domestic credit	-10.8	19.1	-27.0	18.6	-28.0	-30.8	15.5	-8.7	-39.2	173.3	2.5
Banks	-1.8	-3.4	7.3	-13.3	-23.9	-67.6	-4.3	-77.8	-95.2	579.0	11.4
Government,net 4/	-53.3	44.7	-53.2	74.6	-31.5	4.6	53.1	73.3	9.7	157.9	0.0
Exchange rate (LVL/US$)	0.548	0.537	0.549	0.554	0.555	0.556	0.580	0.574	0.586	0.6	0.574
Total NFA (in US$)	465.7	422.5	453.1	516.7	557.5	637.8	625.1	690.1	726.9	734.0	735.1

Sources: Bank of Latvia; and Fund staff estimates.

1/ New accounting to include changes instituted in June 1997 by the BOL and is a break in series. December 1996 data were revised consistent with these changes, for purpose

2/ Valued at current exchange rates.

3/ The Bank of Latvia has virtually no medium- and long-term foreign currency liabilities and, therefore, NFA is equal to NIR. From June 1997, NFA is no longer broken down

4/ Excluding proceeds from foreign loans for balance of payments support.

5/ Includes purchase of treasury bills.

Table 39. Latvia: Monetary Survey and Net Domestic Assets of the Banking System

(in millions of lats)

	1994	1995	1996				New Acct. 1/ 1996	1997		New Acct. 1/ 1997		EBS/97/174
	Dec.	Dec. Adj.	March	June	Sept.	Dec.	Dec.	March	June	Sep	Dec	Dec.
Broad money (M2X)	687.4	524.0	504.4	544.4	601.4	628.2	628.2	654.3	724.5	805.3	870.9	791.9
Currency held by public	213.1	209.5	211.6	230.2	244.4	264.0	264.0	274.0	286.5	303.9	332.7	324.8
Household deposits	190.9	65.0	60.8	62.6	63.7	67.1	67.1	71.2	76.4	86.2	96.4	101.0
Enterprise deposits	93.3	95.0	79.5	84.0	95.2	104.4	104.4	97.8	132.6	148.1	170.2	128.6
Residents' FC deposits 2/	190.1	154.4	152.5	167.6	198.2	192.7	192.7	211.4	229.0	267.1	271.6	237.6
Total deposits	474.3	314.4	292.8	314.2	357.1	364.2	364.2	380.3	438.0	501.4	538.3	467.1
Net foreign assets (total) 3/	370.4	299.9	318.4	367.8	402.8	445.0	445.0	456.9	547.9	619.2	619.0	550.8
Net domestic assets	317.0	224.1	186.0	176.5	198.7	183.2	183.2	197.5	176.6	186.2	252.0	241.1
Domestic credit	447.6	331.7	311.0	332.7	348.2	348.7	366.4	370.5	390.1	427.8	479.0	454.7
Households	31.9	28.1	26.3	25.2	24.9	21.2	21.2	22.8	24.6	31.2	36.6	28.6
Enterprises	337.2	176.3	171.4	168.1	167.8	185.3	185.3	195.9	230.2	267.2	327.3	258.7
Government, net	78.6	127.3	113.3	139.4	155.5	142.2	159.9	151.9	135.3	129.4	115.1	167.3
Restructuring Bonds	63.0	60.9	54.5	53.7	53.2	53.2	53.2	53.2	53.2	53.2	53.2	53.2
Other Credit to Government	15.5	66.4	58.8	85.6	102.3	89.0	106.7	98.7	82.1	76.2	61.9	114.1
Other items, net	-130.7	-107.6	-125.0	-156.1	-149.5	-165.5	-183.3	-173.1	-213.6	-241.6	-227.0	-213.6
Memorandum Items:												
	(Percentage change from end of previous quarter)											
Broad money(M2X)	14.3	-19.1	-3.7	7.9	10.5	4.4	4.4	4.2	10.7	11.2	10.1	5.1
Domestic credit	16.3	-33.2	-6.2	7.0	4.7	0.1	5.2	6.3	5.3	14.0	13.2	3.7
Households	2.1	-34.1	-6.4	-3.9	-1.4	-14.7	-14.7	7.3	8.0	26.5	23.9	8.9
Enterprises	11.0	-49.6	-2.7	-1.9	-0.2	10.4	10.4	5.7	17.5	16.1	27.1	6.2
Other credit to Government	-331.4	59.5	-11.4	45.5	19.5	-13.1	4.2	10.9	-16.8	13.2	-25.4	-0.9
Total NFA (US$mn) 3/												
Total	676.0	558.4	579.9	664.0	725.7	800.4	800.4	787.7	954.6	1056.6	1049.1	959.6
of which : comm. banks	220.7	147.2	137.9	158.0	177.8	172.0	172.0	171.3	273.3	329.7	315.1	233.3

Sources: Bank of Latvia; and Fund staff estimates.

1/ Revised data include accounting charges which began in June 1997 and is a break in series.

2/ As of June 1997, residents' foreign currency deposits are deposits in all currencies except lats

3/ Valued at current exchange rates. Due to changes in accounting, from May 1997 the source of convertible balances is OECD countries only.

Table 40. Latvia: Enterprise and Household Deposits
(in millions of lats)

	1994	1995				1996				1997			
	December	March	June	September	December	March	June	September	December	March	June	September	December
Enterprise deposits	197.7	190.9	200.1	197.5	198.5	181.9	196.8	235.8	234.8	240.5	288.8	332.7	345.7
BoL branches	0.0	0.0.	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	196.0	189.2	197.7	195.3	195.7	180.1	195.0	234.2	233.1	238.2	285.9	329.1	0.0
Latvian Savings Bank	1.7	1.7	2.4	2.2	2.8	1.8	1.8	1.6	1.7	2.3	2.9	3.6	0.0
Household deposits	276.6	281.9	248.5	226.9	115.9	111.0	117.4	121.3	129.4	139.9	149.6	169.0	192.5
BoL branches	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	220.4	215.0	184.6	168.8	56.1	55.4	63.5	72.6	79.4	898.3	97.6	113.6	124.0
Latvian Savings Bank	56.3	66.9	63.9	58.1	59.8	55.6	53.9	48.7	50.0	50.6	52.0	55.4	68.5
Total deposits from private sector	474.3	472.9	448.6	424.4	314.4	292.9	314.2	357.1	364.3	380.4	438.4	501.7	538.2
BoL branches	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	416.4	404.2	382.3	364.1	251.8	235.5	258.5	306.8	312.5	327.5	383.5	442.7	0.0
Latvian Savings Bank	57.9	68.7	66.3	60.3	62.6	57.4	55.7	56.3	51.7	52.9	54.9	59.0	0.0
Memorandum item:													
Enterprise deposits/total (in percent)	41.7	40.4	44.6	46.5	63.1	62.1	62.6	66.0	64.5	63.2	65.9	66.3	64.2

Source: Bank of Latvia; and Fund staff calculations.

Table 41. Latvia: Enterprise and Household Credits

	1994	1995				1996				1997			
	December	March	June	September	December	March	June	September	December	March	June	September	December
Enterprise credit	337.2	353.2	350.9	306.6	176.2	170.2	171.1	171.1	190.1	203.4	234.6	275.1	327.3
BoL branches	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	328.0	344.6	341.6	296.9	166.6	160.7	161.7	162.1	178.7	191.7	223.2	266.2	306.8
Latvian Savings Bank	9.2	8.6	9.3	9.7	9.6	9.5	9.4	9.0	11.4	11.7	11.4	8.9	20.5
Household credit	31.9	35.0	39.3	42.3	28.1	26.3	25.3	25.0	21.4	23.0	24.9	31.5	36.6
BoL branches	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	25.4	27.3	29.6	32.4	18.5	17.4	17.1	17.4	16.3	17.8	19.8	23.5	26.6
Latvian Savings Bank	6.5	7.7	9.7	9.9	9.6	8.9	8.2	7.6	5.1	5.2	5.1	8.0	10.0
Total credit to private sector	369.1	388.2	390.1	348.9	204.3	196.5	196.4	196.1	211.5	226.4	259.5	306.6	363.9
BoL branches	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	353.4	371.9	371.2	329.3	185.1	178.1	178.8	179.5	195.0	209.6	243.0	289.6	333.4
Latvian Savings Bank	15.7	16.3	18.9	19.6	19.2	18.4	17.6	16.6	16.5	16.8	16.5	17.0	30.5
Memorandum item:													
Enterprise credit/total (in percent)	91.4	91.0	90.0	87.9	86.2	86.6	87.1	87.3	89.8	89.8	90.4	89.7	93.7

Sources: Bank of Latvia; and Fund staff estimates.

Table 42. Latvia: Sectoral Distribution of Credit
(In percent of total)

	1994	1995	1996	1997 Q1	1997 Q2	1997 Q3	1997 Q4
Agriculture	8.5	7.1	7.5	4.6	6.9	7.1	5.7
Manufacturing	15.3	24.6	25.4	29.1	26.4	26.1	27.4
Electricity, water supply	4.9	9.9	9.2	5.5	3.1	5.0	3.7
Construction	8.2	6.1	7.6	6.7	8.2	4.8	3.8
Trade	37.5	33.5	31.6	36.3	30.9	30.6	29.2
Transport and Communication	6.1	6.0	5.4	5.9	12.4	12.9	14.3
Financial intermediation	5.7	1.2	3.5	1.2	1.8	2.8	4.2
Other services	11.5	8.9	7.2	8.5	7.8	8.2	9.2
Other	2.2	2.7	2.7	2.2	2.5	2.5	2.5
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
In domestic currency	37.5	39.7	32.4	...	...	...	...
In foreign currency (incl. G-24 credits)	62.5	60.3	67.6	...	...	...	...
Short-term credits (up to 1 year)	74.2	52.3	44.5	...	...	...	...

Source: Bank of Latvia

Table 43. Latvia: Banking System Indicators, 1994–97

(In millions of lats)

Banking institution	Total Assets							Capital and Reserves							Credit to Private Sector							Deposits from private sector						
	1994	1995	1996	1997				1994	1995	1996	1997				1994	1995	1996	1997				1994	1995	1996	1997			
				Q1	Q2	Q3	Q4				Q1	Q2	Q3	Q4				Q1	Q2	Q3	Q4				Q1	Q2	Q3	Q4
Bank of Latvia	444	0	0	0	0	0	0	3	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Branches of Bank of Latvia	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Commercial banks and other credit institutions	1,072	835	1,105	1,123	1,217	1,399	1,691	140	116	145	156	169	170	188	365	204	212	236	260	307	374	468	315	364	417	438	502	539
Five largest	543	358	489	499	552	662	697	60	42	60	65	70	70	71	185	101	115	145	134	165	198	287	188	230	253	275	308	316
Latvian Savings Bank	77	79	68	73	75	82	89	11	12	15	17	17	17	18	16	19	16	17	16	17	21	58	63	52	53	55	59	69
Unibank	70	95	147	144	167	206	222	9	12	21	21	26	26	26	26	33	48	66	58	73	95	30	50	80	105	107	114	122
Parex	91	108	173	182	182	233	247	7	9	15	15	15	15	15	27	23	29	41	40	49	56	20	35	33	28	27	51	39
Baltija	246	0	...	...	...	...	...	27	–	–	–	–	–	–	90	0	0	0	0	0	0	140	0	0	0	0	0	0
Riga Commercial	59	77	101	101	128	142	138	7	10	10	12	13	13	13	27	26	21	22	20	26	27	40	40	64	67	86	85	86
Other commercial banks and credit institutions	529	477	616	624	665	737	45	81	75	85	91	98	100	117	181	104	96.7	91	126	142	176	181	127	135	163	163	193	223
Of which:																												
Latvia Investment Ba	6	7	12	14	18	22	4	6	6	6	6	5	5	5	1	2	5	6	11	14	17	0	0	0	0	0	0	0
Pawnshops	1	0	...	...	...	...	...	0	0	...	...	...	...	...	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Credit Unions	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0

Source: Bank of Latvia.

Table 44. Latvia: Balance of Payments, 1993-1997

	1993	1994	1995	1996	1997 Prel.
	(In millions of U.S. dollars)				
Current account balance 1/	314	-9	-159	-217	-397
excluding Official transfers	267	-47	-203	-276	-440
Trade Balance 2/	3	-301	-580	-798	-887
Exports, f.o.b.	1,054	1,022	1,368	1,488	1,745
Imports, f.o.b.	-1,051	-1,322	-1,947	-2,286	-2,632
Services,income & transfers balance 2/	311	292	421	581	490
Of which:					
Transport sector, net	247	270	362	533	497
Travel, net		-4	-4	-94	-105
Interest, net	11	7	20	3	12
Other income				39	31
Other services			-28	9	-20
Current Transfers, net	78	64	75	96	70
Capital account balance 2/	186	274	249	566	542
Capital transfers	0	0	0	0	0
Foreign investment, net	51	155	244	376	415
Other medium and long-term capital	98	87	63	61	150
Government and govt. guaranteed, net	98	87	63	46	43
Disbursements	105	107	71	62	112
Repayments	-7	-20	-8	-16	-69
Other, net			0	15	107
Other capital, net	37	32	-57	128	-24
Errors and omissions	-178	-125	-189	-99	93
Overall balance	322	140	-98	249	238
Financing items:					
Change in NFA, total	-293	-151	116	-238	-238
NFA of DMBs	-38	-87	76	-25	-143
Convertible (increase,-)	-38	-85	62	-42	0
Nonconvertible (increase,-)	--	-2	15	17	0
Official NIR (increase,-)	-282	-64	40	-215	-96
Gross convertible reserves	-356	-110	43	-190	-59
Use of Fund credit net	74	46	-3	-25	-37
Nonconvertible NFA, BoL	27	--	-1	2	1
Natural gas arrears	-29	11	-18	-11	--
	(In percent of GDP unless otherwise stated)				
Current account balance	14.5	-0.2	-3.4	-4.1	-6.9
Current account balance, excluding official transfers	12.3	-1.3	-4.3	-5.2	-7.7
Gross official reserves in months of GNFS imports 3/	4.8	4.7	3.0	3.1	3.0
Volume growth of goods exports (in percent)		-29	7	9	13
Volume growth of goods imports (in percent)		19	24	23	13
Volume growth of imports of GNFS (in percent)	17	15	29	25	8
Volume growth of exports of GNFS (in percent)	37	-1	7	26	2
FDI stock	4	7	10	16	22
External debt stock, end of period (in millions of US$)	225	362	429	432	417
External debt stock	10	10	9	8	7
Debt service (as a percent of exports)	1	5	2	4	7

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

1/ Substantial revisions from 1993–97 in merchandise trade and some services data were carried out in January 1998.

2/ Owing to improved data coverage of both trade and services, current account data have been revised from 1995 onwards, resulting in a break in the series.
Information on capital flows suggests that imports may be underestimated in 1993 and that services data in the current account account may include some capital inflows.

3/ Gross reserves in months of imports of goods and nonfactor services.

Table 45. Latvia: Trade Outside the Baltics, Russia, and Other Former Soviet Union Countries, 1993–97

(In percent of total)

	Exports				Imports			
	1993	1994	1995	1996	1993	1994	1995	1996
Europe 1/	83.4	84.5	94.0	91.3	91.3	93.4	90.7	91.0
Belgium	3.6	0.8	1.7	2.0	1.6	1.8	2.2	2.9
Denmark	1.6	2.7	3.8	6.9	3.6	3.7	4.7	6.3
Finland	4.5	4.2	6.1	4.5	8.7	13.1	17.0	14.7
France	1.9	2.5	2.4	2.4	1.9	1.9	2.5	2.5
Germany	14.4	18.4	25.6	26.0	20.4	19.7	25.2	22.2
Italy	2.9	1.7	2.2	2.1	1.7	2.1	3.8	4.2
The Netherlands	17.9	3.3	3.7	3.6	2.2	3.3	5.0	5.6
Poland	6.4	2.8	4.7	2.6	1.6	2.3	3.1	4.1
Sweden	13.7	12.0	17.5	12.3	11.0	9.7	13.1	12.6
United Kingdom	9.9	17.0	17.1	20.9	3.8	4.0	4.4	4.4
Africa	3.6	1.0	1.0	2.9	2.0	0.2	0.2	0.2
Asia and Middle East 1/	10.1	11.3	2.3	4.3	2.8	3.3	3.3	2.5
China	2.3	0.9	0.0	0.2	0.1	0.1	0.2	0.2
Thailand	3.8	1.2	0.1	0.0	0.0	0.0	0.0	0.0
Western Hemisphere	2.9	3.1	2.7	1.5	3.9	2.9	4.4	6.1
United States	1.5	2.1	2.5	1.2	2.9	1.8	3.2	3.4
Australia, Oceania	0.0	0.0	0.0	0.0	0.0	0.2	1.4	0.2
Total (outside BRO)	100	100	100	100	100.0	100.0	100.0	100.0

Source: Latvian authorities.

1/ Excluding the Baltics, Russia, and other former Soviet Union countries.

Table 46. Latvia: Trade with the Baltics, Russia, and Other Former Soviet Union Countries, 1995–97

	In millions of US$			In percent of total				
	1995	1996	1997 1/	1993	1994	1995	1996	1997 1/
Exports								
Estonia	40.6	52.8	48.2	3.8	5.1	6.6	7.8	9.9
Lithuania	72.2	107.3	89.7	8.0	10.9	11.8	15.9	18.4
Russia	330.3	329.7	245.2	55.2	55.3	54.0	48.7	50.2
Ukraine	71.5	89.1	49.1	11.0	11.6	11.7	13.2	10.0
Other BRO	97.4	98.2	56.5	22.0	17.1	15.9	14.4	11.5
Total	612.0	677.1	488.7	100.0	100.0	100.0	100.0	100.0
Imports 2/								
Estonia	91.7	132.1	112.1	6.0	7.4	13.0	15.2	18.5
Lithuania	100.6	146.3	122.2	14.5	12.5	14.3	16.8	20.1
Russia	393.4	468.9	290.9	43.1	49.9	55.9	53.9	51.2
Ukraine	41.8	56.3	40.1	4.5	6.4	5.9	6.9	7.7
Other BRO	76.4	66.9	41.6	10.3	8.0	10.9	7.3	2.5
Energy imports adjustment	0.0	0.0	0.0	21.6	15.8	0.0	0.0	0.0
Total	703.9	870.5	606.9	100.0	100.0	100.0	100.0	100.0

Sources: Central Statistical Bureau of Latvia; and Fund staff estimates.

1/ Data for the first three quarters only.

2/ Import figures for 1993, 1994 are based on upwardly adjusted estimates of energy imports. A large share of the imports are from Russia.

Table 47. Latvia: Trade by HS Commodity, 1994-97

(In percent of total)

	1994	1995	1996	1997 1/
Exports				
Live animals and animal products (I)	3.0	4.6	4.6	3.7
Vegetable products (II)	1.0	0.6	0.4	0.6
Animal, vegetable fats and oils (III)	0.1	0.1	0.1	0.1
Food, drinks and tobacco (IV)	8.8	11.1	11.8	10.3
Mineral products (V)	2.2	2.2	2.6	1.5
Chemicals (VI)	7.4	6.4	6.7	6.2
Plastics and rubber products (VII)	0.9	1.0	0.9	0.9
Hide, skin and leather (VIII)	1.8	1.7	1.4	0.9
Wood and wood products (IX)	20.3	26.4	24.4	30.4
Pulp and paper products (X)	0.8	1.2	2.1	2.6
Textiles and textile articles (XI)	13.2	14.0	16.9	15.8
Footwear; feather/down products (XII)	1.8	0.7	0.6	0.8
Stone, cement and ceramic products (XIII)	1.3	2.0	1.9	1.8
Precious metals (XIV)	0.2	0.2	0.3	0.4
Base metals and base metals products (XV)	10.1	7.9	7.0	8.6
Machinery and electrical equipment (XVI)	9.3	8.7	9.7	8.9
Transport vehicles and parts; vessels (XVII)	10.0	6.4	4.1	2.1
Optical equipment and musical instruments (XVIII)	0.6	0.4	0.4	0.4
Arms and ammunition (XIX)	0.0	0.0	0.0	0.2
Furniture; miscellaneous manufactured goods (XX)	4.5	4.4	4.0	4.0
Works of art and antiques (XXI)	0.0	0.0	0.0	0.0
Other goods	2.7	0.0	0.1	0.1
Total	100.0	100.0	100.0	100.0
Imports				
Live animals and animal products (I)	2.3	1.7	2.0	2.3
Vegetable products (II)	2.9	3.1	4.4	3.7
Animal, vegetable fats and oils (III)	0.4	0.7	0.9	0.9
Food, drinks and tobacco (IV)	5.1	5.4	6.1	7.5
Mineral products (V)	29.4	21.7	22.2	13.6
Chemicals (VI)	10.2	11.3	11.0	11.2
Plastics and rubber products (VII)	2.9	3.8	3.9	4.4
Hide, skin and leather (VIII)	0.4	0.4	0.4	0.4
Wood and wood products (IX)	0.5	0.8	0.5	0.7
Pulp and paper products (X)	3.0	4.5	4.5	4.6
Textiles and textile articles (XI)	5.9	7.8	8.0	7.9
Footwear; feather/down products (XII)	0.8	0.7	0.7	0.7
Stone, cement and ceramic products (XIII)	1.4	1.8	1.9	2.3
Precious metals (XIV)	0.1	0.1	0.1	0.3
Base metals and base metals products (XV)	5.0	6.4	6.4	8.1
Machinery and electrical equipment (XVI)	16.1	17.3	16.8	19.3
Transport vehicles and parts; vessels (XVII)	6.7	8.0	5.9	7.7
Optical equipment and musical instruments (XVIII)	2.4	2.0	2.2	2.0
Arms and ammunition (XIX)	0.1	0.1	0.1	0.2
Furniture; miscellaneous manufactured goods (XX)	1.8	2.4	2.0	2.2
Works of art and antiques (XXI)	0.0	0.0	0.0	0.0
Other goods	2.6	0.0	0.0	0.0
Total	100.0	100.0	100.0	100.0

Source: Latvian authorities

1/ Data for first three quarters only.

Table 48. Latvia: Domestic Arrears in the Energy Sector, 1993–97
(In millions of lats)

	Natural Gas	Electricity	Heating and Hot Water	Total	Percent of GDP
1993					
December	37.1	53.0	26.9	117.0	8.0
1994					
March	47.2	69.9	42.4	159.5	10.1
June	46.9	59.6	40.7	147.2	8.6
September	44.5	52.2	39.3	136.0	7.3
December	48.7	70.1	45.1	163.9	8.0
1995					
March	65.6	82.4	52.8	200.8	9.2
June	54.1	79.6	50.6	184.3	8.0
September	54.8	69.1	51.1	175.0	7.3
December	59.4	48.5	52.3	160.2	6.4
1996					
March	65.9	60.4	39.4	165.7	6.4
June	61.0	56.5	33.4	150.9	5.6
September	57.5	53.9	34.3	145.7	5.1
December	59.4	48.7	35.0	143.1	4.9
1997					
March	15.4	57.8	57.7	130.9	4.3
June	19.4	43.4	46.9	109.7	3.5
September	11.7	40.0	42.7	94.4	2.9

Source: Latvian authorities.