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November 24, 1993

To: Members of the Executive Board

From: The Secretary

Subject: Republic of Latvia - Request for Stand-By Arrangement and Purchase Under the Systemic Transformation Facility

Attached for consideration by the Executive Directors is a paper on Latvia's request for a stand-by arrangement in an amount equivalent to SDR 22.875 million and for a request expected to be received for a purchase under the systemic transformation facility, which is proposed to be brought to the agenda for discussion on Wednesday, December 15, 1993. Draft decisions appear on page 20.

Mr. Hansen (ext. 37186) or Mr. Lahiri (ext. 38864) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Preparation Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the Commission of the European Communities (CEC), the European Investment Bank (EIB), and the Organisation for Economic Cooperation and Development (OECD), following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

Request for Stand-By Arrangement and Purchase under the Systemic Transformation Facility

Prepared by the European II Department
(In Consultation with other Departments)

Approved by John Odling-Smee and Anoop Singh

November 23, 1993

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I. Introduction

In a letter dated November 22, 1993 and accompanying Memorandum of Economic Policies, the Latvian authorities request a 15-month stand-by arrangement, covering a program period October 1, 1993 to December 31, 1994, in the amount of SDR 22.875 million, equivalent to 25 percent of quota. The authorities also intend to request two purchases under the Systemic Transformation Facility (STF), each in an amount equivalent to SDR 22.875 million. 1/

Discussions on the new economic stabilization and reform program to be supported by the requested use of Fund resources were initiated in Riga during July 14-27, 1993 in connection with the staff visit to confirm compliance with the June 30, 1993 performance criteria under the previous stand-by arrangement. These discussions were continued during visits to Riga over the periods September 9-17, and October 20-29, 1993. 2/ The Latvian representatives included the Prime Minister, the Minister of Finance, the Minister of the Economy, the Governor of the Bank of Latvia and senior officials from these as well as other ministries and institutions. The mission also met with members of Parliament. Mr. Solheim, Alternate Executive Director for Latvia, participated in some of the meetings in July, while Mr. Fridriksson, Executive Director for Latvia, participated in some of the meetings in September.

Latvia became a member of the Fund on May 19, 1992. 3/ On September 14, 1992 (EBM/92/118), the Executive Board approved a 12-month stand-by arrangement in the amount of SDR 54.9 million (60 percent of quota). Progress under the arrangement was reviewed by the Board on December 23, 1992 (EBM/92/156), April 23, 1993 (at which time the first Article IV consultation was also completed, EBM/93/62) and June 30, 1993 (EBM/93/91). The request for a waiver for the nonobservance of the performance criterion for end-June 1993 with respect to reserve money was granted by the Board on August 25, 1993 (EBM/93/117). Latvia purchased the total amount available under the arrangement. Latvia continues to avail itself of the transitional arrangements of Article XIV, Section 2.

1/ The schedule of purchases and the projection of the IMF position during the stand-by period are shown in Tables 1 and 2, and the performance criteria under the arrangement in Table 3. Eligibility for the use of the STF is described in Appendix IV.

2/ The missions included Messrs. Hansen (head), Lahiri and Richards (all EUR II), Mr. Jaeger (FAD), Mr. Phillips (PDR) and as administrative/staff assistants Ms. Roberts, Ms. Alder and Mrs. Roller (all EUR II). Ms. Suss, the resident representative, assisted the missions. Ms. Castello-Branco (EUR II) participated in the October mission.

3/ Latvia's relations with the Fund are described in Appendix I.

Latvia's reform efforts are being supported by financial assistance from the World Bank, including an import rehabilitation loan in the amount of US$45 million. World Bank activities in Latvia are described in Appendix II.

The Fund is continuing to provide technical assistance in its area of expertise (Appendix III). Technical assistance is also provided from other multilateral sources (in particular by the World Bank and the EC/PHARE) and from bilateral sources. Some of this assistance is now being provided in the form of posting short-term and long-term resident advisors in Latvia. It is the intention to increasingly use this form of assistance, which appears to improve the capacity of the authorities to absorb such assistance. To improve the overall coordination, the authorities have transferred the responsibility for technical assistance to the Ministry of Finance.

II. Political Developments

General elections, the first since Latvia regained independence in the autumn of 1991, were held in June 1993. A new minority coalition government headed by the Latvian Way, the largest party with 36 seats in the 100 seat Parliament, took office on August 3, 1993. The Farmers' Union with 12 seats is the junior coalition partner. The number of ministries in the new Government was reduced significantly and branch ministries were abolished. Eleven of the fourteen ministerial posts, including those of the Prime Minister, the three Deputy Prime Ministers, the Foreign Minister, and the Minister of Finance, have gone to the Latvian Way. The Farmers' Union is in charge of the Ministries of Agriculture, Welfare, and Environment and Regional Development. The reorganization of ministries had an initial disruptive impact on the working of the Government. In the months following the elections, the uncertainty and lack of clear definition of responsibilities of the individual ministries delayed the implementation of many of the Government's initiatives.

III. Performance under the 1992/93 Stand-By Arrangement and Recent Economic Developments

1. Economic developments 1/

The economic program launched in mid-1992 in the midst of high inflation focused primarily on macroeconomic stabilization. A key element of the program was the introduction of a national currency in July 1992, which enabled the Bank of Latvia to pursue an independent monetary policy. The Bank of Latvia, which by law had been granted a large degree of

1/ Tables 4 and 5 contain selected economic, financial and social indicators.

independence, subsequently implemented a tight monetary policy which was supported by a broadly balanced general government budget and complemented by a tax-based incomes policy. As a result of these policies, inflation was brought down rapidly, from a monthly rate of 20 percent in July to less than 3 percent in December 1992 (Chart 1). Since then, average monthly inflation has remained in low single digits--less than 1/2 percent per month over the five months ended August 1993. Inflation picked up somewhat in September and October, reflecting seasonal factors, administrative price adjustments and tax measures--implemented or anticipated--and the significant appreciation of the Russian ruble during the summer.

The negative impact of the terms of trade shock associated with the rise of energy prices to near world market levels and continuing disruptions in trade with the states of the former Soviet Union (FSU) turned out to be more severe than anticipated. Following a decline of 34 percent in 1992, real GDP is estimated to have contracted by a further 13 percent in the first three quarters of 1993. Initially, the decline in economic activity had little impact on employment, but with a gradual hardening of the budget constraint faced by enterprises the rate of open unemployment has more than doubled since end-1992 to about 5 1/2 percent of the labor force at end-September 1993 (Chart 2). No incomes policy measures have been applied since mid-1993. Following sizable declines in 1991 and 1992, average real wages in the public sector have recovered somewhat in recent months. Nevertheless, real wages were by the third quarter of 1993 about 12 percent below their 1991 average.

The balance of payments for 1992 turned out to be significantly different from what had been envisaged under the program. Instead of a sizable deficit, a current account surplus equivalent to about 4 percent of GDP was recorded, and a surplus on the same order of magnitude is estimated for the first three quarters of 1993 (Chart 3). A shift in exports toward nontraditional markets has taken place over this period. As a result of the current account surpluses, unidentified capital inflows and the disbursement of balance of payments support loans, including purchases under the stand-by arrangement, the import coverage of gross official reserves rose to about four months by the third quarter of 1993.

2. Financial policies

a. Fiscal policy

The Government followed a cautious fiscal policy throughout the program period. After some financial strains toward the end of 1992, following the introduction of a flat-rate heating allowance for pensioners, the general government deficit was kept below 1 percent of GDP for the year as a whole (Table 6). After a lengthy debate, the 1993 budget was adopted in late March 1993. Although a small surplus was projected for the year as a whole, for several reasons it was widely recognized that a supplementary budget would be needed following the elections. On the expenditure side, the budget froze nominal pensions and public wages at end-1992 levels. The revenue projections for some tax categories, in particular excise taxes and customs duties, were based on fairly optimistic assumptions. Finally, the budget projected a substantial but uncertain repayment of loans extended to enterprises in 1992 in connection with the build-up of strategic food and energy reserves.

In the event, a higher-than-expected general government fiscal surplus--of about 1 1/2 percent of GDP--was recorded in the first three quarters of 1993. While some of the adverse factors materialized, they were overcompensated by several favorable developments. As expected, repayments of loans for the build-up of strategic reserves as well as excise tax and customs revenues lagged considerably behind budget projections. On the other hand, VAT and in particular profit taxes overperformed by large margins. In the case of the VAT, the change in the accounting law from cash to accrual basis as well as administrative improvements, including collection of VAT on imports at the border, produced significant results. As regards profit taxes, a large portion of the unexpectedly buoyant revenues can be traced to highly profitable re-exports of goods imported from other FSU countries. At the same time, expenditures on pensions and public wages in the first three quarters of 1993 were executed roughly as projected in the budget, but outlays for supplies and maintenance and investment were kept below budgeted levels. Finally, measured unemployment rose much more slowly than projected, resulting in substantial savings on expenditures related to unemployment benefits and active labor market measures.

The favorable budget outcome in the first three quarters of 1993 allowed the Government to stay well below the credit limits agreed with the Bank of Latvia, and to fully repay foreign currency loans taken from state enterprises in 1992. The Government was also able to clear most of the payments arrears stemming from the heating voucher system for nonworking pensioners applied for the previous heating season.

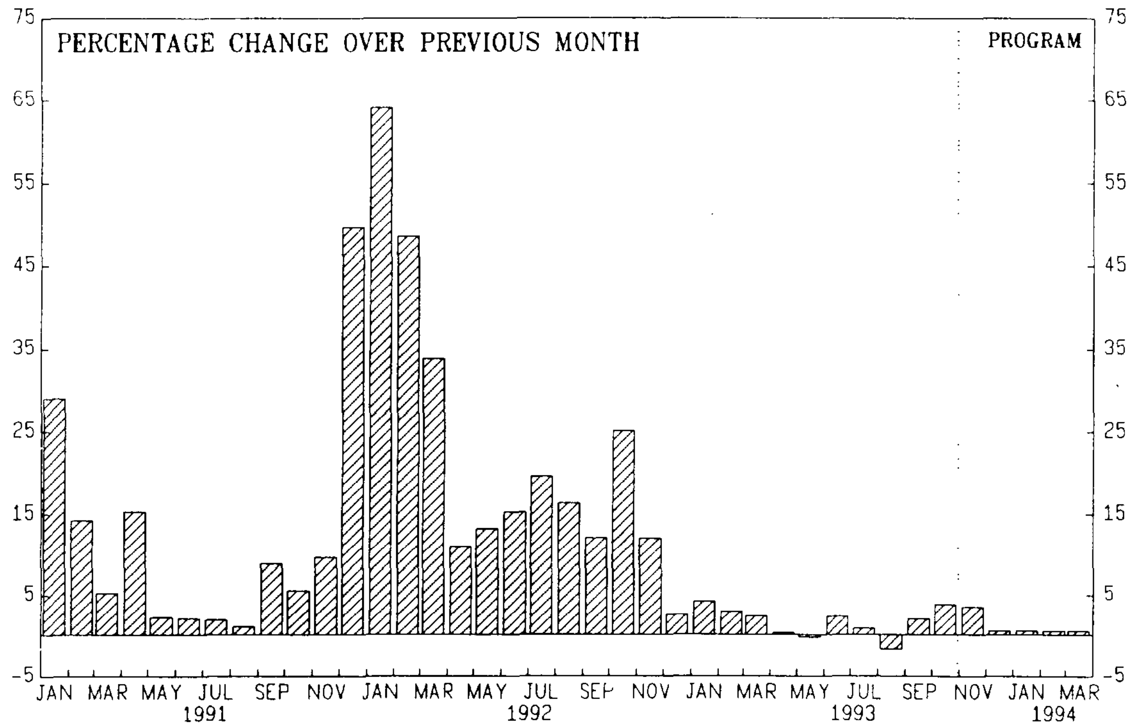
b. Monetary policy

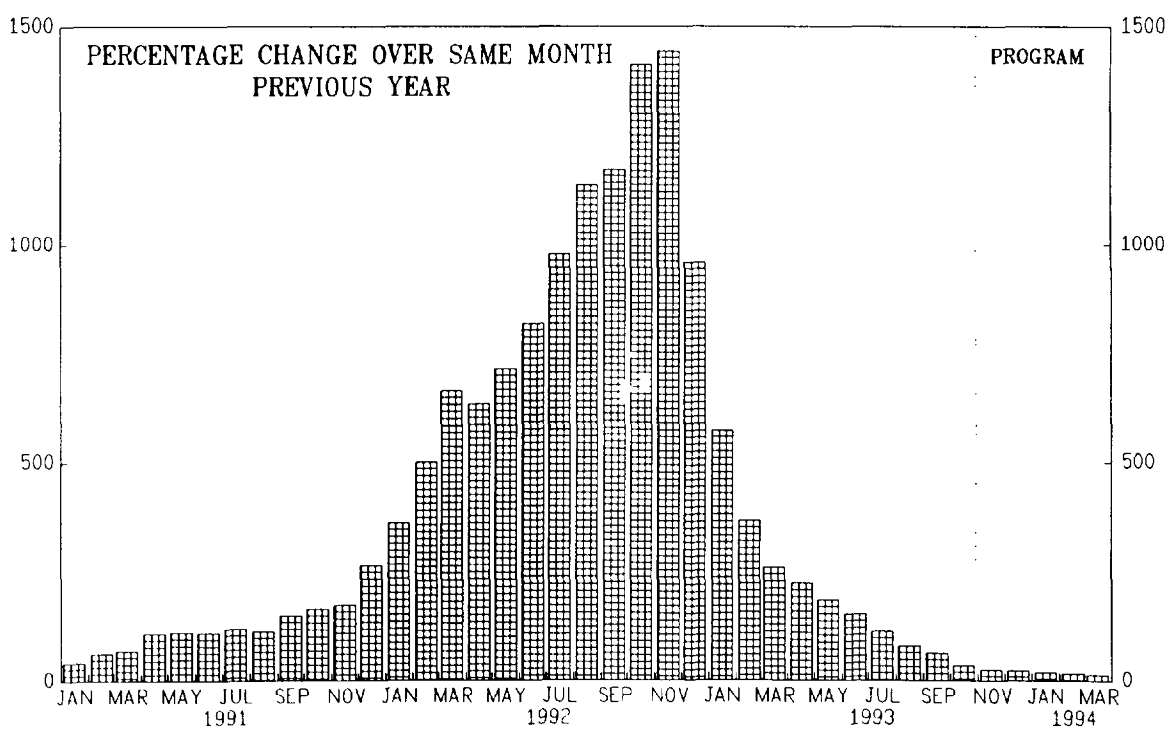
The pursuit of a tight monetary policy since mid-1992, in combination with a possibly under-valued currency, led to a sizable inflow of convertible currency to the Bank of Latvia, particularly in 1993. The Bank, out of concern for stability and Latvia's external competitiveness, was unwilling to allow the higher demand for domestic currency to be fully reflected in a rapid appreciation of the exchange rate. The Bank did allow the exchange rate to appreciate significantly in nominal terms against convertible currencies during the first three quarters of 1993, but gross international reserves almost quadrupled, from about US$100 million in mid-1992 to more than US$400 million at end-September 1993. To bring downward pressure on market interest rates and thus stem the foreign currency inflow, the Bank of Latvia gradually reduced the monthly interest rate on its refinancing facility, from 10 percent at end-1992 to 2 1/4 percent from October 21, 1993. It also countered a large part of the liquidity impact of such inflows by sharply limiting credit to banks.

CHART 1

LATVIA

INFLATION IN CONSUMER PRICES



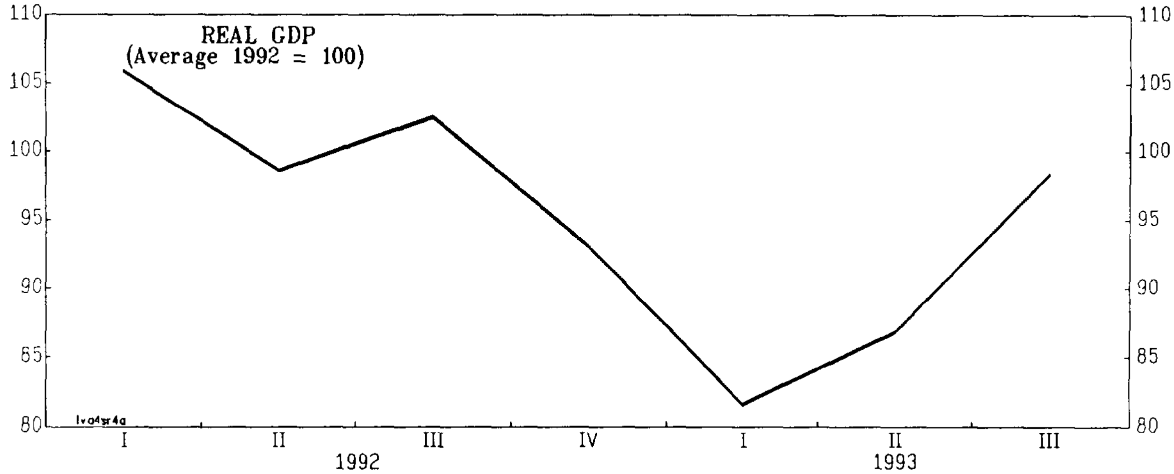


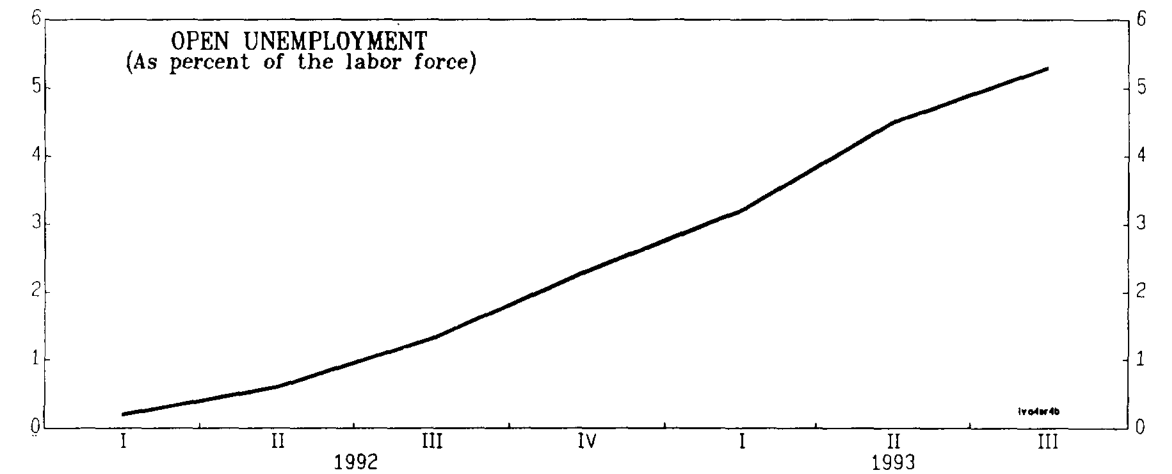
Source: Data provided by the Latvian authorities.

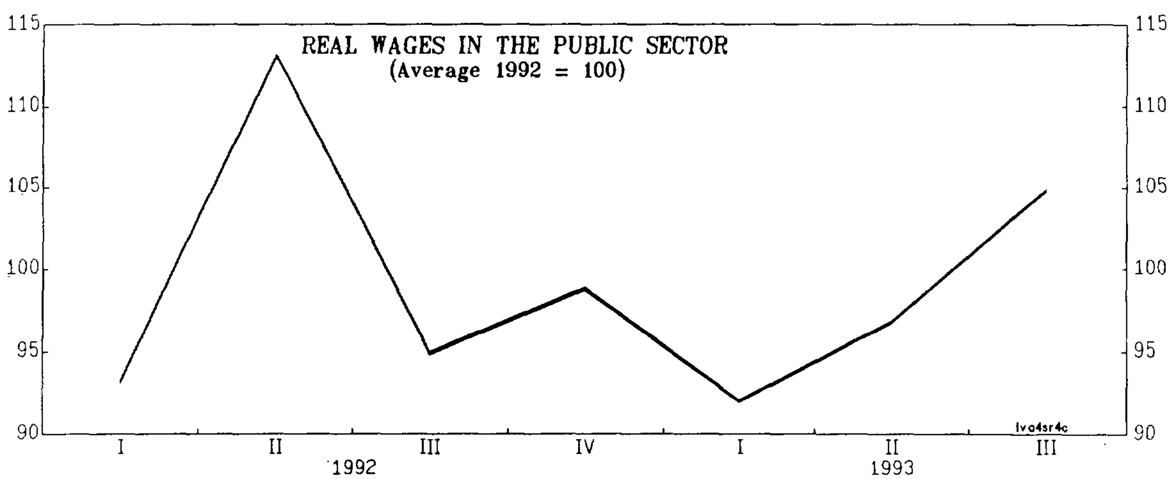
CHART 2

LATVIA

MACROECONOMIC INDICATORS





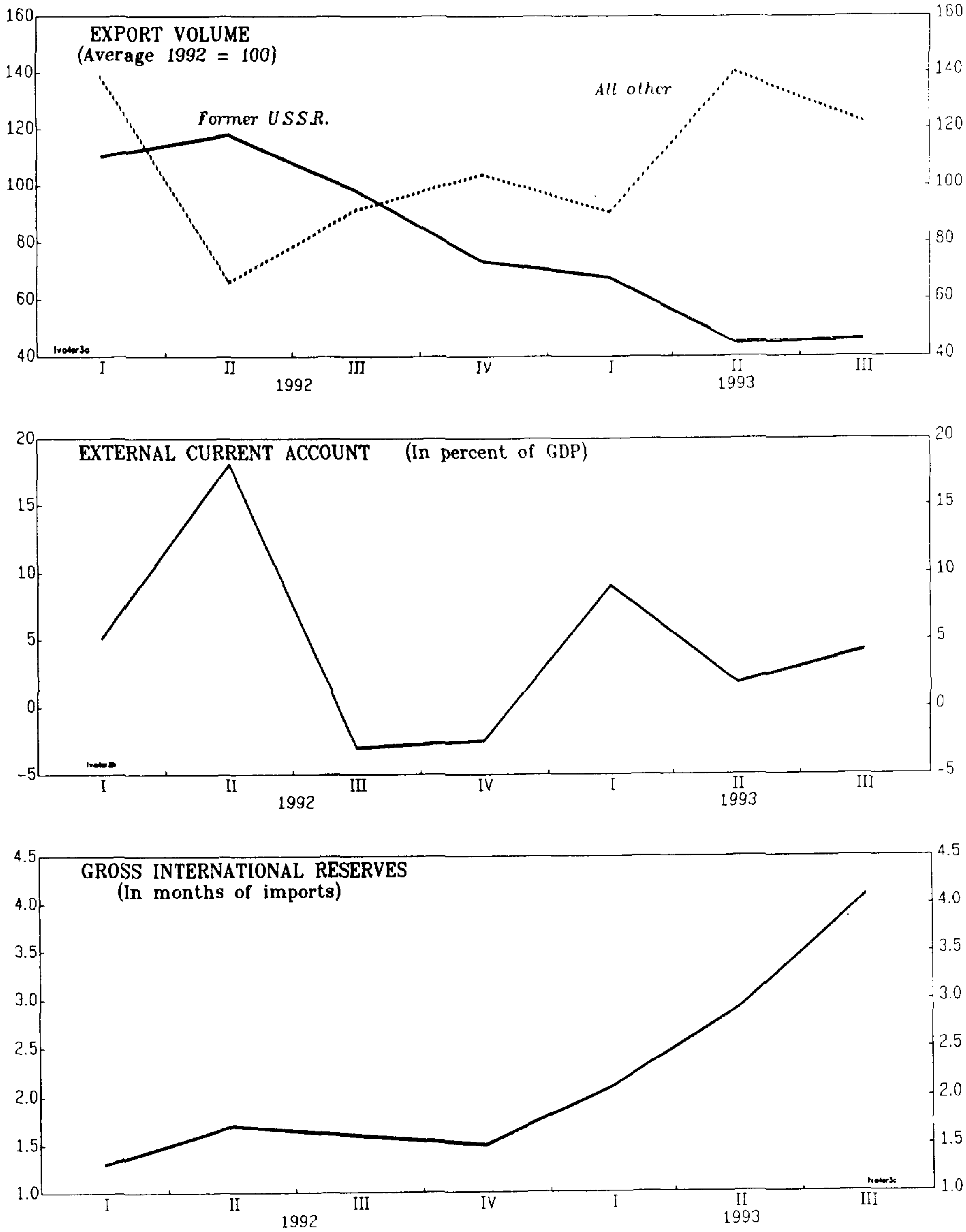


Sources: Data provided by the Latvian authorities; and staff estimates.

CHART 3

LATVIA

EXTERNAL INDICATORS



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

Nevertheless, reserve money increased substantially during the first half of 1993, in the second quarter by 33 percent (Table 7 and Chart 4). Reserve money growth slowed to about 10 percent in the third quarter.

Broader monetary aggregates have risen considerably during 1993 (Table 8). The declining trend in velocity observed since mid-1992 continued through the third quarter of 1993, partly reflecting very high real interest rates offered by banks on both domestic and foreign currency deposits, and the normal process of remonetization after a period of high inflation and a reversal of inflationary expectations. After declining through the first half of 1993, the money multiplier increased significantly in the third quarter. The currency-to-deposit ratio rose markedly during the first half of 1993--possibly as a result of the substitution of the previously circulating and unmeasured foreign currency by domestic currency--but stabilized in the third quarter as this process may have slowed or come to a halt. The reserves-to-deposit ratio was influenced by the several changes made to the reserve requirements during the year. New regulations came into effect from the beginning of 1993, with differentiated rates ranging from 12 percent for deposits with maturity less than one month to none for those with maturity over a year. These regulations were, however, found to be unnecessarily complicated and the reserve requirements were changed to a uniform 8 percent rate for all deposits from July 1, 1993. This may have contributed to the decline in the reserves-to-deposit ratio in the third quarter. At the same time, it appears that the improved efficiency of the payments system has enabled banks to reduce the level of their excess reserves.

3. External policies

Since late 1992, the exchange market intervention policy of the Bank of Latvia has been guided by the consideration that, while there was a need to moderate the liquidity impact of the inflow of foreign reserves, part of this inflow reflected a stronger-than-anticipated recovery of the demand for money--as indicated by the inflation performance--and should be accommodated. Also, the Bank was concerned that sharp changes in the exchange rate would be unsettling for the market and might have an adverse impact on Latvia's international competitiveness. As a result of this policy, the exchange rate of the domestic currency vis-à-vis the U.S. dollar has, despite significant intervention, appreciated over the past year--and rather significantly in real terms (Chart 5). Nevertheless, average wages remain less than US$100 per month, or still competitive by Eastern European standards, but among the highest of the FSU states. Against the ruble, the rate has fluctuated very strongly in real terms. The collapse of the ruble in the autumn of 1992 severely eroded competitiveness of Latvian producers vis-à-vis other FSU markets; however, in recent months the ruble has strengthened and the real rate of the Latvian currency has moved back toward the level prevailing in mid-1992.

The payments system with other FSU states through correspondent accounts functioned without any large accumulation of balances during the first three quarters of 1993. Following the mandatory conversion of all accounts and prices into lati from June 28, 1993, the Bank of Latvia initiated discussions with other FSU central banks about clearing up outstanding balances in the now inoperative, pre-July 20, 1992 correspondent accounts.

Since mid-1992, Latvia has maintained a fairly liberal trade system, with virtually no import tariffs on raw materials, spare parts, and capital equipment, and tariffs of 15-20 percent on most finished products. Also, few quantitative restrictions have existed on international trade since mid-1992. However, the unsettled situation--and in many cases heavy subsidization of goods--in neighboring countries, led the Latvian authorities to impose protective tariffs, mainly on agricultural goods, in December 1992 and April 1993. Remaining export taxes apply mostly to products of wood, metal and leather.

4. Structural policies

Considerable progress was made in initiating institutional and legislative changes. The price liberalization process, which was started in early 1991, advanced with vigor and was virtually completed by late 1992; the only prices that remain regulated are those of utilities and rents. In this connection, it is noteworthy that the deceleration in inflation was brought about simultaneously with price liberalization. While privatization of large-scale enterprises proceeded slowly, considerable progress has been made in land restitution and privatization of small-scale enterprises. A small number of inefficient state enterprises have been liquidated. A two-tier banking system has been created and steps taken to restructure and privatize the former commercial branches of the Bank of Latvia.

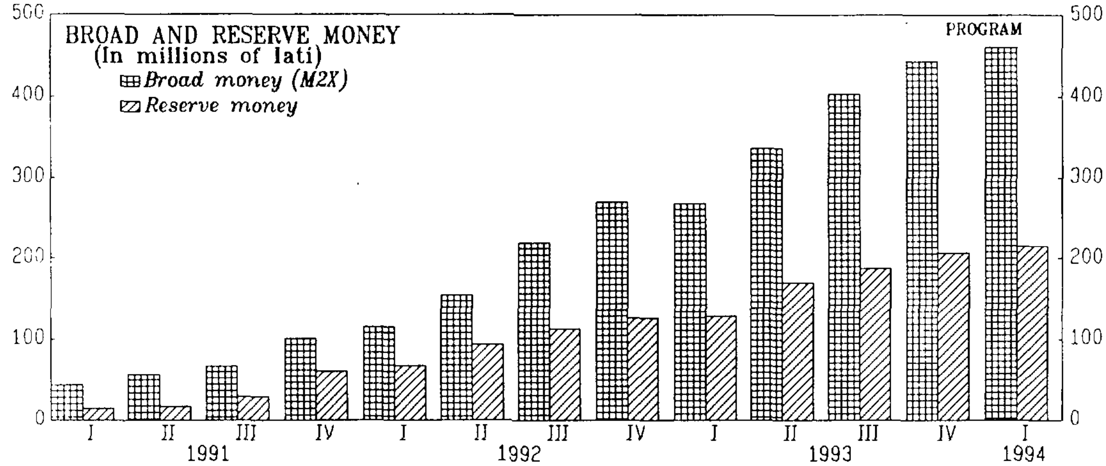
IV. Policy Discussions and the 15-Month Program Through December 1994

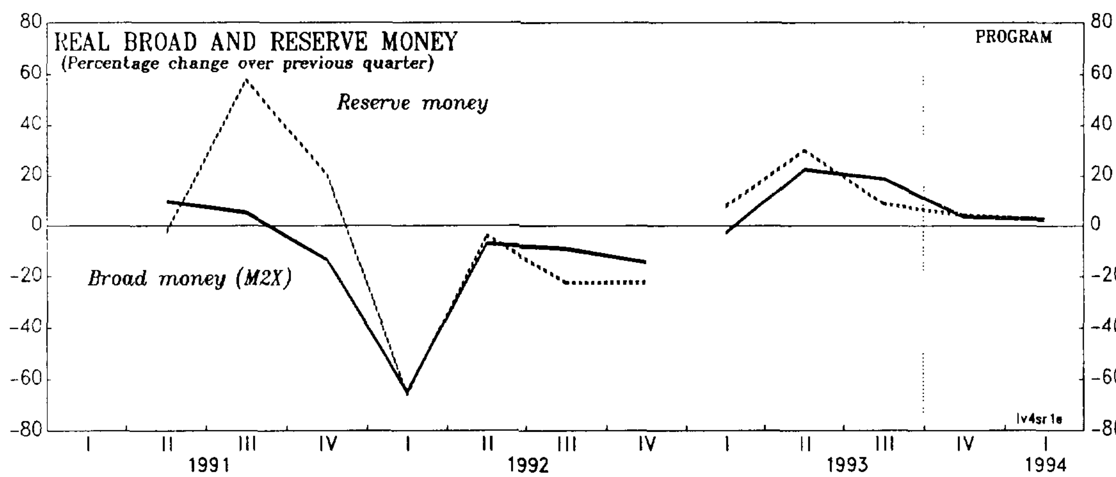
The new Government is fully committed to continue the basic features of the economic program supported by the previous stand-by arrangement. The authorities stressed, however, that while they recognized the need for continued macroeconomic stabilization, their efforts would increasingly focus on reinforcing the reform process within a medium-term perspective. It is within such a framework that the Government has formulated its economic policies for the period October 1, 1993-December 31, 1994. The main objectives of this program are to consolidate the gains achieved so far and to create the basis for sustained growth with a viable balance of payments, while keeping the underlying average monthly rate of inflation at about 1/2 percent through the program period. To achieve these goals, the program envisages: (i) continued restrained fiscal policies; (ii) firm monetary policies; (iii) rationalization of the trade regime; and (iv) a speeding up of the structural reform efforts, particularly in the area of privatization.

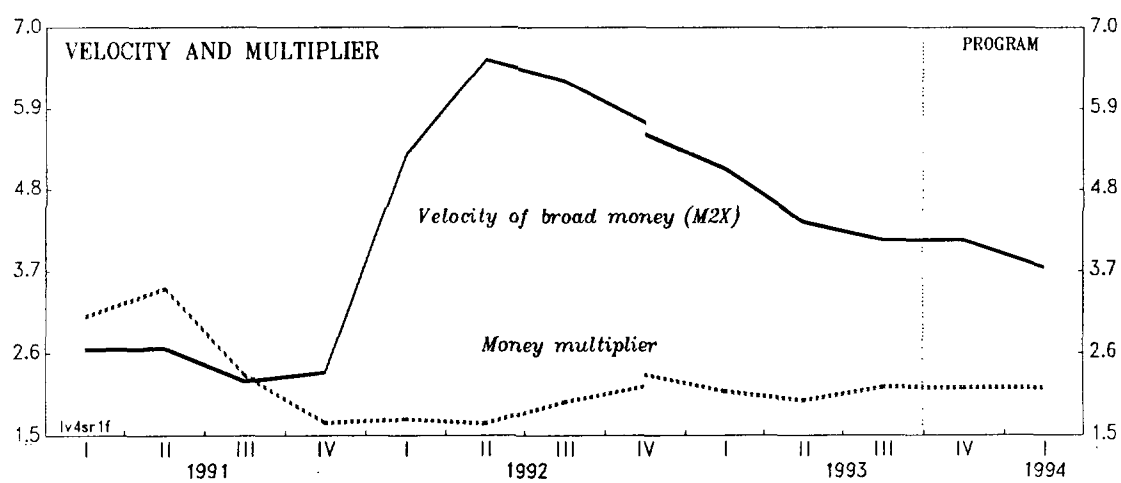
CHART 4

LATVIA

MONETARY INDICATORS





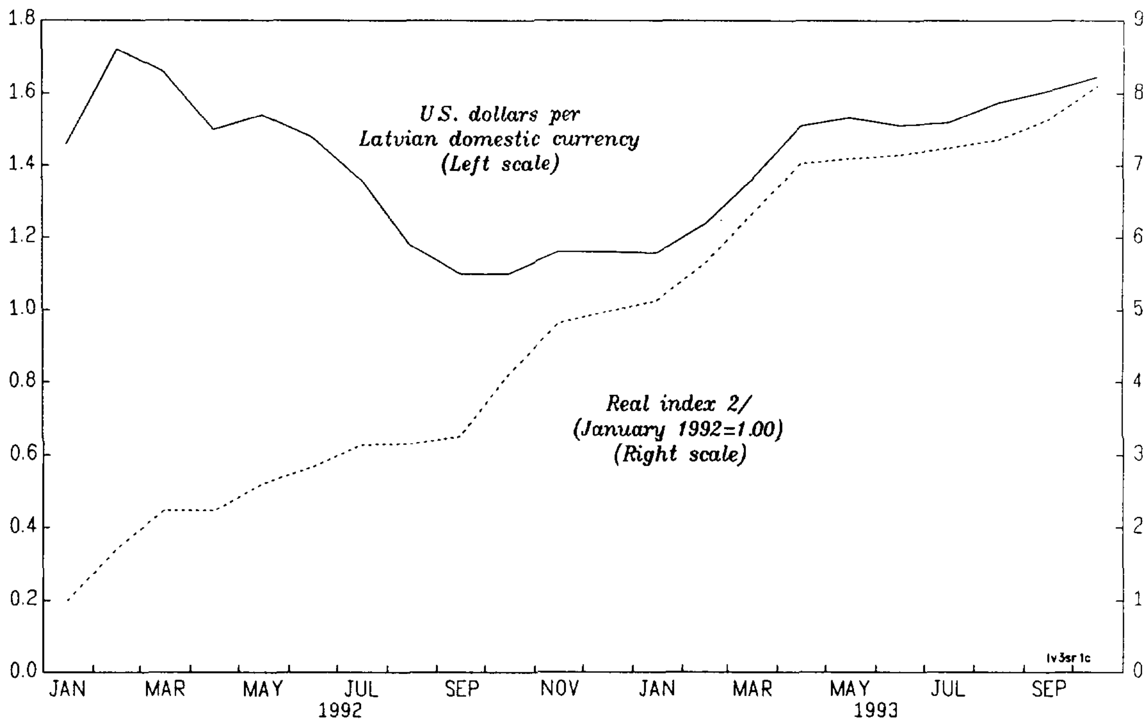


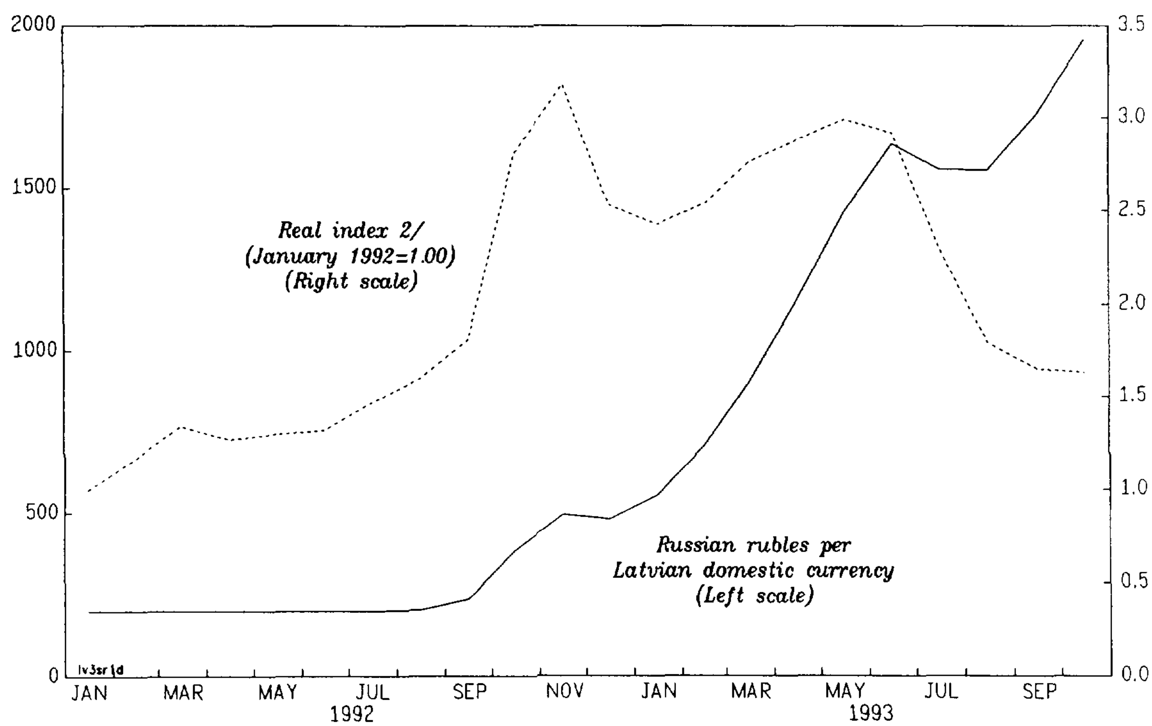
Sources: Data provided by the Latvian authorities; and staff estimates.

CHART 5
LATVIA

NOMINAL AND REAL EXCHANGE RATE DEVELOPMENTS 1/

(January 1992 - October 1993)





Sources: Data provided by Latvian authorities, and staff estimates.
1/ Nominal exchange rates based on monthly average of mid-points of private dealer's buying and selling rates.
2/ Based on relative movements in consumer prices from January 1992.

1. The macroeconomic setting

Macroeconomic developments in Latvia remain difficult to interpret, since key indicators are often subject to sizable revisions. 1/ The State Committee for Statistics has recently revised the national accounts figures for 1992, resulting in significantly higher estimates of the price deflator and nominal GDP. However, these revisions have not yet been taken adequately into account in the national accounts figures published by the Committee for the first three quarters of 1993. These data appear to be seriously flawed, in particular as regards estimates of GDP at constant prices, when compared with other economic indicators such as retail sales, tax revenues and real monetary aggregates, all of which point to a much stronger economy than pictured by the official national accounts statistics. Accordingly, the staff has prepared alternative estimates for 1993. These estimates were broadly accepted by the authorities, although with some reservation about the staff's projection of a pick up in activity during 1993 and in 1994.

According to staff estimates, the decline in real GDP may slow to 10 percent in 1993, and positive growth--perhaps as much as 5 percent--could be attained in 1994 (Table 4). The estimate for 1994 is based on the assumption that the economy can productively absorb the rather large amount of foreign financing that is expected to become available in the last quarter of 1993 and in 1994. On these assumptions, the external current account would move into deficit in the last quarter of 1993, although a surplus equivalent to 1 percent of GDP would be recorded for 1993 as a whole, and turn into a deficit equivalent to 7 percent of GDP in 1994. The implied shift in the savings-investment balance may be difficult to achieve, but the recent experience with disbursement of EC/G-24 loans is encouraging in this respect. The demand for such funds now exceeds the supply, and all such funds have recently been disbursed through the banking system without government guarantees, indicating a pick-up in investment activity.

2. Fiscal policy and social safety net

a. Fiscal policy

There is little doubt about the Government's commitment to a continued tight fiscal policy. However, as a minority Government influenced by agricultural interests, it has needed time to muster support for the necessary measures to put the fiscal situation on a sounder footing for the

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1/ The limitations posed by the lack of timeliness and accuracy of economic data for efficient monitoring and policy formulation is expected to improve over time with the enforcement of the new Statistical Law enacted in June 1993, which grants the State Committee for Statistics enhanced authority to collect data. The posting of a Resident Statistical Advisor from the Fund in Latvia is also expected to contribute to the improvement of statistical information.

remainder of 1993 and beyond. Thus, intensive negotiations were needed before the supplementary budget for 1993 was passed by Parliament on October 28, 1993.

As detailed below, despite a number of expenditure measures, including increases in pensions and public sector wages, the revenues expected from the tax package passed on October 14 are estimated to be sufficient to limit the general government financial deficit to about 1/2 percent of GDP for 1993 as a whole (Table 6). The authorities intend to limit the financial deficit of the general government to no more than 2 percent of GDP in 1994. A budget proposal to achieve this will be presented to Parliament in late November. Taking net lending operations into account, the general government's total borrowing requirement is tentatively programmed to be about 1 3/4 percent of GDP in 1993 and 4 1/2 percent of GDP in 1994. Fiscal performance criteria for the periods from October 1, 1993 to December 31, 1993 and March 31, 1994, respectively, have been established for the financial deficit and for net lending plus government guarantees for loans to enterprises (Table 3). 1/ The authorities plan to finance part of the deficit in the last quarter of 1993 and in 1994 through the issuance of Treasury bills, and part of investment expenditures from external sources (including EC/G-24 loans). In the event of external financing shortfalls, the authorities do not intend to replace such financing by borrowing from domestic sources.

To put public finances on a more sustainable medium-term basis, Parliament passed a comprehensive tax package on October 14, 1993, which significantly improves the revenue outlook for the rest of 1993 and beyond. The standard VAT rate was increased from 12 percent to 18 percent, and the reduced VAT rate for food products from 6 percent to 10 percent, effective November 1, 1993. On June 1, 1994, the reduced VAT rate on food is scheduled to be increased to the standard rate of 18 percent, but as a concession to agriculture, subsidies in the amount of Ls 1.1 million per month will be paid to this sector from then on. Also from November 1, 1993, excise taxes of Ls 0.04 per liter of gasoline and Ls 0.02 per liter of diesel and of 10 percent on cars were introduced. The Government has also taken determined steps to improve the administration of taxes on goods and services. Besides improving tax collection at the border and clamping down more forcefully on tax evasion on the basis of new penal codes, the restructured tax administration department plans to computerize VAT and excise tax collection. Some uncertainties remain with respect to customs revenue in 1994. The introduction of a low but effectively administered across-the-board customs tariff in the context of the scheduled overhaul of the tariff regime could provide some additional revenue for the 1994 budget.

For the 1994 budget, the Government also plans to unify the profit tax rate in the range of 25-35 percent and to abolish some of the profit tax

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1/ See Appendix V for a discussion of the motivation for the establishment of these performance criteria.

preferences. As regards income taxes, Parliament has passed a new income tax law that replaces the current graduated income tax schedule with a flat-rate tax of 25 percent coupled with a surcharge of 10 percent on annual income. The new income tax system will allow for deductions tied to the family situation of the tax payer. It is expected that the impact of these reforms will be revenue neutral, or result in only a small decline in revenue.

Average nominal pensions and wages in budgetary organizations have remained basically unchanged since the end of 1992, resulting in a significant erosion in real terms. As part of the supplementary budget passed on October 28, average pensions were increased by about 50 percent, effective November 1, 1993, to about Ls 23 (US$38) per month. A provisional pension scheme--which will expire in March 1994--formally links pensions to the work history of the beneficiary and average wage growth in the economy. It is the plan to adopt a more permanent pension scheme early next year. Wages in budgetary organizations were also increased effective November 1, 1993, by about 25 percent. A more differentiated wage scale was introduced to mitigate the problems in recruiting and retaining qualified staff in view of the widening wage differential between employees in budgetary organizations and the emerging private sector.

The 1994 budget is expected to include interest payments to the State Savings Bank on the Ls 23 million of impaired claims guaranteed by the Government. However, the budgetary implications of cleaning up the nonperforming assets in the rest of the banking system have not yet been determined. The World Bank is currently assisting the authorities in drawing up a public investment program for 1994. The tentative projections assume that public investment will increase from 3/4 percent of GDP in 1993 to about 2 percent of GDP in 1994.

The Government plans to strengthen further the institutional arrangements for planning and executing fiscal policy. With technical assistance from the Fund, the nucleus of a functioning Treasury has been established in the Ministry of Finance. Banking arrangements have been streamlined, daily reports on balances on government accounts are being produced, and expenditure processing has been computerized. A new budget law giving a clear budget management mandate to the Ministry of Finance is currently under consideration and will, if passed in a timely manner, be applied in the execution of the 1994 budget. The Ministry of Finance will adopt new analytical presentations of the budget to improve monitoring and reviewing of its macroeconomic impact.

b. <u>Social safety net</u>

Pensioners form by far the largest group in need of support during the current process of transition to a market economy. While the increase in average monthly pensions from November 1, 1993 has improved the financial situation of pensioners, the concurrent sharp increases in VAT rates and the removal of remaining ceilings on heating and hot water supply prices will erode at least some of the nominal gains from the pension increase. In a distinct change from social safety net policies during the last heating season, support payments to cover heating costs of needy persons, including pensioners, will be provided on a means-tested basis through the social assistance network at the local government level. The reform of the current system of universal children allowances in the context of the income tax reform will require additional social assistance payments to poor families with children unable to claim the income tax deductions envisaged in the income tax law.

The outlook for unemployment in 1994 remains highly uncertain, with unemployment rate projections ranging from as low as 8 percent to as high as 20 percent; the tentative budget projections for 1994 assume an unemployment rate of about 15 percent. Reflecting these uncertainties as well as the significant steps toward a system in which means-tested social benefits play a larger role, the central government plans for the 1994 budget include social assistance payments equivalent to about 1 3/4 percent of GDP, up sharply from about 3/4 percent of GDP in 1993.

3. Monetary policy and structural issues in the financial sector

a. Monetary policy

The monetary authorities are currently struggling with two key issues. First, how to minimize--given the limited instruments available--the liquidity impact of the continued inflow of convertible currency to the Bank of Latvia, and, second, how to bring downward pressure on market interest rates, which have remained very high despite the sustained decline in inflation and the significant reduction in interest rates charged by the Bank of Latvia.

As regards the first issue, the authorities not only recognize the endogenous nature of monetary aggregates--both reserve and broad money--in a managed exchange rate regime, and in particular their dependence on international flows of funds, but also the sensitivity of such aggregates to changes in the demand for money. Nevertheless, they are concerned about any build-up of inflationary potential, and intend to continue with reserve money targeting until they are fully convinced that inflationary expectations are consistent with the medium-term inflation target.

The monetary program for the fourth quarter of 1993 and the first quarter of 1994 is based on the inflation and growth projections referred to earlier. Velocity of broad money, which has dropped sharply this year, is expected to decline further--in the first quarter of 1994 partly for seasonal reasons (Chart 4). The reserve money multiplier is programmed to remain at the level observed at end-September 1993. On those assumptions, broad money including foreign currency deposits and reserve money are both expected to grow by about 10 percent during the fourth quarter of 1993 and 4 percent during the first quarter of 1994 (Tables 7 and 8).

The ceilings on reserve money for end-December 1993 and end-March 1994 are performance criteria. They have been established on the basis of some overperformance of net convertible international reserves (excluding the unutilized part of EC/G-24 loans) in excess of the floor established on such reserves in the program, and will be adjusted downward should such an overperformance not materialize. Conversely, the ceilings will be adjusted upward for any excess up to US$20 million, from the programmed increase in net convertible international reserves. The net domestic assets of the banking system for end-December 1993 and end-March 1994 are indicative ceilings under the stand-by arrangement. While net domestic assets are programmed to grow moderately, credit is expected to expand sharply--17 percent during the fourth quarter of 1993 and 14 percent during the first quarter of 1994--largely as a result of the anticipated utilization of balance of payments loans.

Concerning the second issue referred to above, the authorities view the very high market interest rates, in spite of the favorable movements in inflation and the exchange rate, as a reflection of the preference of commercial banks to engage in short-term activities. Particularly important in this respect is the financing of traders who earn very large rates of return by buying goods subject to price controls in Russia and other FSU states and re-exporting them to non-FSU markets. Normal business activities with a longer production cycle, including agriculture, generally cannot afford to pay such high interest rates, and commercial banks do not appear to be interested in financing this kind of business. These particular market conditions are unlikely to disappear until price subsidization ceases in FSU countries. The authorities intend to follow a two-pronged strategy to alleviate the problem of high interest rates. First, the Bank of Latvia intends to introduce an auction system for part of its refinancing facility to promote the development of an interbank money market. Second, the special mechanism for disbursement of EC/G-24 loans to domestic users (i.e., lending in foreign currency at the cost of borrowing plus a mark-up for the bank intermediating the loan) will continue to be applied. It is hoped that these measures will bring down market interest rates gradually.

b. Currency conversion

The gradual introduction of the lats to replace the interim currency, the Latvian ruble, started in March 1993. From June 28, 1993, all contracts and prices were redenominated into lati and the posting of prices in foreign currency was forbidden, although the use of such currencies in transactions in Latvia continues to be permitted if the transacting parties so wish. In mid-September, the Bank of Latvia announced that the Latvian ruble would cease to be legal tender as of October 18, 1993. However, the Bank of Latvia will indefinitely convert Latvian ruble notes into lati at the original conversion rate of 200:1. As of early November 1993, Latvian rubles constituted only about 1/2 percent of currency in circulation.

c. Structural issues in the financial sector

With assistance from the World Bank and the Swiss Government, the Privatization Commission in charge of the former branches of the Bank of Latvia is currently winding up its work. The former branches have been classified into four groups: a first group of 15 branches which have been converted into joint stock companies and handed over, or are going to be handed over, to the share-holders; a second group of 11 branches which have been, or will be, auctioned off to existing banks; a third group of 21 branches which have been consolidated into a core bank--the Universal Bank of Latvia--to be operated with assistance from the World Bank and privatized once it has been rehabilitated; and finally one branch which was liquidated in early July 1993. The authorities intend to transform the former Vneshekonombank branch into an Export-Import Bank for Latvia.

The World Bank and EC PHARE are also assisting the authorities in their effort to restructure and rehabilitate the State Savings Bank. The Government recognizes the need for fiscal support in the process of bank restructuring, and it intends to make provision for such support in the 1994 budget. As part of the efforts to rehabilitate and restructure the former commercial branches of the Bank of Latvia, the Bank agreed to extend interest-free credits for one year to branches with nonperforming agricultural credits. Most of these credits were refinanced by the Bank of Latvia and the branches had been unable to repay these credits to the Bank, so the rescue operation did not involve significant amounts of new credit. It will, however, affect the profitability of the Bank adversely. It is the Government's intention to eventually take over this quasi-fiscal operation performed by the Bank of Latvia.

Significant progress has already been made, with technical assistance from the Fund, in developing the prudential supervisory capabilities of the Bank of Latvia. With assistance from a Resident Advisor provided by the Fund, the authorities expect to have an operational banking supervision system in place by end-1993. The authorities also plan to seek help from foreign donors to finance external audits of the main private commercial banks.

4. External policies

The authorities remain committed to a liberal trade system. However, developments in the area of customs tariffs have over the past year been haphazard and the system has become irrational and distorted. The authorities recognize this and have requested the assistance of the World Bank in conducting a complete overhaul of the system to be implemented by mid-1994. As an intermediate step, the Ministry of Finance has put forward a proposal for an interim tariff law to take effect from January 1, 1994. According to this proposal, low tariff rates would be introduced on raw materials/spare parts and equipment, which are currently exempt from customs duties, while most of the high protective tariffs introduced on a range of agricultural goods since late 1992 will be cut in half. The latter may prove politically difficult to implement, given the influence of agriculture in the Government and in Parliament. The continued widespread subsidization of agricultural products in FSU countries and barriers to Latvian agricultural products in industrial country markets are put forward as arguments for continued protection. The proposal by the Ministry of Finance also includes several measures to abolish or reduce export taxes and to simplify the export tax regime.

The current provisions in the foreign investment law allowing liberal repatriation of capital and transfer of shares in the event of liquidation will be maintained to attract foreign investments and transfer of technology. The authorities intend to encourage payments for trade with foreign countries, including the states of the FSU, to take place directly through the correspondent accounts that Latvian banks maintain with banks in such countries. From January 1, 1994, the Bank of Latvia proposes to abolish the system of settling payments with the FSU states through its own correspondent accounts with such states.

5. Systemic changes

A key objective of the new Government's program is to speed up and broaden the reform process, particularly in the areas of privatization, financial discipline of enterprises, and bankruptcy and anti-monopoly regulations. While there is no doubt about its commitment in this respect, the many changes in the administrative set-up and in legislation proposed by the Government may have slowed down the process temporarily--albeit promising a more rational approach in the longer run. This is particularly the case in the area of privatization of medium- and large-scale enterprises. It is widely recognized that the decentralized approach followed so far has been a failure, with the former branch ministries being reluctant to privatize enterprises under their purview. However, the switch to a more centralized approach will take time, requiring necessary legislation and institution building.

The Government is currently in the process of establishing a State Property Fund to oversee all state property, and a Privatization Agency with centralized authority over the privatization of large-scale enterprises, including those in agriculture. Both institutions are expected to become operational before the end of 1993. In the meantime, distribution of privatization vouchers to citizens will continue, but their role in the privatization of enterprises remains unclear. To speed up the privatization process, a pilot scheme will be set up in early 1994, with assistance from the World Bank, to privatize a small number of selected large enterprises using a series of different techniques.

To accelerate and simplify the process of restitution of land and residential property to former owners, revisions to the restitution laws on residential property and rural land as well as a new draft law on restitution of urban land are expected to be passed before end-1993. Deadlines for filing applications for restitution of old property rights will be considerably shortened by these new laws, thereby removing important obstacles to the privatization process. Legal entities, including foreigners, will be allowed to acquire land as private property by mid-1994; this is expected not only to foster a market in land, but also to spur private enterprise and investment. Furthermore, efforts to break up enterprises with monopoly power in a sector are expected to speed up the process of enterprise restructuring and privatization.

The improvement in financial discipline brought about by the strict fiscal and monetary policy regime is to be reinforced by rigorous supervision of enterprises and the threat of liquidation. The State Committee for Statistics will collect information on interenterprise arrears, and the authorities intend to create, with the assistance of the World Bank, a secondary market in such debt. The Government will ensure that official payments are made on schedule and it intends to impose the same discipline on enterprises. The Price and Tariff Council, in cooperation with the committee established to administer the competition and anti-monopoly legislation, will continue to oversee price determination for goods and services provided by monopolies, including state enterprises and utilities. In this connection, the authorities intend to ensure that users pay the full costs of imports to domestic suppliers of energy services.

V. Balance of Payments Prospects and Financing From the Fund

1. Balance of payments prospects in the fourth quarter of 1993 and in 1994

For the 15-month program period through end-1994, the available external financing projected for Latvia would permit a 32 percent rise in the volume of imports which, if utilized productively, would be consistent with the programmed recovery in investment and production. The improved availability of imports together with expanding activity of the emerging private sector are also expected to lead to growth of merchandise export volume of 9 1/2 percent, reflecting continued growth of exports outside the FSU, and a limited recovery of FSU exports resulting from sharply improved competitiveness. Altogether, a current account deficit of US$290 million or nearly 7 percent of GDP is targeted for the program period (Table 9).

It is assumed that the absorptive capacity of the economy will grow steadily, as privatization and other structural reform measures take hold, and that a large part of the balance of payments support loans (including Fund purchases) will initially be held as reserves. This is reflected in the import coverage of gross external reserves which is programmed to fall gradually over the program period to about three months at the end of 1994. In addition to the purchases from the Fund, the financing requirement for the program period is expected to be covered from the disbursement of the remainder of the EC/G-24 loans pledged in 1992 and EBRD as well as World Bank loans already granted or expected.

2. Medium-term outlook

In line with the larger than anticipated decline in economic activity in 1992-93, smaller disbursements of foreign assistance, and sharply lower FSU exports, the staff has revised earlier medium-term balance of payments projections (Table 10). After a significant recovery in 1994--mainly for capital equipment purchases--the volume of nonenergy imports would remain unchanged in 1995, but thereafter would grow again, after 1997 in line with the growth of output. Energy import volumes would recover partially in 1994, but would thereafter be expected to grow more slowly than output, reflecting both investments in energy conservation and a continuous shift toward less energy-intensive activities. The observed tendency of a shift in exports toward non-FSU countries is expected to continue, boosted by foreign investments in the export sector oriented toward these countries. Given the relatively small size of the Latvian economy, such export growth is assumed to be primarily determined by competitiveness and capacity expansion, rather than foreign demand growth.

In the medium term, with a slow decline in net receipts from service transactions--partly reflecting increasing interest payments--the current account deficit is estimated to decline gradually, from 7 percent of GDP in 1994 to 1 percent by the year 2000. A gradual rise in the import coverage of gross international reserves is targeted over the period. Small financing gaps would exist in the period 1995-97, but it is expected that these gaps could be filled by additional multilateral flows. Including use of Fund credit, Latvia's external debt is projected to peak at 19 percent of GDP in 1997, before declining to 16 percent by the year 2000. Debt service payments in terms of merchandise exports are expected to increase from 1 percent to 6 percent between 1993 and 1998, but to increase to 10 percent in the year 2000 when most of the EC/G-24 loans disbursed in 1993 will mature.

3. Capacity to repay the Fund

The medium-term balance of payments scenario indicates that, with a sound policy environment, Latvia's financing gaps will disappear by 1997, prior to the period when the bulk of the repurchases stemming from the proposed stand-by arrangement would have to be made. However, between 1995 and 1997 there will be a continuing need for financing from official sources, and additional requests for the use of Fund resources may be envisaged until then, possibly in the context of an Extended Fund Facility.

Based on the medium-term projections, use of Fund credit under the proposed arrangement as a proportion of Latvia's total external debt will gradually decline from its peak of 62 percent at end-1992 to about 36 percent at the end of the program period and 4 percent in the year

2000. 1/ Debt service to the Fund would peak at SDR 35 million in 1997 or 2 percent of current account receipts (Table 11). The total level of debt obligations is considered to be within Latvia's servicing capacity. Given the authorities' commitment to the implementation of the reform program, the staff is of the view that with continued support from the international community to help carry the reform forward, Latvia will be current in meeting future obligations to the Fund.

VI. Performance Criteria and Program Reviews

The performance criteria under the proposed arrangement are specified in the authorities' Memorandum of Economic Policies, and are also enumerated in Table 3. The submission to Parliament of the interim tariff law is a prior action under the program. Understandings have been reached on all the quantitative performance criteria for December 31, 1993 and March 31, 1994. Quantitative performance criteria for June 30, 1994 and September 30, 1994 will be specified at the time of the first program review under the arrangement to be completed in May 1994, and for December 31, 1994 at the time of the second review to be completed in August 1994. The first review will also focus, inter alia, on: progress made toward the implementation of the new tariff system; the operations of the Privatization Agency and the State Property Fund and progress in privatization of large-scale enterprises; progress in the rehabilitation and privatization of the Universal Bank of Latvia and in rehabilitation and restructuring of the State Savings Bank; the functioning of the banking supervision system; and the granting of government guarantees. It will also evaluate technical assistance received and additional technical assistance needs. The second review will, inter alia, evaluate the functioning of the new tariff system, further progress in financial sector and enterprise restructuring, and the quality of economic statistics.

Purchases under the arrangement have been phased so as to provide for a second purchase under the Systemic Transformation Facility to be made upon completion of the first program review. Thus, in order to provide for appropriate distribution of resources over the period of the arrangement, the phasing provisions of the stand-by arrangement do not provide for an additional amount to be made available under the arrangement upon completion of that review.

1/ Assuming no further use of Fund resources in addition to the proposed stand-by arrangement and STF purchases.

VII. Staff Appraisal

In the context of a comprehensive economic program launched in mid-1992, the Latvian authorities have made a determined effort to move from a centrally planned to a market-based economic system. The program, which was supported by a one-year Fund stand-by arrangement, was implemented broadly as envisaged, enabling Latvia to make all the purchases under the arrangement. The adjustment effort that has been made so far has been very large by any standards and is highly commendable. Nevertheless, much remains to be done, and the authorities should resist any tendency to rest on their laurels.

The degree of success so far has varied between different areas. While a large degree of macroeconomic stability was attained, progress was more modest in the area of structural reform, in particular as regards privatization which was hampered by an inadequate administrative set-up and uncertainties concerning citizenship and restitution of property to previous owners. In these circumstances, the economy was unable to absorb available balance of payments assistance productively and fully. As a result, the decline in economic activity was much sharper than envisaged, while the external current account recorded surpluses and international reserves rose markedly.

The new Government, which took office in mid-1993, is fully aware that the adjustment effort has become unbalanced, and it has in its economic program rightly emphasized the need to speed up the reform effort, while consolidating the stabilization gains achieved so far. The Government's program for the period to the end of 1994 is seen as a first step in a medium-term strategy to promote the development of a vibrant private sector through accelerated privatization of state enterprises as well as other structural measures to achieve better resource allocation and efficiency gains.

While there is little doubt about the Government's commitment to the program, there is some uncertainty concerning the implementation of it in a timely fashion, given the Government's rather weak parliamentary backing. The time needed for consensus building has already caused delays in several areas, such as the adoption of the supplementary budget for 1993 and, as a consequence of this, also the submission to Parliament of the 1994 budget. Measures to streamline procedures and to shorten the decision-making process are urgently needed.

With the adoption of the tax package in mid-October, the Government has taken an important step to place the fiscal situation on a sounder footing for the remainder of 1993 and beyond. The programmed increases in the fiscal deficits entail certain risks, and it is essential that these deficits be contained at the targeted levels. Efforts to improve tax administration should be intensified, and the authorities should stand ready to take further measures in case the fiscal targets for 1994 were to be endangered. There is a continued need to keep expenditures, particularly for social benefits and subsidies for agriculture, in check. Also, the current ad hoc and transitory adjustments to the pension system should give way to more permanent and financially sustainable arrangements. In this context, the staff would urge the authorities to pay close attention to the expenditure review and the elaboration of the public investment program initiated with assistance from the World Bank. The staff welcomes the decision to channel the majority of the EC/G-24 loans to domestic users through the banking system, and encourages the authorities to keep government guarantees for such loans, as well as domestic loans, to a minimum. The staff also welcomes the authorities' plans to finance part of the budget deficit through issuance of Treasury bills, but within reasonable limits, given the high domestic interest rates.

The monetary situation needs to be closely monitored in the coming months. While the rapid growth in monetary aggregates this year has largely accommodated an increase in the demand for money, recent inflation figures--albeit partly influenced by seasonal factors, import costs and tax increases--are somewhat higher than expected. The Bank of Latvia should stand ready to take offsetting measures if this trend continues, although external competitiveness considerations may limit the Bank's scope for action. The staff agrees with the Bank of Latvia that the use of administrative means to bring down the high market interest rates should be avoided. In the circumstances, there is little that the Bank can do in the short run to guide the market, in addition to the leadership already shown in reducing the refinancing rate. Development of new monetary policy instruments, improved banking supervision, competition from the disbursement of EC/G-24 loans to domestic users, increased competition in the banking system--including admission of foreign banks into Latvia--and maintenance of a strong fiscal position, should eventually bring market rates down.

The emphasis on structural measures in the Government's program is welcome, but in some areas considerable further elaboration is needed to translate these intentions into action plans. The staff urges that this be done as soon as possible, particularly in the area of privatization. The legislation on the Privatization Agency and the State Property Fund must be adopted before the end of 1993 so that these institutions can become fully operational by early 1994. Equally important is the prompt adoption of the restitution laws. Furthermore, while the staff is encouraged by the speed with which the former branches of the Bank of Latvia have been reorganized, the major task of rehabilitation of these as well as other banks with nonperforming loans still lies ahead. This problem has to be dealt with in an open and transparent fashion, with the costs of these transactions being clearly recorded in the budget. Should this happen during the program period, additional measures must be implemented as necessary to safeguard the fiscal objectives of the program.

The erosion of the liberal trade system since late 1992 is worrisome. The staff is encouraged, however, by the authorities' plans to implement, with the assistance of the World Bank, a complete overhaul of the tariff system by mid-1994, which will eliminate the discriminatory aspects of the present system. It will be important, however, that the interim tariff law proposed by the Ministry of Finance be adopted in time for it to take effect from January 1, 1994. There is, in the staff's view, no justification for delaying the measures contained in this proposal, in particular the envisaged reduction in the protective tariffs for agricultural products.

The Latvian authorities have designed a strong stabilization and reform program that merits support from the international community. The staff believes that the policies set out in the Memorandum of Economic Policies for the period October 1, 1993 to December 31, 1994 represent a strong base for continuing the stabilization and reform process initiated last year. Accordingly, the staff recommends approval of Latvia's request for a 15-month stand-by arrangement in the amount of SDR 22.875 million, and the first purchase under the Systemic Transformation Facility in the amount of SDR 22.875 million.

VIII. Proposed Decisions

The following draft decisions are proposed for adoption by the Executive Board:

A. Request for Stand-by Arrangement

1. The Government of the Republic of Latvia has requested a stand-by arrangement for a fifteen-month period in an amount equivalent to SDR 22.875 million.

2. The Fund approves the stand-by arrangement set forth in EBS/93/186.

B. Request for Purchase under Systemic Transformation Facility

1. The Fund has received a request by the Government of the Republic of Latvia for a purchase equivalent to SDR 22.875 million under the Decision on the Systemic Transformation Facility (Decision No. 10348-(93/61) STF, adopted April 23, 1993).

2. The Fund approves the purchase in accordance with the request.

3. The Fund waives the limitation in Article V, Section 3 (b)(iii).

Table 1. Latvia: Schedule of Purchases Under the Proposed Stand-By Arrangement and Under the Systemic Transformation Facility

Amount of Purchase	Available On or After	Contingent On
SDR 4,575,000 (5 percent of quota)	Board approval	
SDR 22,875,000 (25 percent of quota)	Board approval	
SDR 4,575,000 (5 percent of quota)	February 15, 1994	Observance of end-December 1993 performance criteria 1/
SDR 22,875,000 (25 percent of quota) 2/	May 15, 1994	Completion of program review to be based, inter alia, on observance of end-March 1994 performance criteria 1/
SDR 4,575,000 (5 percent of quota)	August 15, 1994	Observance of end-June 1994 performance criteria and completion of program review 1/
SDR 4,575,000 (5 percent of quota)	November 15, 1994	Observance of end-September 1994 performance criteria 1/
SDR 4,575,000 (5 percent of quota)	February 15, 1995	Observance of end-December 1994 performance criteria 1/

Sources: Draft stand-by arrangement and the Memorandum of Economic Policies.

1/ In addition to the standard clauses on overdue financial obligations or expectations to the Fund and on the exchange and trade system and the performance criterion on the accumulation of external arrears.

2/ The expected amount and timing of the second purchase under the STF.

Table 2. Latvia: Projection of IMF Position
During Period of Proposed Stand-By Arrangement and
Financing Under the Systemic Transformation Facility

	1993	1994				1995
	Oct.-Dec.	Jan.-Mar.	Apr.-June	July-Sep.	Oct.-Dec.	Jan.-Mar.
	(In thousands of SDRs)					
Purchases	27,450	4,575	--	27,450	4,575	4,575
Tranche policies	4,575	4,575	--	4,575	4,575	4,575
Ordinary resources	4,575	4,575	--	4,575	4,575	4,575
Special facilities	22,875	--	--	22,875	--	--
Total Fund credit outstanding (end of period)	82,350	86,925	86,925	114,375	118,950	123,525
Tranche policies	59,475	64,050	64,050	68,625	73,200	77,775
Special facilities	22,875	22,875	22,875	45,750	45,750	45,750
	(In percent of quota)					
Total Fund credit outstanding (end of period)						
Tranche policies	65.00	70.00	70.00	75.00	80.00	85.00
Special facilities	25.00	25.00	50.00	50.00	50.00	50.00

Source: Staff estimates.

Table 3. Latvia: Performance Criteria under the Stand-By Arrangement 1/

	Variable and Periods	Amounts	
		(In millions of lati)	
I.	Limits on the general government financial balance:		
	October 1, 1993 - December 31, 1993 (Performance criterion)	-25	
	October 1, 1993 - March 31, 1994 (Performance criterion)	-35	
II.	Limits on net lending plus government-guaranteed loans to enterprises		
	October 1, 1993 - December 31, 1993 (Performance criterion)	25	
	October 1, 1993 - March 31 1994 (Performance criterion)	50	
III.	Limits on reserve money:		
	September 30, 1993: Position	187	
	December 31, 1993: Performance criterion	207 2/	
	March 31, 1994: Performance criterion	216 2/	
		(In millions of U.S. dollars)	
IV.	Minimum cumulative change in convertible net international reserves of the Bank of Latvia	Minimum limits	
	From September 30, 1993 until:		
	December 31, 1993: Performance criterion	23 3/	
	March 31, 1994: Performance criterion	26 3/	
		Maximum limits	
V.	Cumulative limits on contracting and guaranteeing of external debt	1-12 year maturity	1-5 year
	From September 30, 1993 until:		
	December 31, 1993: Performance criterion	40	10
	March 31, 1994: Performance criterion	60	20
VI.	Limits on external government debt of up to one year		
	December 31, 1993: Performance criterion	20	
	March 31, 1994: Performance criterion	20	
		(In millions of lati)	
VII.	Indicative limits on net domestic assets of the banking system		
	September 30, 1993: Position	134	
	December 31, 1993: Indicative limit	140	
	March 31, 1994: Indicative limit	170	

Source: Memorandum of Economic Policies.

1/ Definitions of the performance criteria are included in the Annexes to the Memorandum of Economic Policies attached to the letter dated November 22, 1993.

2/ The ceilings will be adjusted downward for any shortfall and upward for any excess up to US$20 million, from the programmed increase in net convertible international reserves, excluding the unutilized part of EC/G-24 assistance, of US$28 million to December 31, 1993 and of US$36 million to March 31, 1994, respectively. The deviations will be valued at the accounting rate of US$1 = Ls 0.616.

3/ Excluding the unutilized part of EC/G-24 assistance. Foreign currencies valued at end-September exchange rates.

Table 4. Latvia: Selected Economic and Financial Indicators.

	Actual				Program			
			1993		4th	1st		
	1991	1992	1st Half	3rd Quarter	Quarter 1993	Quarter 1994	1993	1994
	(Percentage changes over same period previous year, unless otherwise specified)							
National income, prices, and wages:								
GDP at constant prices	−8.3	−33.8	−17.7	−4.1	−−	6	−10	5
Consumer price index − period average	124.5	951.2	249.4	82.7	25	14	105	11
Consumer price index − end period	262.5	958.1	151.6	63.1	20	11	20	6
Monthly state sector average wage (Lati)	2.80	24.16	45.57	52.30	...	...	...	...
Real wage 1/	−14.3	−15.7	−8.5	10.4	...	...	...	...
External sector 2/								
Exports (U.S. $ million) 3/	6,357	831	536	271	341	333	1,149	1,422
Imports (U.S. $ million) 3/	5,186	1,015	595	303	425	447	1,323	1,838
Export volume	−33	12	−17	−8	8	12	−9	7
Import volume	−33	−29	−15	−15	11	39	−8	27
Terms of trade (deterioration −)	1	−53	9	8	6	3	8	8
Money and credit								
Domestic credit 4/	90.6	303.8	140.0	161.1	162.2	108.9	162.2	...
Broad money 4/ 5/	153.1	169.9	141.6	83.8	76.1	71.8	76.1	27.2
Velocity, level 6/	1.9	5.2	4.4	4.1	4.1	3.7	4.1	3.7
Interest rates, percent								
Deposit	4.1	23.0	30.7	41.6	...	...	...	...
Credit	23.0	92.0	95.3	81.0	...	...	...	...
Bank of Latvia refinance rate 7/	8−12	120.0	3.5	2.5	...	...	...	...
	(In percent of GDP)							
General government revenue	37.4	28.2	33.8	31.1	27.9	32.3	31.4	32.0
General government expenditure	31.0	28.2	33.2	28.0	32.5	34.8	31.8	33.7
General government financial balance	6.4	−−	0.6	3.1	−4.6	−2.5	−0.4	−1.7
General government net lending	−−	−0.8	0.1	−1.0	−3.8	−3.6	−1.3	−2.6
General government fiscal balance	6.4	−0.8	0.7	2.1	−8.4	−6.1	−1.7	−4.3
External trade balance	...	−14.1	−6.0	−4.8	−11	−15	−7	−12
External current account balance	...	3.9	4.8	4.0	−5	−9	2	−7
Exchange rate, lati per U.S. dollar 8/	...	0.843	0.658	0.616	...	...	...	...

Sources: Latvian authorities; and staff estimates.

1/ Refers to salary in the state sector, comprising budgetary organizations and state enterprises.

2/ Calculated on the basis of constant 1992 weights, except for in 1991 where 1990−91 weights have been used; includes nonfactor services, notably the sea transport sector, because of its relative importance.

3/ Figures for 1991 are distorted due to exchange valuation effects.

4/ End period; ruble deposits and credit valued at par prior to 1993, and at market exchange rates beginning 1993.

5/ Broad money includes foreign currency deposits, and from 1992 excludes Russian and Soviet rubles in circulation.

6/ Velocity defined as the ratio of annualized GDP in quarter or final quarter of period to end−period broad money. The value for 1994 is the programmed value for the first quarter.

7/ From the beginning of 1993 the rate is on a monthly basis. The second quarter rate came into effect from June 11, 1993. The rate was reduced to 2 1/2 percent in September 1993, and further to 2 1/4 percent on October 21, 1993.

8/ End of period.

Table 5. Latvia: Social Indicators 1/

Population and vital statistics	
Total population resident, at end of period (in thousands)	2,606
Population growth rate (in percent)	-1.9
Life expectancy at birth (in years)	
Male	63.8 2/
Female	74.8 2/
Population age structure (in percent)	
0-14 years	21.3
15-64 years	66.1
65 and above	12.6
Crude birth rate (per thousand)	12.0
Crude death rate (per thousand)	13.5
Infant mortality rate (per thousand)	17.4
Food, health, and nutrition	
Per capita supply of:	
Calories (per day)	2,312
Proteins (grams per day)	66
Population per physician	244
Population per hospital bed	77
Labor force	
Economically active population (in thousands)	1,367
Female (in percent)	48
Agriculture (in percent)	19
Industry (in percent)	25
Education	
Enrollment (in thousands)	
Junior (grades 1-4)	137.1
Primary (grades 5-9)	166.0
Secondary (grades 10-12)	33.8
Colleges, specialized schools, and universities	97.0
Pupil-teacher ratio:	
In junior, primary, and secondary schools	10
Other	
Telephones, excluding parallel switched (per thousand)	26.3
Private cars (per thousand)	12.6

Source: Latvian authorities.

1/ Data for 1992, unless otherwise indicated.

2/ Refers to 1991.

Table 6. Latvia: Summary of General Government Operations

	Actual			Program				
		1993		1993			1994	
	1992	1st Half	3rd Quarter	4th Quarter	2nd Half	Year	1st Quarter	Year
				(In millions of lati)				
Revenue	282.2	238.8	128.9	127.1	256.0	494.8	139.4	626.4
Of which:								
Profit tax	56.0	61.1	25.8	20.8	46.6	107.7	22.9	111.3
Income and social tax	123.3	104.8	51.2	52.0	103.2	208.0	55.5	220.0
Taxes on goods and services	65.0	48.7	35.7	41.4	77.1	125.8	46.8	233.2
Expenditure	282.5	234.7	116.0	148.1	266.9	501.6	150.1	660.6
Of which:								
Goods and services	110.4	83.6	43.3	51.5	94.7	178.3	50.9	213.7
Transfers to households	96.4	105.6	60.8	69.5	130.2	235.9	74.8	306.7
Investment	14.7	6.1	2.5	3.9	6.5	12.6	3.0	39.0
Financial Surplus (+) / Deficit (−)	−0.3	4.1	12.9	−21.0	−10.9	−6.8	−10.7	−34.2
Net Lending	−8.0	0.7	−4.2	−17.3	−21.5	−20.9	−15.6	−50.4
Fiscal Surplus (+) / Deficit (−)	−8.3	4.8	8.7	−38.3	−32.4	−27.6	−26.3	−84.6
Composition of Fiscal balance	−8.3	4.8	8.7	−38.3	−32.4	−27.6	−26.3	−84.6
Central government and social security	−9.3	−6.8	8.5	−46.3	−37.8	−44.5	−27.9	−91.6
Local governments	6.3	10.2	−2.6	7.0	4.4	14.6	1.7	7.1
Extrabudgetary funds	−5.4	1.3	2.8	1.0	1.0	2.3	−−	−−
Financing of Fiscal balance	8.3	−4.8	−8.7	38.3	32.4	27.6	26.3	84.6
Domestic	11.5	−9.8	−14.7	19.3	7.4	−2.5	9.2	11.7
Banking system	3.0	−8.1	−9.2	19.3	12.8	4.7	9.2	11.7
Other domestic	8.5	−1.8	−5.4	−−	−5.4	−7.2	−−	−−
Foreign	−3.2	5.1	6.0	19.0	25.0	30.1	17.1	72.9
				(In percent of GDP)				
Revenue	28.2	33.8	31.1	27.9	27.9	31.4	32.3	32.0
Of which:								
Profit tax	5.6	8.7	6.2	4.6	5.1	6.8	5.3	5.7
Income and social tax	12.3	14.8	12.4	11.4	11.2	13.2	12.9	11.2
Taxes on goods and services	6.5	6.9	8.6	9.1	8.4	8.0	10.9	11.9
Expenditure	28.2	33.2	28.0	32.5	29.1	31.8	34.8	33.7
Of which:								
Goods and services	11.0	11.8	10.5	11.3	10.3	11.3	11.8	10.9
Transfers to households	9.6	15.0	14.7	15.3	14.2	15.0	17.3	15.6
Investment	1.5	0.9	0.6	0.9	0.7	0.8	0.7	2.0
Financial Surplus (+) / Deficit (−)	−0.0	0.6	3.1	−4.6	−1.2	−0.4	−2.5	−1.7
Net Lending	−0.8	0.1	−1.0	−3.8	−2.3	−1.3	−3.6	−2.6
Fiscal Surplus (+) / Deficit (−)	−0.8	0.7	2.1	−8.4	−3.5	−1.8	−6.1	−4.3
Composition of Fiscal balance	−0.8	0.7	2.1	−8.4	−3.5	−1.8	−6.1	−4.3
Central government and social security	−0.1	−1.0	2.1	−10.2	−4.1	−2.8	−6.5	−4.7
Local governments	0.6	1.4	−0.6	1.5	0.5	0.9	0.4	0.4
Extrabudgetary funds	−0.5	0.2	0.7	0.2	0.1	0.1	−−	−−
Financing of Fiscal balance	0.8	−0.7	−2.1	8.4	3.5	1.8	6.1	4.3
Domestic	1.1	−1.4	−3.5	4.2	0.8	−0.2	2.1	0.6
Banking system	0.3	−1.1	−2.2	4.2	1.4	0.3	2.1	0.6
Other domestic	0.8	−0.3	−1.3	−−	−0.6	−0.5	−−	−−
Foreign	−0.3	0.7	1.5	4.2	2.7	1.9	4.0	3.7
Memorandum items:								
Government loan guarantees 1/	−−	2.3	0.9	1.4	1.1	1.7	2.0	0.9
Net lending plus loan guarantees	0.8	2.2	1.9	5.2	3.4	3.0	5.6	3.5

Sources: Latvian authorities and staff estimates.

1/ Government guarantees for enterprise loans extended in the context of EC/G−24, EBRD and IBRD loans for balance of payments support.

Table 7. Latvia: Reserve Money and Net Domestic Assets of the Bank of Latvia
(In millions of Lati)

	December 1992	1993 Actual March	1993 Actual June	1993 Actual September	1993 Program December	1994 March Program
Reserve money	108.3	128.3	170.5	187.2	206.9	215.4
Currency in circulation	77.5	84.7	117.1	141.8	156.9	163.4
Bank deposits	30.9	43.6	53.4	45.4	49.9	52.0
Net foreign assets	114.8	129.9	166.5	203.1	247.4	243.7
Convertible net international reserves 1/	101.1	117.2	166.0	208.0	252.4	248.7
Correspondent accounts 1/ 2/	13.7	12.7	0.5	-5.0	-5.0	-5.0
Net domestic assets	-6.5	-1.6	4.0	-15.8	-40.5	-28.3
Domestic credit	59.5	50.4	76.8	55.9	71.5	91.7
Banks	56.1	45.3	61.7	38.7	51.0	68.7
Of which:						
G-24 credits	...	...	26.5	28.8	41.1	57.2
Others	56.1	45.3	35.3	9.9	9.9	10.9
Government,net 3/	3.4	5.1	15.1	9.4	12.7	15.2
Others 4/	--	--	--	7.8	7.8	7.8
Other items, net	-65.9	-52.0	-72.8	-71.8	-112.0	-120.0
Of which:						
Blocked funds 5/	--	--	-32.3	-45.3	-83.3	-91.7
Memorandum Items:						
Change from the end of previous quarter:						
Domestic credit	2.5	-9.1	26.5	-20.9	15.6	20.2
Banks	8.5	-10.8	16.5	-23.0	12.2	17.7
Government,net 3/	-6.0	1.7	10.0	-5.7	3.3	2.5
Percentage change from the end of previous quarter:						
Reserve money	26.9	18.4	32.9	9.8	10.5	4.1

Sources: Bank of Latvia and staff estimates.

1/ Valued at end-September 1993 exchange rates for the period beyond September 1993.
2/ Sum of net balances in the correspondent accounts opened since January 1, 1992 with former republics of the Soviet Union, technical credits and cash Russian rubles(except R 1,476 million pending negotiations with Russia).
3/ Excluding blocked deposits on account of local currency proceeds from foreign loans for balance of payments support.
4/ Loans to the Privatization Fund.
5/ Blocked deposits on account of local currency proceeds from foreign loans for balance of payments support.

Table 8. Latvia: Monetary Survey and Net Domestic Assets of the Banking System
(In millions of Lati)

	December 1992	1993 Actual March	1993 Actual June	1993 Actual September	1993 Program December	1994 March Program
Broad money (M2X)	251.2	268.1	335.6	402.6	442.3	460.6
Currency	73.3	77.0	104.7	126.0	140.1	145.6
Household deposits	37.7	48.0	58.0	75.5	97.3	108.3
Enterprise deposits	52.1	46.5	65.0	75.3	79.6	83.4
Residents' FC deposits	88.1	96.5	107.9	125.8	125.4	123.3
Net foreign assets	195.1	181.8	237.1	268.5	304.6	291.6
Convertible net international reserves 1/	175.2	168.3	235.6	263.5	299.6	286.7
Correspondent accounts 1/ 2/	20.0	13.5	1.5	5.0	5.0	5.0
Net domestic assets	56.0	86.2	98.5	134.1	137.7	169.0
Domestic credit	108.2	154.7	162.9	242.0	283.7	323.2
Households	1.7	7.0	8.1	12.2	14.6	17.6
Enterprises	117.6	138.0	149.2	232.2	252.2	279.7
Government, net 3/	−11.0	9.7	5.5	−2.4	16.8	26.0
Other items, net	−52.2	−68.4	−64.4	−107.9	−145.9	−154.3
Of which:						
Blocked funds 4/	--	--	−32.3	−45.3	−83.3	−91.7
Memorandum Items:						
Broad money (M2)	163.0	171.5	227.7	276.8	316.9	337.3
Change from the end of previous quarter:						
Domestic credit	15.5	46.5	8.2	79.1	41.7	39.6
Households	−1.4	5.3	1.2	4.1	2.4	2.9
Enterprises	18.4	20.4	11.3	83.0	20.0	27.5
Government, net 3/	−1.5	20.8	−4.3	−7.9	19.3	9.2
Percentage change from the end of previous quarter:						
Broad money(M2X)	...	6.7	25.2	20.0	9.9	4.1
Broad money(M2)	...	5.2	32.7	21.5	14.5	6.4

Sources: Bank of Latvia and staff estimates.

1/ Valued at end-September 1993 exchange rates for the period beyond September 1993.
2/ Sum of net balances in the correspondent accounts opened since January 1, 1992 with former republics of the Soviet Union, technical credits and cash Russian rubles(except R 1,476 million pending negotiations with Russia).
3/ Excluding blocked deposits on account of local currency proceeds from foreign loans for balance of payments support. In March 1993 the figure reflects the impact of replacing Ls 23.4 million worth of impaired claims of the State Savings Bank by claims on the Government.
4/ Blocked deposits on account of local currency proceeds from foreign loans for balance of payments support.

Table 9. Latvia: Balance of Payments, 1992–94

	1992	Program 1993	Program 1994	Estimated 1993 First Half	Estimated 1993 Third Quarter	Program 1993 Fourth Quarter	Program 1994 First Quarter
	(In millions of U.S. dollars)						
Current account balance	53	36	–252	47	26	–38	–71
Excluding transfers of aid	–21	–5	–283	21	19	–45	–79
Trade balance	–184	–175	–416	–59	–31	–84	–115
Exports	831	1,149	1,422	536	271	341	333
CIS & Baltic	396	546	771	245	120	181	177
Other countries	435	602	651	291	151	160	156
of which: re–exports of energy	134	222	220	112	55	55	55
Imports (including humanitarian aid)	–1,015	–1,323	–1,838	–595	–303	–425	–447
CIS & Baltic	–595	–898	–1,150	–417	–204	–276	–289
Energy	–453	–655	–694	–325	–142	–187	–190
Nonenergy	–142	–242	–456	–92	–62	–89	–99
Other countries	–420	–426	–688	–178	–98	–150	–158
Services, net	236	210	164	106	57	46	44
Receipts of aid transfers	73	41	31	26	8	8	8
Transport sector, net	188	194	200	89	55	50	50
Direct investment	43	50	60	25	14	11	15
Financing	58	266	165	73	61	131	51
IMF purchases, net	36	81	58	14	28	39	6
World Bank	--	45	25	7	9	29	5
EBRD	--	1	36	--	--	1	10
EC/G–24	--	135	50	49	21	65	30
Other official borrowing, net	22	5	–3	4	3	–2	--
Net errors and omissions 1/	15	–17	–15	8	–13	–12	–15
Net foreign assets of deposit money banks							
Net convertible (increase –)	–82	16	15	–13	16	13	15
Net nonconvertible (increase –)	2	--	--	--	--	--	--
Central bank reserves (increase –)							
Gross convertible	–52	–360	28	–141	–113	–106	5
Of which: IMF purchases, net	–36	–81	–58	–14	–28	–39	–6
Net nonconvertible	–38	9	--	1	8	--	--
	(In percent of GDP)						
Current account balance	4	1	–7	5	4	–5	–9
Trade balance	–14	–7	–12	–6	–5	–11	–15
Exports	62	49	41	55	42	45	44
Imports	–76	–56	–52	–61	–47	–56	–59
Gross reserves (in months of imports)	2	5	3	3	4	4	3
Memorandum items: 2/	(Index, 1992=100)						
Export volume							
CIS and Baltics	100	55	58	28	11	15	14
Other countries 3/	100	121	133	58	31	33	32
Import volume							
Energy 3/	100	86	98	39	19	28	26
Nonenergy							
CIS and Baltics	100	83	93	46	18	20	21
Other countries	100	99	157	41	23	35	36
	(Percentage changes) 4/						
Export volume							
CIS and Baltics	–19	–45	6	–51	–53	–16	–17
Other countries 3/	107	21	10	13	34	27	40
Import volume							
Energy 3/	–11	–14	14	–14	–32	6	15
Nonenergy							
CIS and Baltics	–55	–17	11	–5	1	–42	11
Other countries	–35	–1	59	–24	–7	62	114

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

1/ Including errors in trade data related to re–exports and unrecorded capital movements.

2/ Merchandise trade, excluding nonfactor services.

3/ Excluding re–exported energy resources.

4/ Changes from corresponding period of previous year.

Table 10. Latvia: Medium-Term Scenario, 1992-2000

	Estimated 1992	1993	1994	1995	1996	1997	1998	1999	2000
				(In millions of U.S. dollars)					
Current account balance	53	36	-252	-204	-173	-139	-104	-88	-61
Excluding aid transfers	-21	-5	-283	-224	-173	-139	-104	-88	-61
Trade balance	-184	-175	-416	-342	-281	-237	-195	-174	-144
Exports	831	1,149	1,422	1,567	1,725	1,902	2,101	2,302	2,525
CIS and Baltic	396	546	771	817	861	907	956	1,007	1,061
Other countries	435	602	651	750	864	995	1,145	1,295	1,464
Imports	-1,015	-1,323	-1,838	-1,909	-2,006	-2,139	-2,296	-2,476	-2,670
Energy	-471	-668	-708	-746	-774	-812	-861	-923	-991
Nonenergy	-543	-655	-1,130	-1,163	-1,232	-1,327	-1,435	-1,552	-1,679
CIS and Baltic	-142	-242	-456	-469	-497	-526	-562	-601	-643
Other countries	-401	-412	-675	-694	-735	-801	-873	-951	-1,036
Services, net	236	210	164	138	108	99	91	86	83
Official transfers	73	41	31	20	--	--	--	--	--
Interest, net	2	4	-7	-22	-34	-44	-50	-54	-55
Of which: Fund charges	--	-2	-7	-9	-8	-7	-5	-3	-2
Foreign direct investment	43	50	60	75	83	92	101	105	112
Medium- and long-term loans, net	22	185	107	104	108	116	113	119	7
Net errors and omissions	15	-17	-15	--	--	--	--	--	--
Net foreign assets of deposit money banks (increase -)	-79	16	15	--	--	--	--	--	--
Bank of Latvia reserves (increase -)									
Gross convertible	-52	-360	28	-25	-45	-55	-74	-117	-47
Net nonconvertible	-38	9	--	--	--	--	--	--	--
Residual financing need	36	81	58	50	27	-14	-37	-20	-11
Fund purchases, net	36	81	58	-3	-24	-42	-37	-20	-11
Financing gap	--	--	--	52	51	28	--	--	--
				(Percent change)					
Real GDP	-34	-10	5	5	5	5	5	5	5
Export volume									
CIS and Baltic	-19	-45	6	3	3	3	3	3	3
Other	107	21	10	12	12	12	12	10	10
Import volume									
Energy	-11	-14	14	--	--	2	3	5	5
Nonenergy									
CIS and Baltic	-55	-17	11	--	3	3	4	4	4
Other	-35	-1	59	--	3	6	6	6	6
Memorandum items:									
Current account, as percent of GDP	4	1	-7	-5	-4	-3	-2	-2	-1
External debt (including IMF), as percent of GDP	4	14	14	17	18	19	18	18	16
External debt, as percent of merchandise exports	7	28	34	41	45	46	46	46	42
Debt service, as percent of merchandise exports	2	1	3	3	5	6	6	5	10
Gross international reserves, millions of U.S. dollars	156	522	494	519	564	619	693	810	857
(in months of total imports)	1.8	4.7	3.2	3.3	3.4	3.5	3.6	3.9	3.9

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

Table 11. LATVIA - Projected Payments to the Fund as at October 31, 1993
(in millions of SDRs)

	Overdue	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	Beyond	Total
Obligations from existing drawings													
1. Principal													
a. Repurchases	-	-	-	1.9	17.5	25.5	9.9	-	-	-	-	-	54.9
b. ESAF/SAF repayments	-	-	-	-	-	-	-	-	-	-	-	-	
c. Trust Fund obligations	-	-	-	-	-	-	-	-	-	-	-	-	-
2. Charges and interest 1/	-	.7	2.8	2.8	2.4	1.3	.2	-	-	-	-	-	10.3
Total Obligations 2/	-	.7	2.8	4.7	20.0	26.9	10.2	-	-	-	-	-	65.2
(percent of quota)	-	.7	3.1	5.1	21.8	29.3	11.0	-	-	-	-	-	71.3
Obligations from prospective drawings													
1. Principal													
a. Repurchases	-	-	-	-	-	4.6	16.6	14.5	8.2	7.6	7.6	9.5	68.6
b. ESAF/SAF repayments	-	-	-	-	-	-	-	-	-	-	-	-	
c. Trust Fund obligations	-	-	-	-	-	-	-	-	-	-	-	-	
2. Charges and interest 1/	-	-	1.9	3.4	3.4	3.3	3.0	2.2	1.6	1.2	.8	.5	21.2
Total obligations	-	-	1.9	3.4	3.4	7.9	19.6	16.7	9.8	8.8	8.4	10.0	89.8
(percent of quota)	-	-	2.0	3.7	3.6	8.6	21.3	18.2	10.6	9.6	9.1	10.9	98.1
Cumulative (existing and prospective)													
1. Principal													
a. Repurchases	-	-	-	1.9	17.5	30.1	26.5	14.5	8.2	7.6	7.6	9.5	123.5
b. ESAF/SAF repayments	-	-	-	-	-	-	-	-	-	-	-	-	-
c. Trust Fund obligations	-	-	-	-	-	-	-	-	-	-	-	-	-
2. Charges and interest 1/	-	.7	4.8	6.2	5.8	4.7	3.2	2.2	1.6	1.2	.8	.5	31.5
Total obligations 2/	-	.7	4.8	8.1	23.4	34.8	29.7	16.7	9.8	8.8	8.4	10.0	155.1
(percent of quota)	-	.7	5.2	8.8	25.5	38.0	32.4	18.2	10.6	9.6	9.1	10.9	169.4

1/ Projections are based on current rates of charge, including burden-sharing charges where applicable, for purchases in the GRA, and on current interest rates for SAF, ESAF and Trust Fund. The current SDR interest rate is assumed for net use of SDRs.
2/ Overdue obligations (if applicable) will be settled in full at close of business November 1, 1993.

Prepared by Treasurer's Department

Latvia -- Fund Relations

(As of October 31, 1993)

I. Membership Status

(a) Date of Membership		May 19, 1992
(b) Status		Article XIV

II. General Resources Account

	(In millions of SDRs)	(In percent of quota)
(a) Quota	91.50	100.0
(b) Total Fund Holdings of Currency	146.40	160.0
(c) Reserve Tranche Position	0.01	--

III. SDR Department

		(In percent of allocation)
Holdings	48.60	n/a

IV. Outstanding Purchases and Loans

		(In percent of quota)
Stand-by arrangement	54.90	60.0

V. Financial Arrangements

Type	Approval Date	Expiration	Amount Approved (SDR Million)	Drawn (SDR Million)
Stand-By	9/14/92	9/13/93	54.90	54.90

VI. Projected Obligations to Fund (SDR Million; based on existing use of resources and present holdings of SDRs):

	Overdue 10/31/93	Forthcoming 1993	1994	1995	1996	1997
Principal	...	...	...	1.9	17.5	25.5
Charges/interest		0.7	2.9	2.8	2.5	1.3
Total	...	0.7	2.9	4.7	20.0	26.8

VII. Exchange Arrangements

The currency of Latvia is the lats, which was introduced in March 1993 to replace the Latvian ruble. The exchange rate of the lats is allowed to float.

VIII. Resident Representative

The first Resident Representative of the Fund in Latvia, Ms. Suss, took up her post in August 1992.

IX. Consultation Cycle

Latvia is on the 12-month consultation cycle.

Latvia--World Bank Relations

Latvia became a World Bank member on August 11, 1992. On October 22, 1992, the Board of Directors approved the first loan to Latvia, a Rehabilitation Loan for US$45 million equivalent. This loan will (a) assist the Government in the design and implementation of its economic reform program; and (b) help reduce further declines in economic activity through support for the importation of essential goods for high priority sectors. The loan is financing essential imports for the energy, agriculture and health sectors, and includes a technical assistance component for the support of the economic reform program. At end-October 1993, a total of US$19 million had been disbursed under this loan.

The first World Bank Country Economic Memorandum (CEM) was published in April 1993. The CEM provided a comprehensive overview of the Latvian economy, focused on macroeconomic and systemic reform issues, and presented recommendations for policies and institutional reform. The report also included an overview and analysis of the main sectors. An economic updating mission visited Latvia in March 1993 and provided advice to the Government on various macroeconomic and structural reform issues.

The Bank is in the process of preparing lending operations in the energy, agricultural, and social sectors. Preparations for a loan of US$25 million for agriculture are almost complete and funds could be available for disbursement in early 1994. The Bank has also undertaken sector reviews in the areas of public sector management, enterprise development and financial sector reform. The sector work on the latter will lead to an early lending operation focusing on financial/enterprise reform, including a pilot program for the privatization of large enterprises. A public expenditure review mission took place in October/November 1993 and provided the Government with recommendations on public expenditure planning, programming and management.

Latvia: Technical Assistance

The following summarizes the technical assistance from the Fund to Latvia since November 1991:

Department	Subject/ Identified Need	Action	Timing	Counterpart
MAE	Central Bank Organization	Mission	November 1991	Bank of Latvia
INS	Macroeconomic Policies	Seminar	December 1991	
STA	Training on Fund methodology and collection of balance of payments, budget, national accounts, prices and money statistics	Mission	March 1992	State Committee for Statistics
FAD	Tax policy and administration, budget and expendi- ture management, social safety net	Mission	March to April 1992	Ministry of Finance Ministry of Welfare
MAE	Monetary policy and analysis, accounting, payment system, foreign exchange management, central bank organization	Mission	March to April 1992	Bank of Latvia
STA	Price statistics	Mission	April 1992	State Committee for Statistics
MAE	Payment and settlement systems	Short-term expert	June 1992	Bank of Latvia
FAD	Tax administration and cash management	Mission	June to July 1992	Ministry of Finance and Customs Depart- ment (State Finance Inspection Board)
STA	Balance of Payments	Mission	July 1992	State Committee for Statistics, Bank of Latvia
STA	Price statistics	Mission	July/August 1992	State Committee for Statistics

Department	Subject/ Identified Need	Action	Timing	Counterpart
MAE	Foreign exchange	Short-term expert	June 1992	Bank of Latvia
MAE	Bank reorganization	Staff visit	June 1992	Bank of Latvia
MAE	Bank supervision	Short-term expert	July 1992	Bank of Latvia
FAD	Cash management/ Treasury system	Mission	October 1992	Ministry of Finance
MAE	Foreign exchange operations, accounting, and banking supervision	Mission	November 1992	Bank of Latvia
STA	Balance of payments compilation	Mission	November 1992	State Committee for Statistics, Bank of Latvia, Customs Department
MAE	Accounting	Short-term expert	February 1993	Bank of Latvia
MAE	Bank supervision	Short-term experts	February 1993	Bank of Latvia
MAE	Monetary policy	Short-term expert	February 1993	Bank of Latvia
MAE	Foreign exchange	Short-term expert	February 1993	Bank of Latvia
FAD	Establishment of Treasury Unit	Mission	January 1993	Ministry of Finance
FAD	Establishment of Treasury Unit	Short-term resident advisor	March to April 1993	Ministry of Finance
STA	Money and banking	Mission	April 1993	Bank of Latvia
MAE	Foreign exchange, accounting, payment and settlement systems, banking supervision	Mission	May 1993	Bank of Latvia

Department	Subject/ Identified Need	Action	Timing	Counterpart
STA	Balance of payment	Mission	May 1993	State Committee for Statistics
STA	Money and banking	Mission	June 1993	Bank of Latvia
FAD	Establishment of Treasury Unit	Mission	July to August 1993	Ministry of Finance
FAD	Establishment of Treasury Unit	Mission	September 1993	Ministry of Finance
MAE	Bank supervision	Short-term expert	September 1993	Bank of Latvia
STA	Consumer price index	Mission	October 1993	State Committee for Statistics
MAE	Bank supervision	Long-term advisor	October 1993 - April 1994	Bank of Latvia
STA	Money and Banking	Mission	November 1993	Bank of Latvia
STA	Resident statistical advisor	Long-term advisor	November 1993 to November 1994	State Committee for Statistics

Eligibility for Use of the Systemic Transformation Facility

Latvia's eligibility to draw under the Systemic Transformation Facility (STF) is established on the basis of the substantial and permanent increase in net import costs as a result of increases in the price of energy imports, largely from the Russian Federation, toward world market levels.

Apart from some domestically-generated hydroelectricity, Latvia is without domestic sources of energy and is therefore strongly dependent on external supplies. During the Soviet era the relative price of energy resources was set administratively at artificially low levels. As a result, by the early 1990s the productive structure of the Latvian economy and the techniques of energy supply and consumption had developed in a manner ill-suited to a more realistic price structure.

During 1992, the prices of energy resources imported from traditional FSU suppliers were raised sharply toward market levels, representing a severe external shock to the Latvian economy. Adjustment opportunities were in many cases limited for structural reasons (for example, in the case of heating, by a general lack of individual thermostats and regulatory valves). It is expected that a considerable portion of investment activity in Latvia will for some time be devoted to energy conservation, both in consumption and production.

The impact of the increase in net energy import costs on Latvia's balance of payments has been evaluated on the basis of constant energy import volumes of 1993. 1/ As Table 12 demonstrates, when the net energy import bills for 1992 and 1993 are calculated in this manner, the increase from 1992 to 1993 is estimated to be equivalent to SDR 108 million, or 118 percent of Latvia's quota. This estimate of the impact on Latvia's balance of payments is for a number of reasons likely to be understated, 2/ but is in any case far in excess of the threshold required for Latvia to be eligible to draw under the Systemic Transformation Facility.

1/ Prior to 1992, exports of energy resources from Latvia were quite limited. However, since 1992 there has been a considerable development of re-export activity of energy resources. These flows have been excluded from the net energy import figures shown in Table 12.

2/ Most notably, the price of energy imports rose significantly within 1992, thus raising the annual average base from which the increase in the energy import bill is calculated (estimates using 1991 as a base would be sensitive to the choice of exchange rate). Also, the use of constant quantities of 1993 (rather than 1992) understates the increased cost, as the 1993 quantities partly reflect a volume adjustment to the increased costs, Furthermore, the reported quantities reflect mild winters in both 1991/1992 and 1992/1993.

In the judgment of the staff, the effects of the increased cost of energy imports continue to give rise to balance of payments difficulties in an amount equivalent to at least 50 percent of quota.

Table 12. Latvia: Calculation of Increase in Net Energy Import Costs, 1992–1993

	Net import volumes (thousand tons) 1/			Unit price, in U.S. dollars 2/ 3/			Value of Net Energy Imports (in millions of U.S. dollars)				
							1992		1993	Increase, 1992 to 1993	
	1992	1993	percent change	1992	1993	percent change	estimated	at 1993 volumes	projection		at constant 1993 volumes
Fuel oil	1,033	1,117	8.1	58	70	20.4	60	65	78	18	13
Natural gas	2,100	1,721	−18.0	40	80	101.1	84	69	139	54	70
Coal	648	456	−29.6	19	36	85.1	13	9	16	4	8
Electricity	4,077	2,856	−29.9	10	13	40.9	39	27	39	−1	11
LPG	59	58	−2.5	75	175	133.4	4	4	10	6	6
Gasoline	504	510	1.2	159	180	13.5	80	81	92	12	11
Diesel	765	767	0.2	111	155	39.0	85	86	119	34	33
Total											
In millions of U.S. dollars	...	...	...	...	...	...	365	341	492	127	152
(million SDRs) 4/	...	...	...	...	...	...	...	...	...	90	108
(as percent of quota)	...	...	...	...	...	...	...	...	...	99	118

Sources: Latvian authorities and staff estimates.

1/ Volumes for natural gas and electricity are million cubic meters and million kilowatt–hours, respectively.
2/ Price per ton, except for natural gas and electricity, which are per thousand cubic meters and thousand kilowatt–hours, respectively.
3/ Implicit annual averages. Figures for 1992 reflect strong within–year price growth.
4/ Based on average U.S. dollar/SDR rate of 1992.

Fiscal Performance Criteria

Annex I of the Memorandum of Economic Policies (Attachment II) sets forth the fiscal performance criteria on the general government financial deficit and net lending plus government guarantees for loans to enterprises. Under the stand-by arrangement, which expired in September 1993, fiscal performance was monitored through limits on the change in net credit from the banking system to the general government. This appendix discusses the reasons for adopting the new fiscal performance criteria.

The change in fiscal performance criteria under the proposed stand-by arrangement is motivated by two recent developments. First, the scope for financing expenditures has significantly increased following the Government's decision to issue Treasury bills and given the Government's option to use part of the EC/G-24 balance of payments support loans for budgetary purposes. Second, the inflow of balance of payments support loans creates new Government liabilities. In the case of net lending operations based on the IBRD and EBRD loans, the foreign liability of the Government is matched by a corresponding but potentially uncertain claim against the domestic beneficiary of the loan. In the case of balance of payments support loans intermediated through the banking system, government-guaranteed loans extended to enterprises will create a contingent liability that may burden future budgets.

The increased scope for financing expenditures called for a broadening of the performance criterion on the change in net domestic banking system credit to the general government used under the recently expired stand-by arrangement. This purpose is served by the first performance criterion on the general government financial deficit, which is defined as the fiscal deficit excluding net lending operations. The enhanced role of the Government as an intermediator and guarantor of financial claims is reflected in the separate performance criterion on net lending plus government guarantees for loans to enterprises.

The definition of the general government is comprehensive and includes all extrabudgetary funds, including the privatization funds. Gross receipts of privatization funds are treated as an exchange of public sector assets for an increase of government claims on the banking system. Thus, privatization receipts appear below the line in the accounts of the consolidated general government and do not affect the financial deficit. However, outlays of privatization funds used for financing public expenditures appear above the line and therefore increase the financial deficit. This treatment of privatization receipts and outlays is intended to discourage undesirable uses of one-time budgetary receipts. Due to technical difficulties, the performance criteria set for end-December 1993, and end-March 1994, cover only the privatization funds at the central government level. The Ministry of Finance will establish a system to monitor privatization funds at the local government level before end-March 1994.

The definition of the general government net lending includes lending by the IBRD, the EBRD and other external creditors extending credit to Latvian importers. Government guarantees for loans to enterprises are measured as guaranteed amounts of loans disbursed through the banking system. However, the performance criteria set for end-December 1993, and end-March 1994, cover only guaranteed amounts of loans disbursed in the context of balance of payments support loans. A system to monitor other government guarantees will be developed by the Ministry of Finance before end-March 1994.

The performance criterion on the financial deficit will be measured from below the line because these data are usually available more rapidly than data from above the line. Thus, the financial deficit will be measured as the increase in net claims on the general government of the domestic banking system, the domestic nonbank sector, and the foreign sector, plus the gross receipts of the privatization funds, less net lending operations. Data on net claims on the general government by the domestic banking system will be obtained from the monetary survey, while data on all other claims on the general government, privatization receipts, and net lending operations will be obtained from the Ministry of Finance. Data on guarantees required for monitoring the performance criterion on net lending plus government-guaranteed loans to enterprises will also be obtained from the Ministry of Finance.

Latvia: Stand-By Arrangement

Attached hereto is a letter, with annexed memorandum, dated November 22, 1993 from the Minister of Finance of Latvia and the Governor of the Bank of Latvia requesting a stand-by arrangement and setting forth:

a. the objectives and policies that the authorities of Latvia intend to pursue for the period of this stand-by arrangement; and

b. understandings of Latvia with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Latvia will pursue for the remaining period of this stand-by arrangement.

To support these objectives and policies the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For the period from December __, 1993 to March __, 1995, Latvia will have the right to make purchases from the Fund in an amount equivalent to SDR 22.875 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2. a. Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 4.575 million until February 15, 1994, the equivalent of SDR 9.150 million until August 15, 1994, the equivalent of SDR 13.725 million until November 15, 1994, and the equivalent of SDR 18.300 million until February 15, 1995.

b. None of the limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Latvia's currency subject to repurchase beyond 25 percent of quota.

3. Latvia will not make purchases under this stand-by arrangement that would increase the Fund's holdings of Latvia's currency subject to repurchase beyond 25 percent of quota:

a. during any period in which the data at the end of the preceding period indicate that

(i) the limit on the General Government Financial Balance described in paragraph 13 and in Annex I of the memorandum, or

(ii) the limit on Net Lending by the General Government plus Government-Guaranteed Loans to Enterprises described in paragraph 13 and in Annex I of the memorandum, or

(iii) the limit on domestically-financed Net Lending by the General Government described in Annex I of the memorandum, or

(iv) the limit on Reserve Money described in paragraph 16 of the memorandum, or

(v) the floor on the Net International Reserves of the Bank of Latvia described in paragraph 30 and in Annex III of the memorandum, or

(vi) the limit on the contracting or guaranteeing by the Government, the Bank of Latvia, or other agencies of external debt of maturities between 1 and 12 years described in paragraph 31 and in Annex IV of the memorandum, or

(vii) the limit on the contracting or guaranteeing by the Government, the Bank of Latvia, or other agencies of external debt of maturities between 1 and 5 years described in paragraph 31 and in Annex IV of the memorandum, or

(viii) the limit on the outstanding stock of government and government guaranteed external debt of maturities of less than one year described in paragraph 31 of the memorandum, is not observed; or

b. if, at any time during the period of the stand-by arrangement, the limit on the accumulation by the Government of external payments arrears described in paragraph 20 of the memorandum is not observed; or

c. after May 14, 1994 and August 14, 1994, until the respective reviews contemplated in paragraph 33 of the memorandum are completed; or

d. if, at any time during the period of the stand-by arrangement, Latvia

(i) imposes or intensifies restrictions on the making of payments and transfers for current international transactions; or

(ii) introduces or modifies multiple currency practices; or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII; or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When Latvia is prevented from purchasing under this stand-by arrangement because of this paragraph 3, purchases will be resumed only after consultation has taken place between the Fund and Latvia and understandings have been reached regarding the circumstances in which such purchases can be resumed.

4. Latvia will not make purchases under this stand-by arrangement during any period in which Latvia has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation (a) in respect of a noncomplying purchase pursuant to Decision No. 7842-(84/165) on the Guidelines on Corrective Action, or (b) in respect of a purchase in support of debt and debt service reduction operations pursuant to Decision No. 9331-(89/167), as amended, or (c) pursuant to subparagraph 16(a) or 33(a) of Decision No. 8955-(88/126), as amended, on the Compensatory and Contingency Financing Facility.

5. Latvia's right to engage in the transactions covered by this stand-by arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Latvia. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Latvia and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, unless, at the request of Latvia, the Fund agrees to provide SDRs at the time of the purchase.

7. Latvia shall pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

8. a. Latvia shall repurchase the amount of its currency that results from a purchase under this stand-by arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Latvia's balance of payments and reserve position improves.

b. Any reductions in Latvia's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

9. During the period of the stand-by arrangement Latvia shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Latvia or of

representatives of Latvia to the Fund. Latvia shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Latvia in achieving the objectives and policies set forth in the attached letter and annexed memorandum.

10. In accordance with paragraph 2 of the attached letter, Latvia will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 3 above have not been observed or because the Managing Director considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Latvia has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Latvia's balance of payments policies.

Riga
November 22, 1993

Dear Mr. Camdessus:

Over the past year, significant progress has been made towards transforming Latvia into a fully fledged market economy. The first phase of the reform process, initiated with the introduction of an independent currency in July last year, concentrated on stabilizing the economy. Much has been achieved in this respect. Our new currency has maintained its strength vis-à-vis convertible currencies, and average monthly inflation has declined to about 0.5 percent over the past half year. However, mainly because of the difficult external environment, the decline in economic activity has been steeper than anticipated and unemployment has been rising rapidly. At the same time, the economy has been opened up to foreign competition through a comprehensive liberalization of the trade and payments system, and most domestic prices have been liberalized. Enduring success of our transformation effort--in particular a revival of economic growth over the medium term--now crucially depends on the consolidation of the gains already achieved and the speeding up and broadening of the reform process.

The Government believes that the policies set out in the attached memorandum will be adequate to further these aims. In support of these policies, the Government hereby requests a fifteen-month stand-by arrangement in the amount of SDR 22.875 million. We also intend to request shortly a first purchase under the Systemic Transformation Facility (STF) in an amount equivalent to SDR 22.875 million (25 percent of quota). We intend to request a second purchase in the same amount when the conditions for such a purchase are met. The Government will provide the Fund with any information it may request for purposes of monitoring progress of the program supported by the stand-by arrangement, and will remain in close consultation with the Fund in accordance with the Fund's policies on such consultations. Furthermore, we stand ready to take any further measures that may become necessary to attain the aims of the program. In addition, we will complete with the Fund two reviews of economic developments and policies under the program, the first by May 15, 1994, and the second by August 15, 1994. Quantitative performance criteria will be specified for June 30 and September 30, 1994 in the context of the first review, and those for December 31, 1994 in the context of the second review.

Sincerely,

/s/	/s/
Uldis Osis	Einars Repse
Minister of Finance	Governor
Ministry of Finance	Bank of Latvia

Attachments

Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431

Memorandum of Economic Policies

1. Background

1. Since the autumn of 1991, when Latvia regained its independence, the Government has made a determined effort to transform the economy from a centrally planned to a market based system. The reform process had to be conducted in a difficult environment characterized by macroeconomic imbalances inherited from four decades of central planning, disruptions caused by a sharp contraction of trade with Russia and other states of the former Soviet Union, and the worsening of the terms of trade resulting from the switch to trade at world market prices for energy and raw materials. Furthermore, until mid-1993, the continuation with an interim Parliament and the run up to new elections created obstacles for political consensus on several structural reform issues. Nevertheless, we have made significant progress in laying the foundations for the transformation process by attaining a large degree of macroeconomic stability, a prerequisite for sustained reform. The main components of our reform program over the last year included currency reform, tight fiscal and monetary policies, a significant liberalization of prices and of the exchange and trade system, and a number of systemic changes designed to promote efficiency and to stimulate the privatization process to reduce the role of the Government in the economy.

2. Our decision in July 1992 to leave the ruble area by making our transitional currency, the Latvian ruble, the only legal tender in Latvia created the condition for the pursuit of an independent monetary policy. The process of converting the Latvian ruble into our national currency, the lats, has proceeded smoothly, and with our decision on the mandatory quotation of prices and denomination of contracts in lati from June 28, 1993, the currency reform is now completed. The pursuit of tight fiscal and monetary policies, supported by a tax-based incomes policy, brought monthly inflation down from nearly 20 percent in July 1992 to a monthly rate of less than 0.5 percent in the third quarter of 1993. These achievements were, however, accompanied by a much steeper decline in economic activity than had been anticipated, as well as a significant increase in unemployment, among other things due to the lack of progress in the area of privatization. As a result, a surplus was recorded in the external current account instead of the targeted deficit.

3. Considerable progress was also made over the last year in initiating important institutional and legislative changes. The price liberalization process, which started in early 1991, advanced with vigor, and by mid-1993 only a few items remained subject to control. Land restitution and privatization of small-scale enterprises have progressed considerably, despite unresolved issues of citizenship and restitution of residential property to previous owners. Privatization of large-scale enterprises has proceeded slowly. Further, only a small number of

inefficient state enterprises have been closed down so far. A two-tier banking system has been created and steps taken to restructure and privatize the former commercial branches of the Bank of Latvia. A relatively liberal trade and exchange system has prevailed since the abolition of virtually all export quotas and licensing in June 1992.

4. The Government remains fully committed to the basic features of last year's economic stabilization and reform program. Our recent efforts toward reinforcing the reform process are described below, as is an outline of the economic program that the Government intends to implement for the remainder of 1993 and beyond.

2. The program for October 1, 1993-December 31, 1994

5. The Government has formulated economic policies for the period October 1, 1993-December 31, 1994 in the context of a medium-term perspective for Latvia's reform process. The key objectives for the medium-term will be to consolidate the gains achieved so far in the area of price stability, to continue the restructuring of the economy in line with the new set of relative prices, and to promote a vibrant private sector through accelerated privatization of state enterprises as well as other structural measures to achieve better resource allocation and efficiency gains. We believe that this is the only way to create the basis for sustained growth while maintaining a viable balance of payments over the medium term. However, many uncertainties remain, including prospects for the external environment and the response of the economy to the reform process, that will necessitate periodic review of these objectives.

6. The program for the period October 1, 1993-December 31, 1994 is the first step toward these goals. A key aim is to keep average monthly inflation below 1/2 percent through the program period, and at the same time to strengthen the functioning of the markets--in goods, factors and financial assets--and to improve relative price and wage flexibility by structural policies. A significant improvement in the external environment is unlikely in the near term and this will continue to have an adverse bearing on output and employment. However, by promoting private sector activity, particularly in the export sector oriented toward nontraditional markets, we hope to limit the rate of decline in GDP in 1993 to less than half of that recorded the year before and to achieve a positive rate of growth in 1994. Gross official international reserves are targeted to increase by about US$80 million during October 1, 1993-December 31, 1994, while a current account deficit of about US$290 million is targeted for this period on the basis of an expected revival of imported inputs, including investment goods. The financing requirement implied by these targets is expected to be available from external sources and consistent with the economy's longer term debt servicing capacity.

7. The main elements of our program are the following:

a. prudent fiscal policies designed to prevent a further decline in the revenue-to-GDP ratio and to provide adequately for productive outlays and the social safety net, but with the deficit limited to a level that can be financed in a noninflationary way;

b. monetary policies aimed at securing price stability while at the same time accommodating the increase in the demand for money induced by growing credibility of our policies in general and the substitution from foreign currency into lati in particular;

c. rationalization of the trade regime to increase its transparency and consistency, and to achieve a fuller integration of the Latvian economy in the multilateral trading system; and

d. structural adjustment efforts, including further price liberalization, expedited privatization, improvement of financial discipline in the economy, restructuring and rehabilitation of banks and enterprises, additional fiscal reform measures, and improvement in the operation of the social safety net through better targeted benefits.

3. Fiscal policy, infrastructural investment and social safety net

8. With revenues lagging behind budget projections, a small financial surplus was recorded in the first three quarters of 1993 through tight expenditure controls and also through the accumulation of some expenditure arrears. We are concerned that--at this stage of transition--the growth rate of budget revenues falls short of the growth rate of nominal output. This development, if not halted, would necessitate severe expenditure cuts to keep the budget deficit under control. Accordingly, we have taken a number of revenue-enhancing measures, focusing mainly on taxes on goods and services to minimize potential efficiency losses. The standard rate of the value-added tax has been increased from 12 percent to 18 percent for all goods except food products, and for food products from 6 percent to 10 percent, with effect from November 1, 1993. The rate for food products will be increased to 18 percent from June 1, 1994. Also, from November 1, 1993, excise taxes of Ls 0.04 per liter of gasoline and Ls 0.02 per liter of diesel and of 10 percent on cars were introduced. Moreover, we have strengthened value-added tax collection by levying VAT on imports at the border. Furthermore, we plan to improve excise tax collections by taking more rigorous measures against illegal activities. The combined effects of the revenue measures are estimated to be equivalent to 1 1/2 percent of GDP during the last quarter of 1993.

9. To further improve the efficiency of profit and income taxation, we intend to implement a number of reforms. Within the program period, we plan to introduce a unified profit tax rate in the range of 25-35 percent for all types of entrepreneurial incomes. As regards income taxation, a flat-rate income tax of 25 percent combined with a surcharge of 10 percent

on annual income and deductions depending on the family situation of the taxpayer will take effect from January 1, 1994. The current system of universal family allowances will be adjusted to allow for the changes in income taxation. We recognize that the budget implications of these reforms have to be weighed carefully to prevent the emergence of unfinanceable revenue shortfalls.

10. The social security system is under severe stress because of rising unemployment and pressures to increase pension benefits. To deal with the substantial regional disparities in unemployment, from January 1, 1994 we will allow the duration of unemployment benefit payments to be temporarily extended beyond the current six-month limit for specific districts. At the same time, we will speed up the implementation of mechanisms for relocation and training of workers and of public works programs. Furthermore, we intend to leave the minimum wage unchanged at its current level of Ls 15 per month until the end of 1993, to avoid any adverse effects on employment, particularly of the young new entrants to the labor market. From November 1, 1993, the average pension was increased to about Ls 23 per month. We recognize that, given our limited resources, there is a need for better targeting of social benefits. Accordingly, we intend to further improve the scheme of means-tested social assistance developed since late 1992 by setting up a realistic minimum subsistence level and by providing local authorities with clearer guidance on the priorities for social assistance.

11. With pension payments comprising more than half of social expenditures, pension reform is an integral part of our efforts to improve the efficacy of the social security system. While we intend to draft a new pension law taking international experience into account, in the interim we intend to raise the retirement age gradually over the next five years starting in 1994. Furthermore, a system of more differentiated pension benefits based on the work history of beneficiaries was introduced from November 1, 1993.

12. We recognize the crucial role of fiscal policy in our stabilization program and continue to aim for a small deficit in current operations. However, there is an urgent need for public sector infrastructural investments, including in the areas of transport, telecommunications, energy production, distribution and conservation, and education facilities. Furthermore, we recognize the need for fiscal support in the restructuring and rehabilitation of banks and enterprises.

13. We propose to aim at a general government financial deficit of no more than 4 1/2 percent of GDP and government net lending and guarantees of no more than 5 percent of GDP during the last quarter of 1993. This will limit the financial deficit to 1/2 percent of GDP and government net lending and guarantees to 3 percent of GDP for 1993 as a whole. We plan to finance part of the financial deficit during the last quarter of 1993 through the issuance of Treasury bills as well as small amounts from external sources (G-24 loans) and from domestic borrowing from the nonbank sector. These

basic aims of fiscal policy will be maintained in the budget for 1994, which will be presented to Parliament in late November 1993. Thus, the objective for 1994 is to limit the financial deficit to no more than 2 percent of GDP and government net lending and guarantees to no more than 4 percent of GDP. In the 1994 budget, part of investment expenditures is expected to be financed from external sources (including EC/G-24 loans)--earmarked for infrastructural projects clearly identified in a public investment program elaborated with assistance from the World Bank. Neither for the remainder of 1993 nor in 1994 do we intend to onlend EC/G-24 loans through the budget or to replace the planned external financing of the budget by borrowing from domestic sources. Taking account of seasonality, the financial deficit of the general government, as defined in Annex I, shall not exceed Ls 25 million during the period October 1-December 31, 1993, nor Ls 35 million during the period October 1, 1993-March 31, 1994. Similarly, government net lending plus government guaranteed loans to enterprises, as defined in Annex I, shall not exceed Ls 25 million during the period October 1-December 31, 1993, nor Ls 50 million during the period October 1, 1993-March 31, 1994.

14. In the area of structural reform in the fiscal sector, we will continue to strengthen tax administration, expenditure management, and efficiency of public services and administration. The Finance Inspection Department of the Ministry of Finance has already started to confiscate bank deposits from enterprises in tax arrears and intends to pursue enterprises defaulting on tax payments even more vigorously in the future. Also, in the context of reforming tax administration we have requested from the Fund the posting of a resident advisor in the Ministry of Finance. The establishment of a Treasury unit, which has been proceeding with assistance from the resident Treasury advisor provided by the Fund and the German Ministry of Finance, is expected to be completed by end-1993. A new budget law giving a clear budget management mandate to the Ministry of Finance will be presented to Parliament, which if passed in a timely manner, will be applied to the execution and control of the 1994 budget. The Ministry of Finance will adopt new analytical presentations of the budget to improve monitoring and reviewing of the macroeconomic impact of the budget. The compression of wage scales in budgetary organizations has created difficulties in recruiting and retaining qualified personnel at higher skill categories. To deal with this problem, a new more differentiated wage scale was introduced with effect from November 1, 1993, at an estimated cost of Ls 3 million to the budget during the last quarter of the year.

4. Monetary policy

15. The pursuit of tight monetary policies has resulted in a sharp dampening of inflationary expectations, growing confidence in the national currency, and a large measure of reverse currency substitution. In the context of the flexible exchange rate framework, our monetary policy will continue to be guided by the considerations of maintaining price stability and orderly conditions in the exchange market and accommodating the increase in the demand for lati induced by the increasingly credible monetary stance.

16. We will continue to target reserve money until inflationary expectations have been firmly lowered, with reserve money defined as currency in circulation plus domestic currency deposits of banks with the Bank of Latvia. Reserve money, which reached Ls 187 million at end-September 1993, shall not exceed Ls 207 million on December 31, 1993 nor Ls 216 million on March 31, 1994. These ceilings are established on the basis of some overperformance of net convertible international reserves above the increases from September 30, 1993 of US$23 million to end-December 1993 and of US$26 million to end-March 1994 referred to in paragraph 30. Accordingly, the ceilings on reserve money for December 31, 1993 and March 31, 1994 will be adjusted downward for any shortfall, and upward for any excess up to US$20 million, from the programmed increase in net convertible international reserves of US$28 million to December 31, 1993 and of US$36 million to March 31, 1994, respectively, with the deviations valued at the accounting rate of US$1 = Ls 0.616. These reserve figures exclude the unutilized part of EC/G-24 assistance. The obligatory reserve requirement ratio for banks will remain at its present level through March 31, 1994. We will continue to monitor indicators of demand for money closely, and adjust policies as necessary to secure the program objectives. As part of our cautious approach to monetary policy, indicative ceilings have been established for the net domestic assets of the banking system. As defined in Annex II, net domestic assets of the banking system, which were Ls 134 million on September 30, 1993 will be limited to Ls 140 million on December 31, 1993 and Ls 170 million on March 31, 1994.

17. In the three quarters of the year, credit market conditions were tight with interest rates at high levels in spite of the favorable movements in inflation and the exchange rate. Although the Bank of Latvia reduced the monthly interest rate on its refinancing facility gradually from 10 percent on January 1, 1993 to 2 1/4 percent on October 21, 1993, market lending rates have fallen much more gradually. The Bank of Latvia intends to introduce an auction system for part of the refinancing facility and to promote the development of an interbank money market during the last quarter of 1993 as a step toward relying increasingly on market related monetary policy instruments.

18. We recognize that an enduring solution to the problem of excessively high interest rates and poor financial intermediation will have to await the restructuring and rehabilitation of the former branches of the Bank of Latvia. The Bank Privatization Commission, which was set up in December 1992 and has been supported by the World Bank and the Swiss Government, is currently winding up its work. A large number of the former branches of the Bank of Latvia have already been privatized on an individual basis or sold to existing commercial banks. The remaining branches have been merged into one bank--"The Universal Bank of Latvia"--with several branches. It will be privatized in due course. The World Bank and the EC PHARE are also assisting us in our effort to restructure and rehabilitate the State Savings Bank. Starting from January 1, 1994, the central government budget will pay the State Savings Bank interest on the Ls 23 million of impaired claims guaranteed by the Government. Significant

progress has already been made with the assistance from the Fund in developing the prudential supervisory capabilities of the Bank of Latvia, and we expect, with the help of a resident advisor provided by the Fund, to have a fully operational banking supervision system in place by the end of the year. We will also seek help from the EC PHARE (or other donors) in the financing of external audits of the main private commercial banks.

5. External sector policies

19. We remain committed to a liberal trade system in a multilateral framework and view the protective tariffs introduced since late 1992 as temporary measures taken in response to the unsettled situation and subsidization of goods in neighboring countries. We plan a comprehensive overhaul of the tariff system, including both the structure of tariffs and the institutional mechanisms of tariff policy, to be fully implemented by July 1, 1994. In this connection, we have requested the assistance of the World Bank, and we are now studying its preliminary recommendations. In the meantime, we have extended the temporary exemption of raw materials and spare parts until the end of 1993. We intend, however, to introduce a new interim Law on Tariffs to take effect from January 1, 1994, in order to begin narrowing the dispersion of import tariff rates and to provide additional government revenues. According to this law, only a small number of items, such as food for infants, textbooks, and certain medical equipment, will remain exempt from import tariffs, while minimum tariffs will be imposed on raw materials/spare parts and on equipment. Initially, different ranges will be applied for the two categories of goods, but we intend to move to a unified minimum tariff for such goods during 1994. As regards goods for final consumption, whenever possible, the rates of import tariffs will not exceed the basic rate of 15 percent (20 percent in the case of countries without trade agreements with Latvia). Thus, the higher temporary protective tariffs established in late 1992 on various personal products will be abolished and replaced with these basic rates. The interim Law on Tariffs also stipulates a significant reduction in most of the special protective tariffs on agricultural goods introduced in December 1992 and April 1993. However, the situation with regard to imports of agricultural products remains difficult, and it will not be possible to entirely abolish the protective tariffs in this area in the near future. Nevertheless, we will monitor the foreign situation for early opportunities to abolish these tariffs, taking into account the recommendations of the World Bank. We will also aim at converting all remaining specific tariffs to ad valorem rates. Other than certain remaining agricultural items, import tariffs higher than the basic rates of 15 percent and 20 percent will be limited to alcohol. With regard to export tariffs, a new structure will apply according to the interim Law on Tariffs, involving fewer categories of exports and significant reductions in tariff rates for a number of products, although in a few areas export tariff coverage will be extended. The practice of applying different rates on goods exported to ruble area countries will be abolished, and export tariff rates will depend only on whether the country of destination has a trade agreement with Latvia. Although these measures will be a significant step in reducing certain

distortions which have emerged, we regard them as interim steps toward the intended comprehensive reform mentioned above. We will discuss progress in this area, and agree on further measures, in the context of the first review of the program with the Fund.

20. In order to ensure a more stable tariff structure and to avoid ad hoc changes, we have modified the process of tariff policy formation. The former Tariff Council has been replaced by a new body which will evaluate but not act on proposals for tariff modifications. Changes in tariff policy are expected to become possible only by act of Parliament, with the exception only that the Government may act independently to reduce trade tariffs for a period of up to three months without Parliamentary approval. The widespread granting of enterprise-specific exemptions from import duty will cease. Furthermore, the Government does not intend to introduce new, or intensify existing exchange restrictions or import restrictions for balance of payments purposes, or introduce or modify multiple currency practices. Also, the Government will not accumulate external arrears nor conclude bilateral payments agreements inconsistent with Article VIII of the Fund's Articles of Agreement during the period of the arrangement.

21. The paramount need to maintain price stability, and the current unsettled conditions of the markets together with the continuing adjustments in relative prices of traded and nontraded goods, warrant a continuation of the current exchange rate policy. Thus, in the near future, the exchange rate of the lats will continue to be mainly market determined and be used as an indicator of monetary policy conditions. The Bank of Latvia will, however, intervene and provide leadership to maintain orderly conditions in the foreign exchange market.

22. The Government recognizes the catalytic role that foreign direct investment and transfer of technology from abroad can play in reviving growth and employment in the economy. Thus, the current stipulations in the foreign investment law allowing liberal repatriation of capital and transfers of shares in the event of liquidation will be maintained. With prudent financial policies underpinning the viability of our external accounts, residents and enterprises will continue to be permitted to hold foreign currencies in cash, in bank accounts, or abroad and to use them for domestic payments.

23. The conduct of international economic relations on a nondiscriminatory basis in line with multilateral principles remains our aim. However, we recognize the need for continued close economic relations with the states of the FSU because of past ties and geographical proximity, and we have concluded trade agreements with all states of the FSU with the exception of Kazakhstan, the Kyrgyz Republic and Georgia with which the agreements are currently being prepared. We will continue to encourage payments for trade with foreign countries, including the states of the FSU, to take place directly through the correspondent accounts that Latvian commercial banks maintain with banks in such countries. Some payments with the FSU states, however, continue to be settled through the correspondent

accounts of the Bank of Latvia with central banks of such states opened since July 1992, but we intend to abolish this system from January 1, 1994 and from then on settle payments with these countries through commercial banks. We will ensure that official payments are made on schedule and impose the same discipline on enterprises. We will also continue our efforts to negotiate with Russia an agreement on outstanding foreign assets and liabilities of the former U.S.S.R..

6. Systemic changes

24. The Government recognizes that, with the measure of success already achieved in the area of macroeconomic stabilization, it is crucial to persevere with institutional and structural reform to sustain the stabilization effort as well as to improve economic efficiency and the supply response of the economy. It is in this context that we consider the development of an appropriate medium-term focus of our policies to be crucial, and we may consider, at an appropriate time, an arrangement under the Extended Fund Facility in support of such policies. We have also initiated discussions with the World Bank on structural and sectoral reform measures. In the interim, we will press ahead firmly with the reform process in the areas described below.

25. The Government intends to move away completely from price control and to allow swift adjustment of prices to external as well as domestic shocks. The Price and Tariff Council, in cooperation with the committee established to administer the competition and anti-monopoly legislation, will continue to oversee price determination for goods and services provided by monopolies, including state enterprises and utilities. As a matter of principle, it will allow a full pass-through of imported input costs into prices. Efforts to break up enterprises with a dominant share in a sector will be intensified to speed up the process of enterprise restructuring. Furthermore, in view of the almost complete dependence of Latvia on imported energy, by December 1, 1993, the Government will complete a pilot study of the energy sector to elaborate an appropriate strategy for development as well as pricing of energy.

26. In early November 1993, draft laws were introduced in Parliament on the establishment of a Privatization Agency, which will have centralized authority over the privatization of large-scale enterprises--including those in the agricultural sector--and of a State Property Fund, which will be responsible for all state property. We expect these laws to be adopted before the end of 1993. The Privatization Agency will be a nonprofit statutory organization, with authority to decide independently of the Government the method of privatization as well as the price of the enterprises to be privatized. It is the intention that the existing Privatization Fund, which collects revenue from privatization, will be administered by the Ministry of the Economy. We have already begun to distribute privatization vouchers to citizens, and legislation on the establishment of investment privatization funds is expected to be passed before the end of 1993. To spur the privatization of medium- and large-

scale enterprises, a pilot scheme will be set up by early 1994 with World Bank assistance to implement the privatization of a small number of selected enterprises using a series of different privatization techniques. To accelerate and simplify the process of restitution of land and residential property to former owners, revisions to the restitution laws on residential property and rural land as well as a new draft law on restitution of urban land are expected to be passed before the end of 1993. The new legislation will shorten the period for submission of applications for restitution of residential property to the end of 1993 and for the restitution of urban land to the end of March 1994. This will remove most obstacles that unresolved restitution issues have posed for the privatization process so far. We expect that legal entities, including foreigners, will be allowed to acquire title to land (to purchase it as private property) before mid-1994. We also intend to promote a dynamic small- and medium-scale private sector by providing training, technical know-how and financial assistance to the nascent entrepreneurs in Latvia. The first business support center to train entrepreneurs and provide information on financing, marketing and other elements of business operations in a market environment was opened in Riga in mid-June 1993. A number of additional centers will be opened in other parts of Latvia during the coming months.

27. We intend to institute rigorous supervision of enterprises and the threat of liquidation, in the context of a strict fiscal and monetary policy regime, is expected to strengthen financial discipline and reduce interenterprise arrears. In this connection, we intend to ensure that users pay the full cost of imports to domestic suppliers of energy services. With the help of other government institutions, the State Statistical Committee will start collecting and monitoring information on interenterprise arrears. We also intend to create a secondary market in interenterprise debt. The World Bank will be assisting the Government to define a policy in this area. A new accounting law establishing internationally accepted standards, adopted in October 1992, has been applied since the beginning of 1993 and is expected to contribute to better financial discipline in enterprises.

28. A new Statistical Law was enacted in June 1993 which grants appropriate authority to the State Statistical Committee to collect data from privatized state enterprises as well as the newly emerging private sector, and thus remedy the incomplete coverage of our economic data which has impeded efficient monitoring and policy formulation in the past. The Statistical Committee intends to publish economic statistics regularly, as will other institutions such as the Ministry of Finance and the Bank of Latvia. The Government is committed to the implementation of technical assistance from the Fund. Therefore, we expect to make significant progress in the timeliness and accuracy of our national accounts, fiscal, monetary and balance of payments statistics. In this context, a resident statistical advisor from the Fund will be posted in the Baltic countries in the near future.

7. Balance of payments prospects and financing from the Fund

29. The Government considers the current account surpluses of US$53 million during 1992 and of US$75 million estimated for the first three quarters of 1993 to be a reflection of the significant decline in investment activity in the economy. There are, however, indications that our structural policies are starting to elicit the appropriate supply response and stimulate investment activities. Accordingly, we anticipate a substantial increase in vital imports, including investment goods, and a current account deficit of about US$40 million is targeted for the fourth quarter of 1993 and about US$250 million in 1994. Together with a targeted increase of US$80 million in gross official reserves over this period, this leaves a financing requirement of about US$370 million which is expected to be covered mainly by official balance of payments support, including from the Fund, the remainder of the EC/G-24 assistance, the EBRD, and the World Bank.

30. We have established targets for the development in convertible net international reserves, as defined in Annex III. Net convertible international reserves defined in this manner amounted to US$338 million on September 30, 1993, and such reserves shall increase by at least US$23 million during the three months to December 31, 1993 and by at least US$26 million during the six months to March 31, 1994.

31. The contracting and guaranteeing of nonconcessional public medium- and long-term external debt, excluding purchases from the Fund, is projected to be about US$60 million during the period October 1, 1993-March 31, 1994. Consistent with this target, contracting (net of cancellations) and guaranteeing of loans with maturities between one and five years will be limited to no more than US$20 million and for maturities between one and twelve years to no more than US$60 million during the period October 1, 1993-March 31, 1994. Details are set out in Annex IV. The outstanding stock of government and government guaranteed debt with maturities of up to and including one year shall not exceed US$20 million by December 31, 1993 or March 31, 1994, with the Government defined as in Annex I.

8. Technical assistance

32. We have received extensive technical assistance from the Fund, the World Bank, EC PHARE and bilateral donors over the past year. We recognize that additional assistance will be needed in a number of areas and we hope that such assistance could increasingly be provided in the form of posting short-term and long-term resident advisors in Latvia, since this will improve our capacity to absorb such assistance and thus make it more efficient. On our part, we have transferred the responsibility for the overall coordination of such assistance to one authority, the Ministry of Finance, to avoid duplication and waste.

9. Review of the program

33. We will complete with the Fund by May 15, 1994, a review of economic developments and policies under the program. In addition to assessing whether quantitative performance criteria have been met and evaluating the effect of financial policies on growth, inflation and the exchange rate, this review will focus, inter alia, on progress made toward the implementation of a new tariff system, the operations of the Privatization Agency and State Property Fund and progress in privatizing large-scale enterprises, progress in the rehabilitation and privatization of the Universal Bank of Latvia and in the rehabilitation and restructuring of the State Savings Bank, the functioning of the banking supervision system, and the granting of government guarantees. This review will also evaluate technical assistance received and additional technical assistance needs. Quantitative performance criteria for June 30, 1994 and September 30, 1994 will also be specified at the time of this review. A second review will be completed by August 15, 1994. This review will evaluate, inter alia, the functioning of the new tariff system, further progress in financial sector and enterprise restructuring, and the quality of economic statistics. Quantitative performance criteria for December 31, 1994 will be specified at the time of this review.

Performance Criteria on General Government Financial Balance and Net Lending plus Government-Guaranteed Loans to Enterprises

Limits on the Financial Balance

	(In millions of Lati)
October 1, 1993 - December 31, 1993	-25
October 1, 1993 - March 31, 1994	-35

Limits on Net Lending plus Government-Guaranteed Loans to Enterprises

	(In millions of Lati)
October 1, 1993 - December 31, 1993	25
October 1, 1993 - March 31, 1994	50

The general government is defined to include: the central government; the local governments which are composed of regions and cities; the social security system; and all extrabudgetary funds including the privatization funds at the central government level. A system to monitor privatization funds at the local government level will be developed before March 31, 1994.

The general government financial deficit is defined as the increase in net claims on the general government of domestic and foreign banks plus the increase in all other claims on the general government of domestic and foreign financial and nonfinancial institutions or households, plus the gross receipts of the privatization funds at the central government level, less net lending operations undertaken by the general government. The financial deficit will be measured excluding valuation gains and losses on all foreign currency denominated assets and liabilities arising from exchange rate fluctuations.

Net claims of domestic and foreign banks on the general government are defined as all claims of these banks on the general government less all deposits of the general government with these banks. The claims of banks on the general government include: bank loans to general government;

securities or bills issued by the general government held by banks with the exception of those issued in connection with bank and enterprise restructuring operations; the government-guaranteed assets of the State Savings Bank; and overdrafts on the current accounts of the general government with banks. They exclude the acquisition of equity in banks. Deposits of the general government with the banks include but are not limited to domestic or foreign currency deposits with banks but exclude blocked counterpart deposits in the Bank of Latvia received for balance of payments support and blocked counterpart deposits from the sale of humanitarian assistance. The agreed amounts of blocked counterpart deposits to be used for financing budget expenditures or net lending operations will be added to the deposits of the general government.

Net lending by the general government consists of lending operations by the general government to the nongovernment sector, less repayments. Lending operations include loans given, purchases of debt or equity, and payments of interest or amortization on debts of others which generate equivalent claims against the original debtors. All net lending operations, except for a quarterly limit of Ls 1 million, cumulative from October 1, 1993, shall be financed only from net foreign loans; compliance with this limit shall be monitored as of December 31, 1993 and March 31, 1994. Government guarantees on loans to enterprises are measured as the guaranteed amounts of loans disbursed through the banking system in the context of EC/G-24, EBRD and World Bank balance of payments support loans. A system for monitoring other government guarantees will be developed before March 31, 1994. In the meantime, the Government will restrict the extension of new loan guarantees outside the context of EC/G-24, EBRD, and World Bank loans to exceptional cases.

Monthly data on net claims of the domestic banking system on the general government are taken from the balance sheets of the Bank of Latvia and other banks. The Ministry of Finance shall provide information on, and confirm the amounts of general government deposits held abroad, disbursements of foreign loans to the general government, net sales of Treasury bills and bonds, borrowing from the nonbank sector, gross receipts of the privatization funds at the central government level, net lending operations of the general government, loan guarantees extended by the general government and any other data regarding the financial balance.

Net Domestic Assets of the Banking System

	(In millions of Lati)
September 30, 1993	134
Indicative limit through December 31, 1993	140
Indicative limit through March 31, 1994	170

Net domestic assets of the banking system are defined as the difference between the liabilities of the banking system to the nonbank public (M2X) and net international reserves (in convertible and nonconvertible currencies) of the banking system. For purposes of calculating the net domestic assets of the banking system for the program, foreign assets and liabilities will be converted into lati at the exchange rates prevailing on September 30, 1993. Net international reserves of the banking system in convertible currencies are the sum of all monetary gold valued at US$300 per ounce and gross claims in convertible currencies on nonresidents less liabilities in convertible currencies to nonresidents with an original maturity of one year or less. Net international reserves of the banking system in nonconvertible currencies will include the sum of net balances in correspondent accounts with all states of the former Soviet Union opened since July 1992. Thus, net domestic assets of the banking system include net credit to the general government; gross credit to the nongovernment sector; and other net assets.

The indicative limits shown in the table will be cumulative and will be monitored monthly from the balance sheets of the Bank of Latvia and other banks.

Targets for the Minimum Cumulative Change in Convertible Net International Reserves of the Bank of Latvia

	Minimum
	(In millions of U.S. dollars)
Position on September 30, 1993	338
Cumulative change from September 30, 1993	
December 31, 1993	23 1/
March 31, 1994	26 1/

1/ Excluding the unutilized part of EC/G-24 assistance.

Net international reserves in convertible currencies consist of gross foreign assets of the Bank of Latvia in convertible currencies minus foreign liabilities of the Bank of Latvia in convertible currencies, both expressed in U.S. dollars.

For purposes of the program, gross foreign assets in convertible currencies will include all foreign assets of the Bank of Latvia, including monetary gold, holdings of SDRs, any reserve position in the Fund, holdings of foreign exchange in convertible currencies, and any deposits with nonresident financial institutions denominated in convertible currencies. Excluded from gross foreign assets will be the participation in international financial institutions except the Fund, as well as holdings of nonconvertible currencies and claims on nonresident financial institutions denominated in nonconvertible currencies, and the unutilized part of EC/G-24 assistance.

For purposes of the program, foreign liabilities in convertible currencies will be defined as use of Fund credit, and convertible currency liabilities of the Bank of Latvia with original maturity of up to and including one year. Excluded from reserve liabilities are any liabilities arising from balance of payments support of maturity longer than one year, including such loans from the EC/G-24, other international financial institutions, foreign governments, or foreign banks.

For the entire period of the program, the exchange rates of the SDR, and nondollar currencies vis-à-vis the U.S. dollar, will for program purposes be kept at their September 30, 1993 levels, and all monetary gold will be valued at US$300 per ounce. For the purposes of calculating net international reserves, the Fund staff will be informed of details of any gold sales, purchases, or swap operations during the program period, so that adjustments can be made to exclude changes in the value of gross reserves that arise merely due to a different valuation of gold.

The targets will be cumulative and will be monitored from information provided monthly by the Bank of Latvia.

Medium- and Long-Term External Debt

Cumulative Contracting and Guaranteeing of External Debt	Maximum Limits 1-12 Year Maturity	1-5 Year Maturity
	(In millions of U.S. dollars)	
During the period from end-September 1993 to:		
December 31, 1993	40	10
March 31, 1994	60	20

External debt limits apply to nonconcessional medium- and long-term external debt of original maturities of more than one year up to and including twelve years that are contracted or guaranteed by the Government, the Bank of Latvia or any other agencies on behalf of the Government, with sub-limits for such debt of maturities of more than one year up to and including five years. The definition of the Government is the same as in Annex I. Excluded from the limits are use of Fund resources; but other balance of payments support of maturity longer than one year would be covered by these limits, including loans from official creditors and foreign banks. Contracted loans shall be valued in the currency of transactions and converted into U.S. dollars at the exchange rate at the time of the contracting of the loan.

Compliance with the limits shall be verified at quarterly intervals for the dates shown above. Information on the contracting of external debt, as well as the outstanding stock of government debt with maturities of up to and including one year, will be reported by the Ministry of Finance to the Bank of Latvia, which will in turn report such figures to the Fund staff.