FOR AGENDA

EBS/92/190

CONFIDENTIAL

November 25, 1992

To: Members of the Executive Board

From: The Secretary

Subject: Latvia - Review of the Stand-By Arrangement and Request for Modification of Performance Criteria

Attached for consideration by the Executive Directors is a paper on the review of Latvia's stand-by arrangement and a request for modification of performance criteria under its stand-by arrangement, which is tentatively scheduled for discussion on Wednesday, December 23, 1992. A draft decision appears on page 16.

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.

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INTERNATIONAL MONETARY FUND

LATVIA

Review of the Stand-By Arrangement and Request for Modification of Performance Criteria

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

Approved by John Odling-Smee and Jack Boorman

November 24, 1992

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I. Introduction

On September 14, 1992 at EBM/92/118, the Executive Board approved a 12-month stand-by arrangement for Latvia in the amount of SDR 54.9 million or 90 percent of quota (EBS/92/131 (8/17/92), Supplement 1 (8/24/92), Supplement 2 (9/11/92), Supplement 3 (9/14/92) and Supplement 4 (9/21/92)). Following approval, Latvia made a first purchase of SDR 15.25 million, representing the first credit tranche. Of the four remaining purchases, each for SDR 9.9125 million, the first two are contingent inter alia on the completion of Board reviews of the program.

Discussions for the first review were held in Riga during the period October 7-23, 1992. 1/ The Latvian representatives included the Prime Minister, the Ministers of Finance, Economic Reform, Foreign Trade, Agriculture, and Industry, and 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, including the Chairperson of the Budget Committee and the Chairman of the Economic Committee. Mr. Fridriksson, Executive Director for Latvia, participated in some of the meetings.

On the basis of the review, the authorities have further clarified their policies in a number of areas, which together with the performance so far under the program are described in the attached letter dated November 5, 1992 (Annex I). All the quantitative performance criteria for the third quarter of the year have been met. Moreover, in view of the recent tightening of monetary policy, the authorities have requested that the floor for net international reserves be raised and the ceiling for net domestic assets of the Bank of Latvia be lowered for end-December 1992, and that the performance criteria be modified accordingly (Table 3).

It is proposed in the draft decision presented in Section V that the Executive Board approve the requested modifications, and that Latvia be permitted to make a purchase equivalent to SDR 9.9125 million upon completion of the review. The schedule for purchases under the arrangement is shown in Tables 1 and 2. As of October 31, 1992, Latvia's outstanding use of Fund credit stood at 25 percent of quota. Further details on Fund relations are contained in Annex II, including projected obligations to the Fund.

1/ The staff team consisted of Messrs. Hansen (Head), Dell'Anno and Lahiri (all EUR II), Mrs. Liuksila (FAD), Mr. Phillips (PDR), Messrs. Jones and Mathisse (both STA) and Mrs. Duffield-Sorkowitz (EUR II) as administrative assistant. Ms. Suss, the resident representative, assisted the mission.

Latvia's reform efforts are being supported by a World Bank rehabilitation loan in an amount of US$45 million, which was approved by the Bank's Board on October 22, 1992 (Annex III).

II. Performance Under the Stand-By Arrangement

Although significant progress has been made in developing a monitoring system covering the key macroeconomic indicators, important gaps and uncertainties remain. Thus, in certain areas (including prices and national accounts statistics) substantial revisions had to be made to historical as well as to projected figures. In addition, the introduction of the Latvian ruble as the only legal tender in the country on July 20 has posed a particular problem for the collection and interpretation of monetary statistics. It is, therefore, difficult to draw firm conclusions on underlying trends in the economy.

Nonetheless, it appears that the stabilization program is beginning to take hold. Following a surge in inflation in July, reflecting largely the uncertainty associated with the introduction of the Latvian ruble as the only legal tender, the monthly rate of price increase decelerated significantly during the third quarter, and the exchange rate of the Latvian ruble against the U.S. dollar has stabilized in recent weeks. It is also clear, however, that a number of adverse developments have made the necessary adjustment even more difficult and costly than initially envisaged. The anticipated normalization of trade and payments relations with Russia and other members of the ruble area has not materialized and, except for humanitarian aid and the first purchase from the Fund, there has not been any disbursement of foreign assistance so far. The resulting shortage of energy resources and raw materials, together with difficulties in exporting to traditional markets, have contributed to a much sharper decline in industrial output than originally forecast. At the same time, the situation in agriculture has deteriorated because of the drought during the spring and summer months. As a result, real GDP is now expected to decline by 30 percent in 1992 and by 21 1/2 percent in the program year (July 1992 - June 1993) (Table 4), compared with the original forecasts of 25 percent and 18 percent, respectively.

1. Output, prices and external sector developments

The economic situation deteriorated further in the third quarter of the year. Industrial production was about 34 percent lower than a year earlier, compared with a decline of 31 percent in the first half of the year. Prices rose by almost 20 percent in July, following an average monthly rate of increase of 13 percent in the second quarter of the year, but by September inflation had fallen to a monthly rate of 12 percent. However, the monthly rate of price increase jumped to 25 percent in October, reflecting a sharp increase in utility and transportation tariffs and the increase in value-added tax rates. The liberalization of prices for alcohol also contributed significantly to the price increase. These price increases are derived from a new consumer price index which has been constructed with technical assistance from the Fund. In general, this index shows much larger price increases than the retail price index which was used previously. The GDP deflator has been revised for this factor as well as the higher than expected price increase in the third quarter and the forecast for nominal GDP for 1992 is now almost double the original forecast. Unemployment has started to rise rapidly, albeit far less than would be expected on the basis of the fall in output. Enterprises continue to rely on unpaid leave and shorter working hours instead of laying off workers.

External trade flows for the second quarter of 1992 turned out to be much smaller than anticipated, principally because of a shortfall in trade with Russia and other members of the ruble area. For the first half of 1992, merchandise trade was roughly balanced, but large net receipts from services, in particular hard currency earnings by the Latvian Shipping Company, resulted in a sizable current account surplus. A large part of the hard currency earnings by enterprises was kept in foreign banks, and gross international reserves of the Bank of Latvia rose only marginally. No information is available as yet on trade developments in the third quarter, but it is likely that the pattern of the second quarter of the year has continued. However, during the third quarter, gross international reserves rose significantly since state enterprises, including the Latvian Shipping Company, transferred US$12 million from their accounts abroad as a loan to the Government, which in turn sold the proceeds of this loan to the Bank of Latvia. Gross reserves were also bolstered by the proceeds from the Fund purchase in mid-September.

2. Policy developments

a. Fiscal policy

The general government deficit reached 3.7 percent of GDP during the third quarter of 1992 (Table 6), or well above the deficit of 1.7 percent of GDP projected for that quarter under the program. Large deficits in the central government and the social security system were offset to some extent by surpluses of the local authorities and the extrabudgetary funds. The much larger than expected central government deficit was the result of the emergency measures taken by the Government to assist farmers through purchases of grain and foodstuffs for strategic reserves described in EBS/92/131, Supplement 2 (9/11/92). However, these transactions were financed through the US$12 million loan from state enterprises referred to above.

The sharper than expected decline in economic activity has affected government revenue adversely, but it is also due to the very rapid growth of unrecorded cash transactions that is linked, in turn, to the breakdown of the payments system within the former Soviet Union. In addition, there has been a significant build-up of tax arrears by enterprises. Outstanding arrears at the end of the third quarter were close to 2 percent of GDP, with revenue from the profit and income taxes being especially affected. The growth of tax arrears reflects in part a genuine inability of some enterprises to pay, but some enterprises have also openly used tax arrears as a political weapon to gain concessions from the Government (see Section III 2.a. below). Despite the revenue shortfall, the authorities managed to limit the fiscal deficit by keeping expenditures well below budgeted levels, and the performance criterion on net credit from the banking system to the general government was observed, with some margin.

b. Monetary policy

Unrestrained credit expansion in neighboring countries, the currency reform in Estonia, and the significant lag between the announcement on July 6 and the actual implementation of the decision to make the Latvian ruble the only legal tender in Latvia as of July 20 led to a sharp inflow of funds into Latvia. To a large extent, these inflows occurred through Latvia's correspondent account with the Central Bank of Ukraine in the weeks leading up to July 20. Prior to that date, the Bank of Latvia had limited tools to counteract such inflows. Since July 20, however, the Bank of Latvia has allowed the exchange rate for the Latvian ruble to float, which has resulted in a significant appreciation against the ruble. The Bank of Latvia has thereby gradually regained control over monetary developments, although the conduct of monetary policy has been complicated by the Government's foreign currency borrowing from state enterprises in August as the proceeds of this loan were converted into Latvian rubles to finance purchases of strategic grain and energy reserves.

As indicated in EBS/92/131 Supplement 2 (9/11/92), the Bank of Latvia intended to sell some of the foreign reserves obtained from the Government in the market to neutralize the domestic liquidity impact of the strategic reserve purchases. However, because of its limited experience in foreign currency operations, the Bank did not manage to undertake such transactions before the end of the third quarter. On the other hand, the Bank made a determined effort to keep domestic credit expansion below the programmed level for the end of September. In the short time available, it was, however, unable to keep net domestic assets LR 600 million below the program level, as had been envisaged earlier.

As a result of these factors, reserve money and broad monetary aggregates expanded more than planned. Thus, reserve money rose by 50 1/2 percent between June and September (Table 7), compared with the programmed increase of 21 1/2 percent. However, this figure should be interpreted carefully for two reasons. First, it appears that there has been a larger switch from rubles into Latvian rubles than was assumed at the time the program was designed. Second, for programming purposes, the ruble balances of domestic banks with the Bank of Latvia have been valued at par with the Latvian ruble, but would, at the market rates prevailing at the end of September, be worth at most half as much as shown in the balance sheet. 1/ Correction for this factor alone would reduce the reserve money growth during the third quarter to about 32 percent. Thus, the measured increase in reserve money overstates the actual growth of liquidity.

Similar factors should be taken into account when assessing the growth in broader monetary aggregates. For example, after adjustment for the valuation of ruble deposits in the monetary survey, the recorded growth of M2 between June and September would be reduced from 59 percent (Table 8) to 45 1/2 percent--which is still significantly above the programmed increase of 34 percent. The main reason for this outcome is the much larger increase in net foreign assets than programmed. Also, the indicative ceiling for net domestic assets was exceeded by a considerable amount, despite a much smaller domestic credit expansion than planned.

The freeing of interest rates on credits from July 1, 1992 has led to a sharp increase in such rates, with commercial banks charging up to 85 percent by September on average for short-term credits. However, deposit rates have continued to be substantially negative in real terms.

c. Incomes policy

In budgetary organizations, where wages are determined as multiples of the minimum wage, the Government has decided to keep the minimum wage unchanged since June 1. The only wage increase since then was a flat allowance of LR 400 per month granted to all workers in budgetary organizations on August 15. This reduced the costs to the budget significantly compared with an identical increase in the minimum wage since such allowances are taxable and do not get magnified by the multipliers for higher skill categories as would have occurred if the minimum wage had been adjusted. The average monthly wage in budgetary organizations rose by only 5 percent between June and September, a period during which prices rose by 56 percent (Chart 1). To compensate partly for such price increases, the flat rate allowance was increased by an additional LR 1,100 per month from October 1--an increase of 25 percent compared with the average monthly wage in September. In real terms, the average monthly wage in budgetary organizations fell by 32 1/2 percent between June and September, and by 38 percent between December 1991 and September 1992.

In the state enterprise sector, a ceiling of 30 percent for the increase in the wage bill in the third quarter compared with the second quarter was in force according to the incomes policy adopted in late July. The average monthly wage in state enterprises rose by 29 percent between

1/ This reflects the appreciation of the Latvian ruble against deposits in correspondent accounts with central banks in the ruble area as described in section d. below.

June and September (Chart 2). In real terms, the average monthly wage in state enterprises fell by 17 percent between June and September, and by 27 percent between December 1991 and September 1992.

d. External sector policies

A foreign exchange department was established in the Bank of Latvia in early July, but it is not yet fully operational. Nevertheless, the Bank of Latvia has been forced to deal with important foreign exchange issues following the July 20 decision on the Latvian ruble. In general, the Bank of Latvia has allowed the exchange rate for the Latvian ruble to be determined by the market. Since July 20, the Latvian ruble has appreciated significantly against the cash ruble from parity to about LR 0.5 per ruble at the end of September, but it initially depreciated against the U.S. dollar from LR 140 per U.S. dollar on July 20 to LR 178 per U.S. dollar at the end of September. The Latvian ruble has since appreciated to approximately LR 170 per U.S. dollar and to about LR 0.35 per ruble.

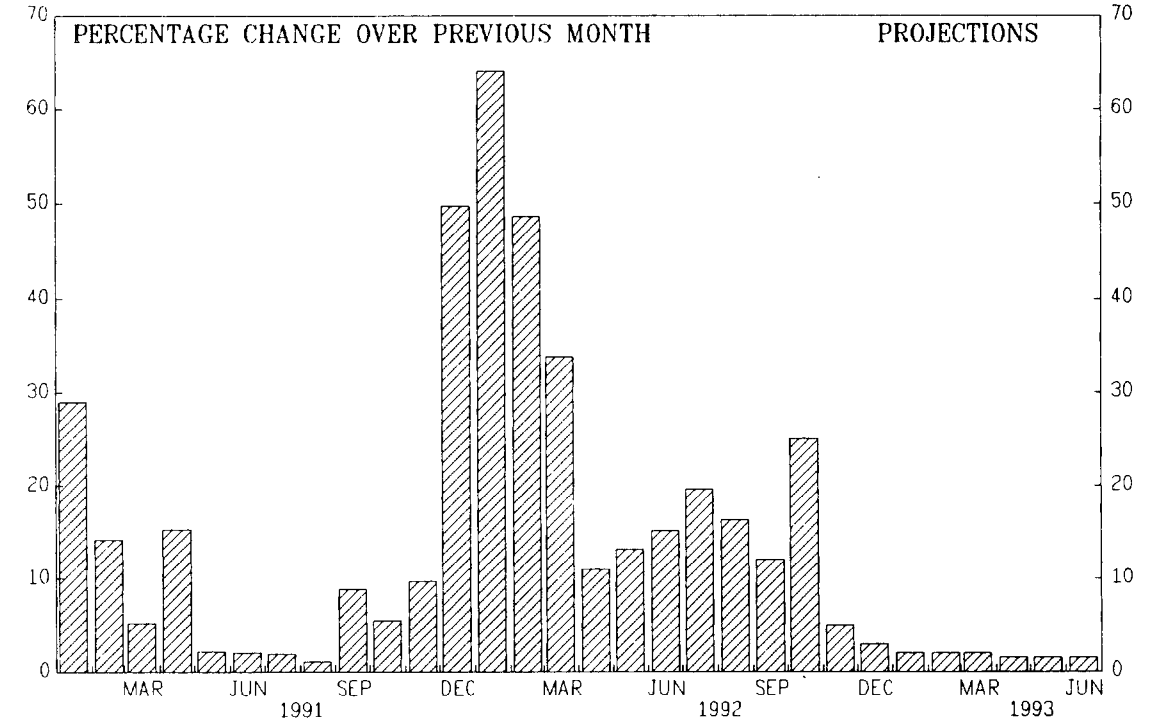
As regards correspondent account balances with other states in the ruble area, an active market has developed outside the Bank of Latvia. The Bank does not participate directly in this market, but announces buying and selling rates at which it is willing to exchange such balances into Latvian rubles. The band between the buying and selling rates is rather wide, and it is intended mainly as a safety net so that enterprises will always be able to either sell or buy such balances in case they are unable to find counterparts in the market. By mid-November, the rates quoted by the Bank of Latvia ranged from LR 0.22 buying and LR 0.48 selling for balances with the Central Bank of Georgia to LR 0.45 buying and LR 0.72 selling for balances with the Central Bank of Lithuania. For correspondent account balances with the Central Bank of Russia, the buying and selling rates were LR 0.36 and LR 0.72, respectively.

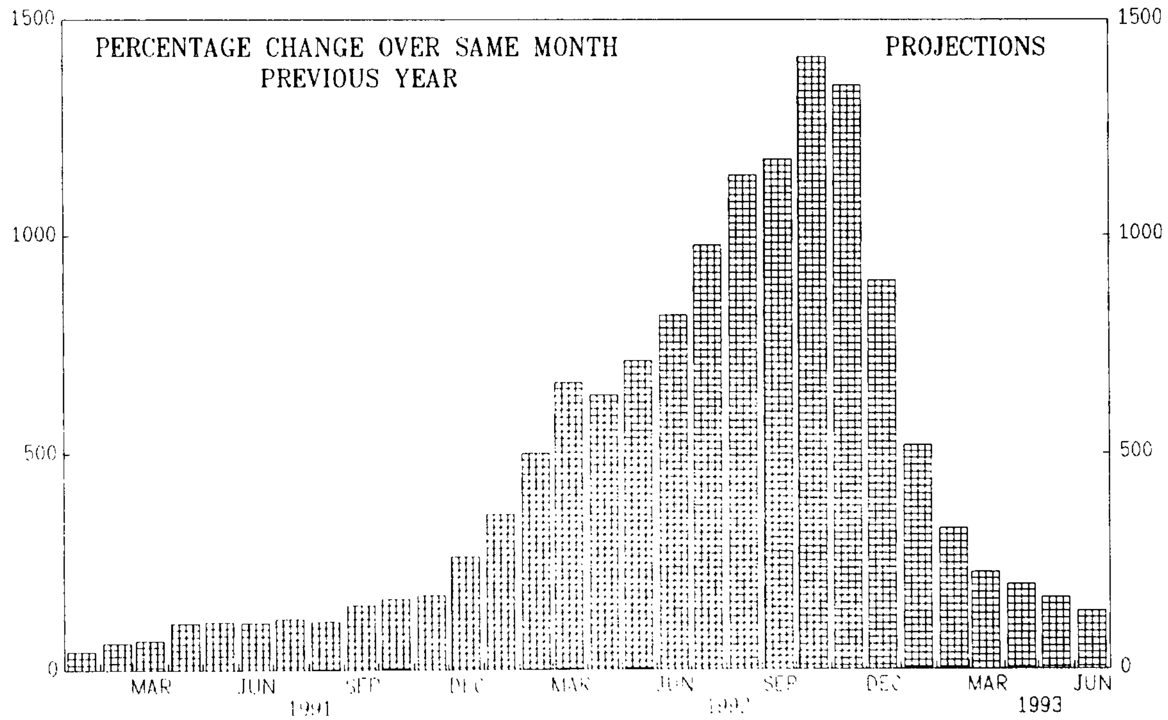
III. Policy Issues for the Remainder of the Year

The Latvian Government remains commicted to the stabilization and reform program, and no major changes are proposed to the original program for the remainder of the year. The authorities are keenly aware that the program is now at a critical stage and of the need to persevere with its implementation despite mounting pressure from different interest groups to ease up on policies. At the same time, they underlined the importance of showing flexibility in policy implementation to avoid erosion of the broad political support for the program that the Government has enjoyed so far. The continued decline in economic activity and the associated fiscal problems, together with the impact of the sharp increase in utility prices from mid-October caused by the steep rise in costs of imported energy, were seen as the key issues. The future success of the program would depend on how these issues were tackled.

CHART 1
LATVIA

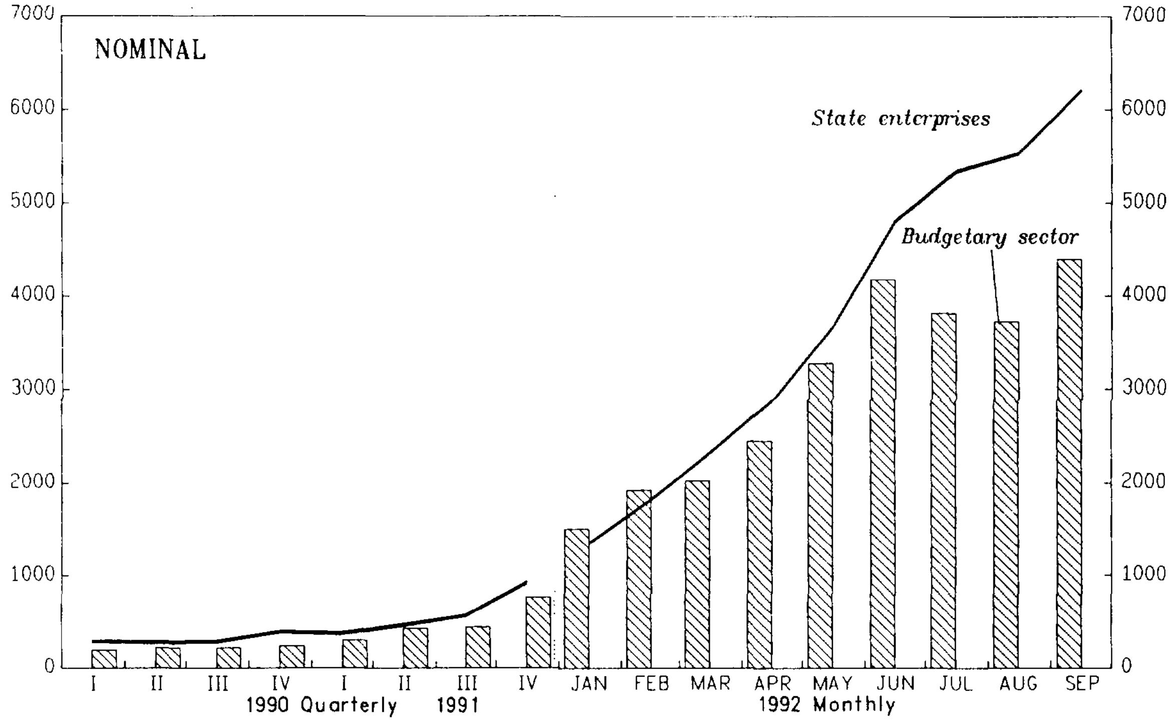
INFLATION IN CONSUMER PRICES

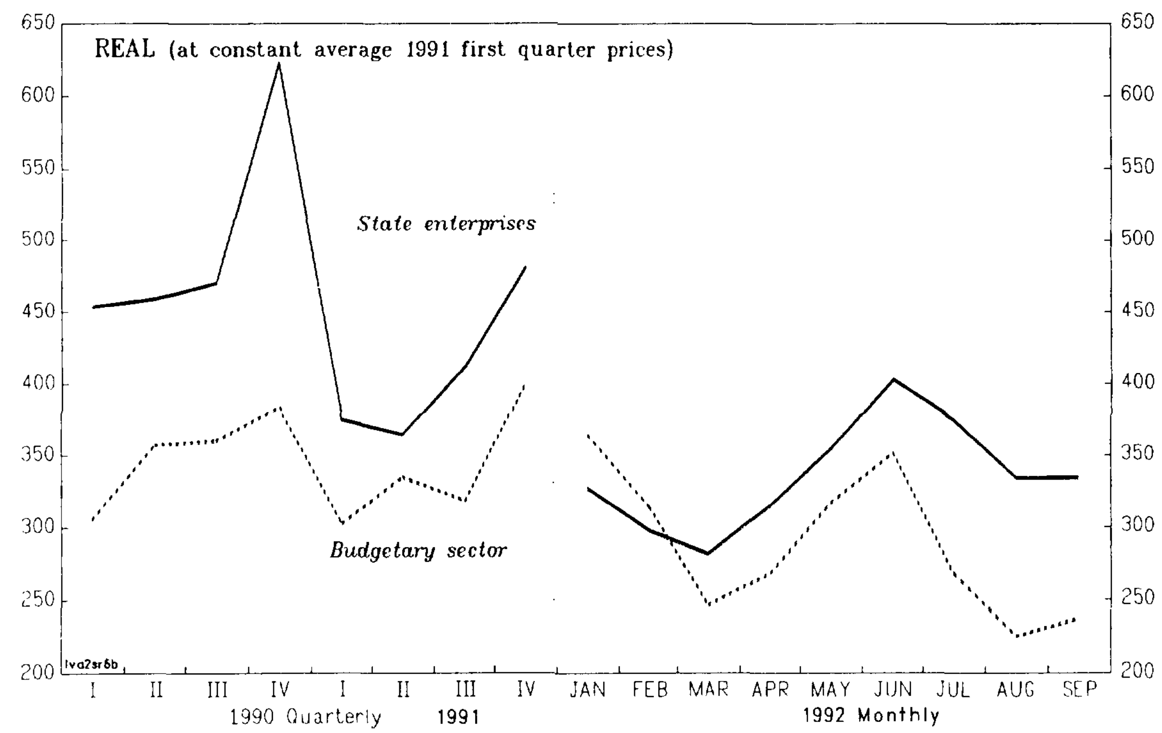




Sources: Data provided by the Latvian authorities; and staff estimates.

CHART 2
LATVIA
NOMINAL AND REAL WAGES
(Rubles per month)





Source: Data provided by the Latvian authorities.

1. Inflation and price policy

The authorities expect the declining trend in monthly inflation observed in the third quarter to continue through the end of the year, following the jump in October caused mainly by the increases in value-added tax rates and in utility prices. The targeted rate of inflation is 35 percent during the fourth quarter of 1992.

Following the liberalization of prices for alcohol in October 1992, only a small number of items remain subject to price control, mainly utility prices and rents. Given the large increase in the costs of imported energy, utility prices have had to be adjusted very sharply. Thus, the cost of heating which was on average LR 1 per square meter per month at the end of the heating season in the spring of this year has gone up to about LR 60 per square meter per month. Together with the increases in electricity and hot water prices and rents, this means that, taking into account the flatness of the income distribution, most households would have had to spend around 75 percent of their income on rents and utilities at the October 1, 1992 wage rates.

Rather than trying to provide compensation through an imperfect means-tested cash compensation scheme, 1/ the Government decided to grant a flat rate allowance of LR 1,500 per month to employees in budgetary organizations and to nonworking pensioners from November 1, 1992, and the incomes policy guidelines for state enterprises for the fourth quarter of the year were adjusted to allow enterprises to grant their employees a similar wage increase.

2. Fiscal policy and social safety net

a. Fiscal policy for the remainder of 1992

While the authorities succeeded in keeping the fiscal program on track in the third quarter of the year, several factors cast some doubt on the ability of the authorities to attain the objectives for the fourth quarter of the year in the absence of corrective measures. First, with the higher than expected inflation rate in the third quarter, the monthly wage in budgetary organizations was increased on October 1 (following the LR 400 adjustment in August) by a flat-rate LR 1,100. The costs of this measure were somewhat higher than the LR 1 billion that had been set aside for this purpose in the budget. Second, as mentioned above, the additional flat-rate allowance of LR 1,500 granted from November 1 to employees of budgetary organizations and nonworking pensioners will result in expenditures in excess of the LR 1 billion which had been earmarked in the budget to compensate the most vulnerable groups for the increase in utility prices.

1/ Means-testing through income declarations is still in the pilot stage. Moreover, the flatness of the income distribution implies that a large proportion of the population would qualify for assistance in any case.

Third, the considerable revenue expected from the introduction of the flat-rate 15 percent duty for imports has been eroded by the exemption of imports of raw materials and spare parts from this duty in early October--a decision taken with a view to reducing the production costs of enterprises.

To compensate for these expenditure overruns and revenue losses, the authorities are taking a number of offsetting measures. First, the Government intends to make a major effort to collect enterprise tax arrears, including if necessary through confiscation and sale of enterprise inventories. To this end, the legal authority of the State Finance Inspection Board has been significantly strengthened. In order to end the stalemate in which enterprises have refused to pay taxes in retaliation against the Government's and the Bank of Latvia's refusal to compensate enterprises for exchange losses on exports shipped before July 20, a compromise was reached in late October. Enterprises had calculated that they would incur an exchange loss of LR 1.1 billion if their ruble balances in the correspondent accounts of ruble area central banks were to be converted at the current appreciated rate for the Latvian ruble rather than at the one-to-one rate applicable before July 20. Because of the inefficiency of the payments system within the former Soviet Union, these enterprises had not received payments by July 20 on exports shipped before that date. The initial decision by the Bank of Latvia to convert payments for such exports only at the prevailing market rate instead of at the one-to-one rate that enterprise managers had expected at the time of export was seen as penalizing them unjustly. Under the compromise solution, the Bank of Latvia has agreed to compensate enterprises for about half of the calculated exchange loss, or LR 660 million. This amount will be transferred by the Bank of Latvia to the Government for it to distribute to enterprises. However, the Government will transfer the amount directly to the budget for those enterprises in tax arrears. In the budget data, the transfer from the Bank of Latvia will be recorded as a reduction in tax arrears. 1/

Second, the rate of import duty for finished goods was increased from 15 percent to 20 percent from November 21, 1992. However, this increase will apply only to countries that do not have preferential trade agreements with Latvia, and its revenue impact is expected to be small. The Government also intends to explore the possibility of using part of the domestic counterparts of the humanitarian aid received from abroad to provide additional compensation for the most vulnerable groups and for those who will not benefit from the wage increases. Finally, expenditure policy

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1/ In the case that an enterprise has no tax arrears but is entitled to the subsidy, the transfer from the Bank of Latvia will be recorded as other revenue and the subsidy to enterprises as other expenditures. In the reserve money data, the transfer from the Bank of Latvia to the Government is shown as an exchange loss under "other items, net" (Table 7).

is to remain very tight. Even taking into account the wage increases mentioned above, general government expenditure is projected to decline by 25 percent in real terms in the fourth quarter.

Taking all these factors into account, the authorities expect to stay within the target for net credit to the general government from the banking system originally determined for the second half of 1992. They realize that this will be very difficult, but they are determined to control expenditures very tightly, and to force the State Finance Inspection Board to make full use of its strengthened legal authority to collect tax arrears.

b. The 1993 budget

The preparation of the 1993 budget is still at a very preliminary stage. The budget proposal, which will be established for the full calendar year, contains certain new features. To facilitate fiscal management, instead of presenting separate budgets for all the elements of government, the general government budget will be presented on a consolidated basis, covering the central and local governments, the social security system and the extrabudgetary funds. In addition, a Treasury will be created, and tax policy, tax administration, coordination of foreign aid, and other functions, which have so far been the responsibility of other ministries, will be transferred to the Ministry of Finance.

The main policy objective for the 1993 budget is to secure a balanced current account for the general government and a small overall deficit that reflects critical investment needs, most of which would be financed through foreign assistance. The expected continued weakness of economic activity, as well as the introduction of more generous depreciation rules that are expected to reduce sharply the base for the profits tax, will affect tax revenues negatively. At the same time, the wage supplements granted in 1992 and increases in other expenditures connected with the move to world market pricing for energy products will add to current expenditures. The extremely tight budget situation in 1992 also led to the postponement of expenditures for operations and maintenance which will have to be resumed in 1993 to avoid impairing the efficiency of public services. To compensate for these factors, the authorities intend to hold down other expenditures, raise value-added tax rates, and impose excise taxes on sales of gasoline and diesel fuel and on automobiles from January 1, 1993. The authorities plan to present a fully detailed budget to Parliament before the end of November that will spell out these objectives and indicate how they will be achieved.

c. Social safety net

The elaboration of a new minimum subsistence measure, based on a very limited basket of goods that are judged to be essential for basic subsistence has been completed. This is being used to determine eligibility for social assistance at the local level. The authorities have begun means-testing for social assistance on a pilot basis in a few municipalities. Individuals are required to make a declaration of their income, assets, and aid they may receive from other sources. If an individual's combined income falls below the minimum level of subsistence, he/she is then eligible for social assistance. The amount of assistance is determined independently by each municipality, depending upon its budgetary resources. The pilot project has revealed a number of drawbacks which suggest that the system will have to be better defined: (i) the flatness of the income distribution means that too large a proportion of the population would qualify for social assistance; (ii) resources to detect fraud are inadequate; and (iii) ways of smoothing out the level of assistance provided by different municipalities would have to be considered. Partly because of these initial difficulties with the means-testing system the authorities decided not to use it as a means to determine compensation for the utility price increases. Other programs to protect the most vulnerable groups, such as the further adjustment on November 1 of the social pension that covers those who do not qualify for a state pension, and public feeding programs, remain as part of the safety net.

3. Monetary policy and currency reform

a. Monetary policy

In order to bring the monetary program back on track, the Bank of Latvia decided to increase its general refinancing rate from 80 percent to 120 percent from October 8; a rate of 180 percent is charged on certain emergency liquidity credits. As a result, but also in response to moral suasion by the Bank, it is expected that commercial banks, in particular the former branches of the Bank of Latvia, will increase deposit rates and rely more heavily on mobilization of deposits from individuals and enterprises to fund their lending activities rather than on funds borrowed from the Bank of Latvia. Accordingly, it was decided to reduce the original ceiling for net domestic assets of the Bank of Latvia by LR 600 million for end-December 1992 (Tables 3 and 7).

It is expected, however, that with the deceleration in inflation and the increasing credibility of the stabilization program income velocity will decline and the money multiplier will increase (Chart 3). The indicative target for net domestic assets of the banking system originally established for end-December 1992 has therefore been kept unchanged (Tables 3 and 8).

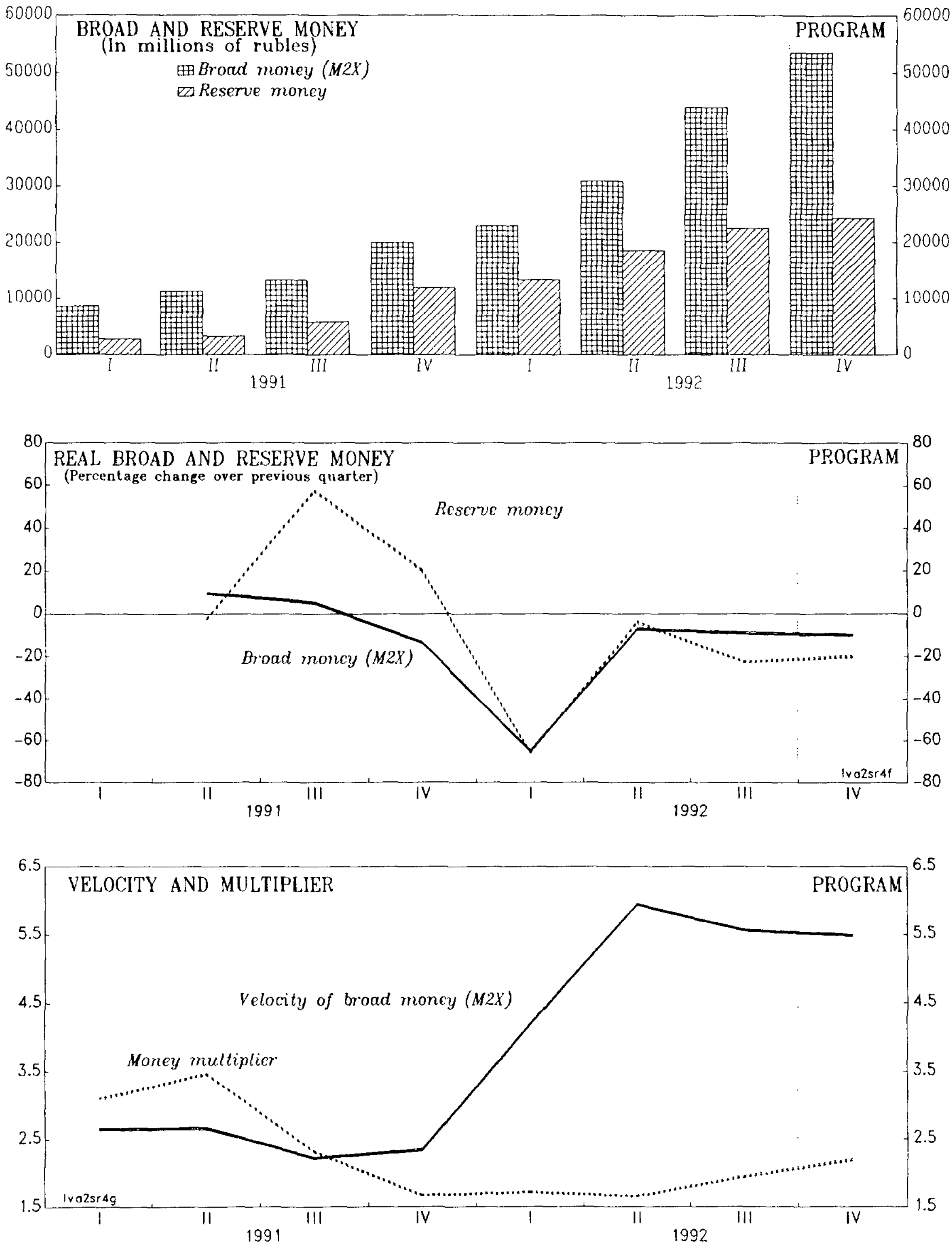
b. Currency reform

The technical preparations for the introduction of the lats to replace the Latvian ruble are proceeding according to plan. However, given the initial success of the experiment with the introduction of the Latvian ruble as an interim currency, the authorities do not plan to introduce the lats until around mid-1993 when they expect the rate of inflation to be down to very low levels.

CHART 3

LATVIA

MONETARY INDICATORS



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

4. Incomes policy

Because the price increase in the third quarter of 1992 was much higher than envisaged in early August when the incomes policy guidelines applicable to state enterprises for the third and fourth quarters of 1992 were issued, the limit for the increase in the wage bill for such enterprises has been revised for the fourth quarter of the year. In addition, it was necessary to accommodate within the revised guideline the flat-rate wage allowance granted from November 1, 1992 to compensate for the increase in utility prices.

In view of these factors, the limit for the increase in the wage bill of state enterprises for the fourth quarter of the year, compared with the previous quarter, which had originally been fixed at 20 percent, has been revised to 37 percent. This compares with an average increase in prices of 47 percent targeted for the fourth quarter of 1992. This would imply that by the fourth quarter of 1992, average wages for all employees in state enterprises and budgetary organizations would have fallen by almost 50 percent in real terms compared with the fourth quarter of 1990, or sufficiently to cope with the terms of trade deterioration experienced by Latvia since 1990.

5. External policies

The Bank of Latvia is currently experimenting with foreign currency operations with part of the unexpected build-up of foreign exchange reserves during the third quarter of 1992. However, it is not the Bank's intention to get involved in the market on any significant scale. Accordingly, the authorities have decided to increase the floor for net international reserves for end-December 1992 by US$6 million to US$111 million.

The authorities have, as mentioned, modified the import duties compared with the original program. This is considered a temporary measure, and it is the aim of the authorities to establish a more permanent and less complex tariff structure. The authorities have, however, continued to abolish or reduce export taxes as planned under the program. In late October, an agreement in principle was reached on a most-favored-nation treaty with Russia. The list of goods to be included in this treaty is still to be determined. At the same time, new agreements were reached between the Bank of Latvia and the Central Bank of Russia on correspondent account balances providing for credits of up to rub 3 billion for the Bank of Latvia with the Central Bank of Russia and LR 1.5 billion for the Central Bank of Russia with the Bank of Latvia.

6. Systemic changes

Progress remains slow on the privatization front, but several measures have been taken during the last few weeks, or will be taken shortly, to speed up the process. Thus, legislation on the use of vouchers in privatization has been adopted; this is expected to remove a significant obstacle to the privatization of large-scale enterprises. In addition, the law on methods for carrying out privatization of state and municipal property, which had been restricted to purchases by foreigners of property for convertible currency, is being modified to allow both domestic and foreign investors to participate and to make payments in Latvian rubles. A Government resolution adopted in early August has established three lists of enterprises: (i) 25 enterprises to be privatized for hard currency; (ii) 300 enterprises not to be privatized during 1992/93; and (iii) 600 enterprises which can be privatized under existing legislation. Five enterprises have been identified for a pilot project, one of which is currently being evaluated by a foreign consultancy firm.

Privatization of farm land is progressing smoothly while that of small-scale enterprises is gaining momentum, but information on the latter is not being collected systematically from the municipalities. However, for those municipalities reporting, progress is clearly evident. For example in Riga, 63 percent of food stores have been either privatized or leased. It is expected that most service establishments will be privatized or leased within the coming few months.

In other reform areas, progress is also evident. The new accounting law was adopted in late October and will be put into effect for the 1993 accounting year. Work is also in progress to make the implementation of the competition and anti-monopoly law more effective, and steps are being taken to establish the necessary administrative procedures to implement the stipulations of the bankruptcy law.

In the financial sector, the technical work on the separation from the Bank of Latvia of its branches and the preparation for their eventual privatization have begun. The authorities are currently being assisted by a team of experts financed by the Swiss Government, and they expect assistance in these efforts from the MAE department of the Fund, the World Bank and EBRD as well. The Fund's MAE department is currently providing technical assistance in establishing prudential banking supervision functions in the Bank of Latvia (Annex IV).

In the area of improving financial discipline of enterprises little has been done since June when the system in which creditors were paid in chronological order when funds were available on the debtor's accounts was abolished. This measure, and the extensive use of prepayment in transactions since then, appear to have slowed down the increase in interenterprise arrears, but little has been done to clean up outstanding arrears. Also, limited progress has been made in improving the functioning of the payments system within Latvia.

7. External assistance and balance of payments prospects

Except for humanitarian aid and the first purchase from the Fund, there has not been any disbursement of foreign assistance so far. It is unlikely that much, if any, contributions from the G-24, the World Bank rehabilitation loan, or the EBRD energy sector emergency loan will be disbursed this year. There may be some catch-up in the first half of 1993, but it is unlikely that all of the financing commitments will be fully disbursed by June 1993. The financing constraint during the program year will be exacerbated by larger repayments on short-term trade-related credits than expected previously. If this tighter situation materializes, it would not be possible to finance imports on the scale envisaged in the agreed program, which together with the compression of trade with the ruble area would have serious consequences for output and employment. In such a case, the current account balance for 1992 would show a surplus of about US$20 million instead of a deficit of about US$90 million, and the current account for the program year (July 1992-June 1993) a deficit of about US$225 million instead of the nearly US$350 million originally programmed. The consequences for output and employment of such a scenario would be alleviated somewhat if the negotiation procedures allowing quick disbursement of the pledged balance of payments assistance could be speeded up so as to keep in line with the time-table originally envisaged. 1/

To coordinate the authorities' strategy vis-à-vis foreign donors, the Government has appointed a group of senior officials from key economic ministries and the Bank of Latvia and including also the Fund's resident representative in Riga. This group will also play a key role in overseeing the implementation of the economic stabilization and reform program supported by the stand-by arrangement and in coordinating technical assistance provided by foreign donors. The authorities have also approached the World Bank to obtain technical assistance in aid coordination and management.

IV. Staff Appraisal

The Government has made a determined effort to implement the economic reform and stabilization program launched at mid-year. Economic policies have been broadly implemented as designed, with all quantitative performance criteria being observed for the first three months of the program. While important gaps and uncertainties remain in the statistical base, which makes it difficult to reach firm conclusions on underlying trends in the economy, there are signs that the stabilization program is beginning to take hold. Monthly inflation decelerated during the third quarter and the exchange rate of the Latvian ruble has stabilized against the U.S. dollar in recent weeks.

The authorities are to be commended for these achievements, which have been attained in much less favorable external circumstances than envisaged. The hoped for normalization of trade with Russia and other members of the ruble area has not materialized and, except for humanitarian aid and the

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1/ The staff has not formally revised the program figures for the balance of payments contained in Table 9 of EBS/92/131 (8/24/92), since it hopes that the pledged assistance will be disbursed quickly.

first purchase from the Fund, there was no disbursement of foreign assistance during the third quarter of the year. As a result, and considering the impact of the drought on agricultural output, real GDP is now expected to decline by at least 30 percent in 1992, with unemployment and the associated social tensions on the rise. At the same time, the higher than expected costs of imported energy necessitated a sharp increase in public utility and other energy related prices in October. As a result, the pressure on the Government to ease up on policies is intensifying. It is crucial that the Government not give in to such pressures and compromise the results achieved so far, but the staff is aware of the need for some measure of flexibility in policy implementation to ensure continued broad political support for the adjustment and reform efforts.

The authorities remain firmly committed to the objectives of the program and have taken a number of bold measures to ensure that the program remains on track for the remainder of the year. Neither the authorities nor the staff is under the illusion that this will be an easy task. The greatest risk to the program is posed by the fiscal situation, which remains highly uncertain. It is vitally important that the State Finance Inspection Board makes use of its strengthened legal authority to the fullest extent to collect tax arrears accumulated by enterprises, if necessary by confiscating and selling enterprise inventories in the market. In view of the larger than expected increase in wage costs associated with the compensation for the utility price increases, recovery of tax arrears and strict control over other expenditures will be the key to keeping the budget within the program target. Looking ahead to 1993, the staff strongly encourages early consideration of a significant increase in value-added tax rates and the imposition of excise taxes on vehicle fuels and automobiles. Moreover, suspension of the three-month waiting period for tax increases to take effect is essential for these measures to be effective. Without such measures, it will be difficult to limit the budget deficit for that year to what can be financed through the domestic counterpart of humanitarian aid.

Following the period of uncertainty related to the introduction of the Latvian ruble as the only legal tender in July, the Bank of Latvia has fought a valiant battle to keep monetary developments under control. While the Bank was unable within the time available to honor its commitment to keep the increase in net domestic assets below the original ceiling for end-September by the full amount pledged, it has since taken strong measures to bring monetary policy back on track. The decision to raise interest rates on its refinancing facility is commendable and should induce banks to offer competitive rates on deposits to attract financial savings of households and enterprises. The staff recommends that the Bank of Latvia reinforce its efforts to explain its policy actions clearly to Government officials, parliamentarians and the public at large, many of whom do not currently seem to understand well the functions and responsibilities of a central bank in the context of a market economy.

The recent experimentation by the Bank of Latvia with foreign exchange operations is welcome, and the staff hopes that the Bank will use the experience gained and forthcoming technical assistance to create a genuine foreign exchange market in Latvia as soon as possible. In this context, the large spread between buying and selling rates currently quoted by the Bank should be reduced.

The authorities should press ahead firmly with institutional reform. In this context, the staff welcomes the different legislative measures taken during the past few weeks to facilitate large-scale privatization. Actual implementation is still lacking, however, and the Government will need to speed up the process in the coming months. It is encouraging that privatization of small-scale enterprises has gained momentum, but the monitoring procedures for the implementation at the municipal level still remain inadequate. Work on the legal separation of the Bank of Latvia from its branches is currently under way. The staff encourages the authorities to proceed cautiously and make use of international expertise before taking decisions on creating new financial units from the branches of the Bank of Latvia. Whatever form of ownership is decided upon, all new financial institutions that may be created must be subject to the stipulations of the Law on Banks and should not be seen as vehicles to serve special interest groups.

The continued trade difficulties with Russia and other members of the ruble area are a matter for concern. The recent negotiations between Latvia and Russia on a most-favored-nation treaty is encouraging, and the staff urges both parties to work out the details of the agreement as quickly as possible and implement it speedily.

The ability of the Government to retain consensus for the program in difficult circumstances would be strengthened by the provision of adequate foreign assistance. It is a matter for concern that the negotiating process has been moving very slowly. The staff therefore encourages foreign donors to conclude agreements as quickly as possible on providing the balance of payments assistance pledged in the G-24 framework, which would ease the very serious financial position expected in the next few months. The creation of a coordination group of senior officials in Latvia to conduct such discussion should facilitate the negotiation process.

The Latvian Government is making a serious effort to implement its stabilization and reform program and to secure adequate foreign financing for this purpose. Considerable progress has already been achieved and the authorities' firm commitment to the program augurs well for its continued implementation. Therefore, the staff recommends that the requested modification to the performance criteria be approved and the proposed decision adopted.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. Latvia has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Latvia (EBS/92/131, Sup. 4, 9/21/92) and the last paragraph of the letter of the Minister of Finance and the Governor of the Bank of Latvia dated August 14, 1992.

2. The letter of the Minister of Finance and the Governor of the Bank of Latvia dated November 5, 1992 shall be attached to the stand-by arrangement, and their letter dated August 14, 1992 shall be read as supplemented and modified by the letter dated November 5, 1992.

3. Accordingly, paragraphs 4(a)(1) and 4(a)(5) of the stand-by arrangement shall be amended to read as follows:

"4(a)(1) the limits on the cumulative change in the net international reserves referred to in paragraph 44 and Annex III of the Memorandum, as modified by paragraph 12 of the letter dated November 5, 1992, or ...

4(a)(5) the limits on net domestic assets of the Bank of Latvia referred to in paragraph 22 and Annex II of the Memorandum, as modified by paragraph 8 of the letter dated November 5, 1992 has not been observed; or"

4. The Fund decides that the review contemplated in paragraph 4(b) of the stand-by arrangement is completed and that Latvia may proceed to make a purchase of SDR 9.912 million under the stand-by arrangement.

Table 1. Latvia: Schedule of Purchases Under the Stand-By Arrangement

Amount of Purchase	Available On or After	Contingent On
1. SDR 15,250,000 (25 percent of quota)	Purchased upon Board approval	
2. SDR 9,912,500 (16.25 percent of quota)	November 15, 1992	(a) Observance of end-September 1992 performance criteria 1/ (b) Completion of first program review
3. SDR 9,912,500 (16.25 percent of quota)	February 15, 1993	(a) Observance of end-December 1992 performance criteria 1/ (b) Completion of second program review
4. SDR 9,912,500 (16.25 percent of quota)	May 15, 1993	(a) Observance of end-March 1993 performance criteria 1/
5. SDR 9,912,500 (16.25 percent of quota)	August 15, 1993	(a) Observance of end-June 1993 performance criteria 1/

Source: Stand-by arrangement, EBS/92/131.

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.

Table 2. Latvia: Projection of IMF Position
During Period of Proposed Stand-By Arrangement

	1992		1993		
	July-Sept.	Oct.-Dec.	Jan.-Mar.	May-June	July-Sept.
	(In thousands of SDRs)				
Purchases	15,250.0	9,912.5	9,912.5	9,912.5	9,912.5
Tranche policies	15,250.0	9,912.5	9,912.5	9,912.5	9,912.5
Ordinary resources	15,250.0	9,912.5	9,912.5	9,912.5	9,912.5
Total Fund credit outstanding (end of period)	15,250.0	25,162.5	35,075.0	44,987.5	54,900.0
Tranche policies	15,250.0	25,162.5	35,075.0	44,987.5	54,900.0
	(In percent of quota) 1/				
Total Fund credit outstanding (end of period)	25.00	41.25	57.50	73.75	90.00
Tranche policies	25.00	41.25	57.50	73.75	90.00

Source: Staff estimates.

1/ Latvia's quota is SDR 61 million.

Table 3. Latvia: Quantitative Performance Criteria

		Type	Performance criterion according to EBS/92/131 September 30, 1992	December 30, 1992	March 31, 1993	June 30, 1993	Outturn September 30, 1992	Proposed modification for December 31, 1992 criterion
			(In millions of Latvian rubles)					
I.	Change in net banking system credit to the general government, cumulative from June 30, 1992	Ceiling	865	180	... 1/	... 1/	494	None
II.	Net domestic assets of the Bank of Latvia	Ceiling	6,200	9,470	... 1/	... 1/	6,168	8,870
			(In millions of U.S. dollars)					
III.	Net international reserves of the Bank of Latvia							
	Total	Minimum	105	105	... 1/	... 1/	163	111
	Convertible currencies	Minimum	105	105	... 1/	... 1/	121	111
IV.	Disbursements of public and publicly guaranteed medium-and long-term external debt, cumulative from June 30, 1992							
	Maturity 1-12 years	Ceiling	100	160	240	300	--	None
	Maturity 1-5 years	Ceiling	60	60	60	60	--	None
V.	Government debt of up to one year	Ceiling	20	20	20	20	--	None
			(In millions of Latvian rubles)					
Memorandum Item:								
	Net domestic assets of the banking system	Indicative ceiling	16,265	24,910	... 1/	... 1/	17,783	None

Sources: Stand-by arrangement (EBS/92/131); and staff calculations.

1/ To be established at the time of the second review of the stand-by arrangement.

Table 4. Latvia: Selected Economic and Financial Indicators.

	1991	1992	1992			Program
			1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
	(Percentage changes over same period previous year, unless otherwise specified)					
National income,prices,and costs:						
GDP at constant prices	-8.3	-30.0	-19.8	-30.0	-34.0	-34.8
Consumer price index	124.5	932.1	517.0	723.3	1,100.2	1,167.0
Real wages 1/	-14.3	...	-14.3	5.4	-19.8	...
Retail sales volume	-29.6	...	-44.0	-44.7	...	...
External sector						
Export volume	-28	-8	4	-35	...	...
Import volume	-31	-29	-21	-41	...	...
Terms of trade (deterioration -)	40	-43	-47	-38	...	...
Money and credit						
Domestic credit 2/	90.6	409.3	199.8	309.1	341.0	409.3
Broad money 2/ 3/	153.1	167.4	167.7	173.4	229.1	167.4
Velocity (level)	2.1	4.9	4.2	5.9	5.6	5.5
Interest rate,percent per annum						
Deposit	4.1	...	5.0	13.0	22.0	...
Credit	23.0	...	27.5	51.1	85.0	...
Refinance rate of the Bank of Latvia	8-12	...	10-15	50.0	80.0	120.0
	(In rubles per month)					
Average wage in state enterprises	560	...	1,909	3,929	5,186	...
Minimum wage	280 4/	...	670 4/	1500 4/	...	...
	(In millions of U.S. dollars)					
Exports	6,421 5/	940	195	185	...	...
Imports	5,258 5/	1,031	204	197	...	...
	(In percent of GDP)					
General government expenditure 6/	31.1	29.1	23.9	28.2	34.5	27.2
General government revenue 6/	37.4	27.2	27.2	22.9	30.7	27.0
General government surplus 6/	6.3	-1.9	3.3	-5.3	-3.7	-0.2
External trade balance	4.9	-7.1	-4.8	-3.9	...	...

Sources: Latvian authorities; and staff estimates.
1/ Refer to salary in the state sector, comprising of budgetary organizations and state enterprises.
2/ Refers to end of period.
3/ Broad money includes foreign currency deposits, and for the program period excludes currency rubles in circulation.
4/ R 166 from January 1, 1991, R 190 from April 1,1991, R 260 from September 1, 1991, R 280 during the last two months of 1991, R 460 during January,1992 and R 670 thereafter. It was revised to R 1,000 from April 16 and R 1,500 from June 1, 1992.
5/ Figures for 1991 are distorted due to exchange valuation effects.
6/ Includes central and local governments, social security system and extrabudgetary funds.

Table 5. Latvia: Social Indicators 1/

Population and vital statistics	
Total population (in thousands)	2,670
Population growth rate (in percent)	-0.4
Life expectancy at birth (in years)	
Male	64.2
Female	74.6
Population age structure (in percent)	
0-14 years	22.8
15-64 years	65.1
65 and above	12.1
Crude birth rate (per thousand)	12.9
Crude death rate (per thousand)	13.0
Infant mortality rate (per thousand)	15.6
Food, health, and nutrition	
Per capita supply of:	
Calories (per day)	2,491
Proteins (grams per day)	73
Population per physician	217
Population per hospital bed	73
Labor force	
Total labor force (in thousands)	1,405
Female (in percent)	56
Agriculture (in percent)	16
Industry (in percent)	30
Education	
Enrollment (in thousands)	
Junior (grades 1-4)	146.2
Primary (grades 5-9)	166.3
Secondary (grades 10-12)	36.2
Colleges, specialized schools, and universities	109.0
Pupil-teacher ratio:	
In junior, primary, and secondary schools	11
Other	
Telephones (per thousand)	27.8
Private cars (per thousand)	10.7

Source: Latvian authorities.

1/ Refers to most recent year for which data are available.

Table 6. Latvia: General Government Operations
(In billions of Latvian rubles and percent of GDP)

	1991	1992 First Half	1992 QIII Est.	1992 QIV Proj.	1992 Proj. Second Half	1992 1/ Program Second Half	1992 Proj.	1992 1/ Program
				(In billions of rubles)				
Revenue	10.7	15.3	16.0	18.1	34.0	30.0	49.3	46.8
Taxes on income and profits	3.5	5.0	4.9	5.1	10.0	8.2	15.0	13.3
Taxes on goods and services	2.9	3.9	4.3	5.0	9.4	8.8	13.3	12.7
Social insurance contributions	3.0	5.5	5.5	6.5	12.0	11.9	17.5	17.4
Other revenue	1.3	0.8	1.2	1.4	2.6	1.1	3.5	3.5
Expenditure	8.9	16.6	17.9	18.2	36.1	30.5	52.7	48.7
Current expenditure	8.1	15.2	16.0	19.2	35.1	29.5	50.4	45.8
Wages and salaries	1.3	3.3	3.1	4.3	7.4	6.1	10.7	9.3
Goods and services	1.6	2.8	5.2	4.1	9.3	5.2	12.1	9.4
Subsidies	0.4	0.6	0.1	0.1	0.2	0.2	0.8	0.9
Transfers	3.3	6.2	6.3	8.6	14.9	13.5	21.1	19.7
Other	1.5	2.3	1.3	2.1	3.4	4.5	5.6	6.5
Capital expenditure and net lending	0.9	1.5	1.9	−1.0	0.9	1.0	2.4	2.9
Balance	1.8	−1.4	−1.9	−0.1	−2.0	−0.5	−3.4	−1.9
Financing	−1.8	1.4	1.9	0.1	2.0	0.5	3.4	1.9
Domestic	−1.8	1.4	2.0	−0.3	1.7	0.2	3.1	1.6
Banking system	−1.8	1.4	0.5	−0.3	0.2	0.2	1.6	1.6
Other	0.0	0.0	1.5	0.0	1.5	0.0	1.5	0.0
Foreign	0.0	0.0	−0.1	0.4	0.3	0.3	0.3	0.3
				(In percent of GDP)				
Revenue	37.4	24.4	30.7	27.0	28.7	25.3	27.2	25.9
Expenditure	31.1	26.6	34.4	27.2	30.4	25.7	29.1	26.9
Balance	6.3	−2.2	−3.7	−0.2	−1.7	−0.4	−1.9	−1.1

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

1/ Data concerning the operations of the Government's foreign currency budget were not available at the time the program was formulated. This information is now available, thus the revenue and expenditure data presented in this table, except for that referring to the program, include the operations of the foreign currency budget.

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

	1992		Program			September	Modified Program
	March	June	Rev. Sept.	September	December	Outturn	December
Reserve money	13,381	18,620	22,768	22,768	25,438	22,479	24,342
Ruble currency in circulation	4,769	3,676	4,612	4,612	4,612	...	...
Reserve money, excluding rubles	...	14,944	18,156	18,156	20,826	22,479	24,342
Currency(LR) in circulation	...	4,118	6,540	6,540	7,937	10,599	11,477
Bank deposits	8,612	10,826	11,616	11,616	12,889	11,880	12,865
Of which: deposits in rubles						5,407	5,000
Reserve money, excluding ruble deposits						17,072	19,342
Net foreign assets	6,969	10,630	12,559	11,959	11,358	16,311	15,472
Convertible net international reserves 1/	10,478	10,478	11,383	10,783	10,783	12,114	11,472
Correspondent accounts 2/	-3,509	151	1,176	1,176	575	4,197	4,000
Net domestic assets	6,412	4,315	5,597	6,197	9,468	6,168	8,870
Domestic credit	7,565	9,242	12,142	12,742	17,742	11,402	16,014
Banks	7,562	8,877	10,443	11,043	17,530	9,512	15,270
Government,net 3/	--	363	1,697	1,697	210	1,888	742
Others	3	2	2	2	2	2	2
Other items, net	-1,153	-4,927	-6,545	-6,545	-8,274	-5,234	-7,144
Ruble claims 4/	4,737	4,134	4,134	4,134	4,134	4,252	4,256
Cash rubles	187	1,944	1,476	1,476	1,476	1,476	1,476
Blocked funds 5/	--	--	-845	-845	-2,574	--	-2,574
Subsidy payment for exchange rate	--	--	--	--	--	--	660
Other items	-6,077	-11,005	-11,310	-11,310	-11,310	-10,962	-10,962
Memorandum Items:							
Change from the end of previous quarter:							
Domestic credit	2,506	1,677	2,900	3,500	5,000	2,160	4,612
Banks	2,506	1,315	1,566	2,166	6,487	635	5,758
Government, net 3/	--	363	1,334	1,334	-1,487	1,525	-1,146
Percentage change from end of previous quarter:							
Reserve money, including rubles	11.5	39.2	22.3	22.3	11.7	...	...
Reserve money, excluding rubles	...	...	21.5	21.5	14.7	50.4	8.3

Sources: Bank of Latvia; and staff estimates.

1/ At the accounting rate of LR 100 per US dollar.

2/ Sum of net balances in the correspondent accounts opened since January 1, 1992 with republics of the former Soviet Union, technical credit, 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/ Balances on correspondent accounts operated prior to December 31, 1991.

5/ Blocked government 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 Latvian rubles)

	1991 December	1992 Indicative Program March	June	September	December	1992 September Outturn	Modified Program December
Broad money (M2X)	20,011	22,956	30,884	38,840	48,545	...	...
Ruble currency held by the non-bank public	4,000	4,113	3,102	3,921	3,921	...	...
Broad money (M2X) 1/	20,011	22,956	27,782	34,918	44,623	43,829	53,503
Currency 1/	4,000	4,113	3,764	6,027	7,291	9,766	10,477
Household deposits	5,941	6,339	7,088	9,066	12,512	7,113	9,933
Enterprise deposits	6,300	6,764	9,245	11,825	16,320	15,105	21,092
Residents' foreign currency deposits	3,770	5,741	7,685	8,000	8,500	11,845	12,000
Net foreign assets	13,442	11,820	17,134	18,655	19,715	26,046	28,595
Convertible net international reserves 2/	13,442	15,329	16,983	17,479	19,140	20,964	21,864
Correspondent accounts 3/	...	-3,509	151	1,176	575	5,082	6,731
Net domestic assets	6,569	11,136	10,648	16,263	24,908	17,783	24,908
Domestic credit	5,550	9,596	14,751	22,153	32,177	18,825	28,268
Households	179	304	376	450	750	616	750
Enterprises	7,740	12,395	15,363	21,828	32,238	19,836	29,458
Government, net	-2,369	-3,103	-988	-125	-811	-1,627 5/	-1,941 5/
Other items, net	1,019	1,540	-4,103	-5,890	-7,270	-1,042	-3,360
Of which:							
Blocked funds 4/	--	--	--	-845	-2,574	--	-2,574
Memorandum Items:							
Broad money (M2)	16,241	17,216	20,097	26,918	36,123	31,984	41,503
Broad money(M2), excluding deposits in rubles	...	...	...	...	...	26,577	36,503
Change from the end of previous quarter:							
Domestic credit	1,281	4,046	4,387	7,402	10,024	4,074	9,442
Households	22	125	-1	74	300	240	134
Enterprises	1,963	4,655	2,441	6,465	10,410	4,473	9,622
Government, net	-704	-734	1,947	863	-686	-639 5/	-314 5/
Percentage change from the end of previous quarter:							
Broad money(M2X), excluding rubles	...	...	...	25.7	27.8	57.8	22.1
Broad money(M2), excluding rubles	...	...	...	33.9	34.2	59.1	29.8

Sources: Bank of Latvia; and staff estimates.

1/ Excludes rubles in circulation from June, 1992.

2/ At the accounting rate of LR 100 per US dollar.

3/ Sum of net balances in the correspondent accounts opened since January 1, 1992 with republics of the former Soviet Union.

4/ Blocked government deposits on account of local currency proceeds from foreign loans for balance of payments support.

5/ Because of non-availability of data, the foreign currency deposits of the government for June 1992 suffered underestimation and similarly affected the indicative limits on net credit to the government for September and December, 1992. This underestimation has to be taken into account while comparing the outturn for September and modified limit for December, 1992.

Riga
November 5, 1992

Dear Mr. Camdessus,

1. We have conducted the first review of the Government's economic program as described in our letter and accompanying memorandum of economic policies dated August 14, 1992. Economic policies have been implemented broadly as designed under the program, and the benefits of this are beginning to be realized. Following a surge in inflation in July associated with the uncertainty in connection with the decision to make the Latvian ruble the only legal tender in Latvia, the monthly rate of price increase is now on a clear downward trend, which we are confident will continue in the coming months. Further, the exchange rate of the Latvian ruble vis-à-vis the U.S. dollar has stabilized in recent weeks, while a significant appreciation has taken place vis-à-vis the ruble.

2. We are keenly aware that the program is now at a critical stage and that we need to persevere with its implementation despite a number of adverse developments that have made the necessary adjustment even more difficult than initially envisaged. The hoped for normalization of trade and payments relations with Russia and other members of the ruble area has not materialized and, except for humanitarian aid, there has been no disbursement of foreign assistance during the third quarter of this year. The resulting shortage of energy resources and raw materials, together with export difficulties in traditional markets, have led to a much sharper decline in industrial output than originally expected. At the same time, the situation in agriculture has deteriorated sharply, because of a severe drought during the spring and summer months. In view of these developments, we now estimate real GDP to decline by at least 30 percent in 1992.

3. The sharper than expected decline in economic activity has affected public sector revenues adversely, in particular through a significant increase in tax arrears of state enterprises. In addition, the breakdown of the payments system has led to a large increase in unrecorded cash transactions, which has also weakened tax collections. Nevertheless, by keeping expenditures well below budgeted levels we managed to ensure that the general government budget deficit in the third quarter of the year was limited to about the outlays to build up strategic food and energy reserves which were financed by the US$12 million loan from state enterprises described in our letter of September 11, 1992. Accordingly, the performance criterion on net credit from the banking system to the general government for the third quarter was observed, with some margin.

4. It will not be possible to maintain the expenditure squeeze in the fourth quarter of the year. In view of the higher than anticipated rate of inflation in the third quarter, wages in budgetary organizations were increased on October 1, following a minor adjustment on August 15, by slightly more than was envisaged when the budget was approved in early July. Further, the reserve allocated for cash benefits to compensate the most vulnerable groups of the population for the increases in rents and utility prices that have been implemented in the fourth quarter of this year will be insufficient, given that the increase in the cost of energy imports is over four times larger than expected. There will also be some revenue loss compared with budget projections as a result of our decision in early October to abolish import duties on raw materials and spare parts.

5. In order to achieve our original target for the second half of the year, as modified to include the purchases of strategic reserves, we intend to implement a number of revenue and expenditure measures. Rather than providing all of the compensation for the increases in rents and utility prices as cash benefits, we have decided to grant a flat-rate wage allowance of LR 1,500 per month to employees in budgetary organizations from November 1, 1992 and to grant a similar supplement to pensions of nonworking pensioners. At the same time, the incomes policy guidelines for state enterprises will be modified to accommodate the same monthly flat-rate salary increase from November 1, 1992 for workers in these enterprises. In addition, we are exploring the possibilities of utilizing part of the domestic currency counterpart of humanitarian aid received from abroad to provide additional compensation for the most vulnerable groups and for those who will not benefit from the wage increases. The State Finance Inspection will intensify its efforts to collect enterprise tax arrears during the fourth quarter of the year, including through the confiscation and sale of stocks accumulated by such enterprises. The legal authority of the State Finance Inspection has been significantly strengthened for this purpose. Finally, the customs duty on finished goods will be increased from 15 percent to 20 percent on November 21, 1992. It is our expectation that these measures will be sufficient to ensure that net credit to the general government from the banking system in the second half stays within the LR 180 million limit referred to in Annex I of the memorandum of economic policies attached to our letter of August 14, 1992.

6. One of our main policy goals for 1993 is to maintain a tight fiscal stance in line with our overall macroeconomic objectives. To this end, the preliminary budget proposal for 1993 aims at achieving a current balance for the general government and a small overall deficit that reflects critical investment needs with most of the latter financed through foreign assistance. The budget proposal also provides for a number of administrative measures that will greatly improve fiscal management, including the consolidation of extrabudgetary accounts and the social security budget with the main budget, and the establishment of a Treasury. Once the Treasury is functioning at the Ministry of Finance, the Bank of Latvia will pay interest on government deposits at a rate 5 percentage points less that the rate it charges for credit to the government. The

expected continued weakness of economic activity, as well as the introduction of more generous depreciation rules that are expected to sharply reduce the base of the profits tax, will negatively affect tax revenues. At the same time, the wage supplements granted in 1992 and increases in other expenditures connected with the move to charging world market prices for energy products will add to current expenditures. The extremely tight budget situation in 1992 led to the postponement of some expenditures, particularly for operations and maintenance. To avoid impairing the efficiency of public services, some of these expenditures must be made in 1993. To compensate for these factors, we intend with effect from January 1, 1993 to raise the value added tax rates and to impose excise taxes on sales of gasoline and diesel fuel and of automobiles. Employment in the public sector will be rationalized by reducing employment in educational and health care institutions financed by the budget. All remaining budgetary subsidies will be eliminated, and other current expenditures, except for the items mentioned above, will be held constant in real terms. We believe that these measures will be sufficient to achieve a current balance for the general government.

7. The uncertainty in connection with the introduction of the Latvian ruble as the only legal tender in July, and the associated inflow of rubles through the correspondent account system, has created difficulties for monetary policy management. Additionally, the Government's foreign currency borrowing from state enterprises, the proceeds of which were converted into Latvian rubles and spent for purchases of strategic grain and energy reserves, further complicated the conduct of monetary policy. As indicated in our letter of September 11, 1992, it was the intention of the Bank of Latvia to sell some of the foreign exchange obtained from the Government to neutralize the domestic liquidity impact of the strategic reserve purchases. However, because of its limited experience in foreign currency operations, the Bank did not manage to undertake such transactions before the end of the third quarter. On the other hand, the Bank made a determined effort to keep domestic credit expansion below the programmed level for the end of September, albeit by less than the LR 600 million pledged in our letter of September 11, 1992. As a result of these factors, reserve money and broad monetary aggregates expanded more than planned.

8. In order to bring the monetary program back on track, the Bank of Latvia increased its general refinancing rate from 80 percent to 120 percent on October 8, and for certain emergency liquidity credits even higher rates are applied. Also, since July 20 the Bank of Latvia has ceased to exchange ruble correspondent account balances into Latvian rubles at par. Thus, with the sizable appreciation of the Latvian ruble against the ruble, the potential liquidity impact of the ruble correspondent accounts component of reserve money, which for programming purposes has been maintained at par vis-à-vis the Latvian ruble, is much less than indicated by the program figures. At the same time, however, we have decided to compensate enterprises in the amount of LR 660 million for part of the losses incurred on their exports undertaken before the July 20 decision on the Latvian ruble, but for which payment had not been received by that date and which

will not be converted at par. This amount will be transferred by the Bank of Latvia to the Government and granted to enterprises as an outright subsidy, but for those enterprises that have incurred tax arrears the subsidy will be retained for the budget. The ruble claims on the Bank of Latvia will be converted into Latvian rubles only at prevailing market exchange rates. Taking all these measures into account, we expect to be able to keep the net domestic assets of the Bank of Latvia LR 600 million below the ceiling of LR 9,470 million for December 31, 1992 established in Annex II of the memorandum of economic policies attached to our letter of August 14, 1992. Accordingly, we request that the ceiling for net domestic assets of the Bank of Latvia for December 31, 1992 be reduced from LR 9,470 million to LR 8,870 million. At the same time, we intend to maintain the indicative limit for the net domestic assets of the banking system of LR 24,910 million referred to in Annex II of the memorandum of economic policies attached to our letter of August 14, 1992.

9. The much higher price increase than envisaged in the incomes policy measures announced in early August, resulted in a significant decline in real wages in the third quarter of 1992. In view of this, and to accommodate the LR 1,500 per month flat-rate salary increase to compensate workers for the higher rents and utility prices mentioned in paragraph 5, we have revised the limit for the increase in the wage bill for the fourth quarter of the year from 20 percent to 37 percent.

10. In the area of systemic reform, the legislation on the use of vouchers in privatization is expected to be passed before the end of October; this will remove a significant obstacle to the privatization of large-scale enterprises. To facilitate further the privatization of such enterprises, the law on methods for carrying out privatization of state and municipal property, which had been restricted to purchase by foreigners for convertible currency, is being modified to allow both domestic and foreign investors to participate and to effect payments in Latvian rubles. A Government resolution adopted in early August has established three lists of enterprises: (i) 25 enterprises to be privatized for hard currency; (ii) 300 enterprises not to be privatized during 1992/93; and (iii) 600 enterprises which can be privatized under existing legislation. Five enterprises have been identified as a pilot project, one of which is currently being evaluated by a foreign consultancy firm. Privatization of farm land and of small-scale enterprises is gaining momentum, but information on the latter is not being collected systematically from the municipalities. However, for those municipalities reporting, progress is clearly evident. For example in Riga, out of 341 foodstores, 63 percent have been either privatized or leased. In other systemic reform areas, we expect the new accounting law to be adopted by Parliament before the end of October and to take effect from January 1, 1993. Work is still in progress to make the implementation of the competition and anti-monopoly law more effective. Similarly, steps are being taken to establish the necessary administrative procedures to implement the stipulations of the bankruptcy law. In the financial sector, the technical work on the separation from the Bank of Latvia of its branches and the preparation of their eventual

privatization have begun, currently with technical assistance from the Swiss Government. The World Bank and the EBRD are expected to provide assistance in this area as well in the coming months.

11. The external trade flows for the first half of 1992 are turning out to be considerably smaller than anticipated, principally because of the shortfall in trade with Russia and other members of the ruble area. Merchandise trade was roughly balanced, but large net services receipts, in particular earnings by the Latvian Shipping Company, resulted in a sizable current account surplus. Imports are expected to pick up in the second half of 1992 as the external financial assistance starts to be disbursed. The availability of imports is expected to improve significantly during the first half of 1993 when the bulk of the balance of payments assistance pledged to Latvia is likely to be disbursed. Nevertheless, because of the delay in disbursement of financial assistance and the continued trade difficulties with our Eastern neighbors, we now expect the current account deficit to be only about US$225 million for the program year, instead of the original forecast of nearly US$300 million.

12. The build-up of gross international reserves during 1992 is expected to be considerably larger than previously anticipated, and by the end of the year convertible currency reserves could reach US$135 million, despite our intention to make part of the unexpected build-up during the third quarter of the year available to the market. In view of these developments, we have decided to revise our targets for net international reserves, both the total and the convertible component, upward by US$6 million. Accordingly, we request that the targets for the minimum cumulative change in total as well as convertible net international reserves referred to in Annex III of the memorandum of economic policies attached to our August 14, 1992 letter be adjusted to show an increase of US$6 million between end-June 1992 and end-December 1992, instead of remaining unchanged as originally envisaged.

Sincerely,

/s/
Elmars Silins
Minister of Finance
Ministry of Finance

/s/
Einars Repse
Governor
Bank of Latvia

Michel Camdessus
Managing Director
International Monetary Fund
Washington, DC 20431

Latvia -- Fund Relations

(As of October 31, 1992)

I. Membership Status

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

II. General Department (General Resources Account)

	(In millions of SDRs)	(In percent of quota)
(a) Quota	61.00	100.0
(b) Total Fund Holdings of Currency	76.25	125.0
(c) Fund Credit		
Credit Tranche	15.25	25.0
CCFF	--	--
(d) Reserve Tranche Position	0.01	--

III. SDR Department

		(In percent of allocation)
(a) Net cumulative allocation	--	--
(b) Holdings	15.21	--
(c) Designated plan amount	--	--

IV. Outstanding Purchases and Loans:

		(In percent of quota)
Stand-by arrangement	15.25	25.0

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	9/14/92	9/13/93	54.90	15.25

VI. Projected Obligations to Fund (SDR millions):
(as at October 31, 1992)

	Overdue	1992	1993	1994	1995	1996	1997	1998	Total
Principal	--	--	--	--	1.9	20.0	25.5	7.4	54.9
Charges/Interest	--	0.1	2.3	3.5	3.4	3.0	1.5	0.3	14.1
Total obligations	--	0.1	2.3	3.5	5.3	23.0	27.1	7.7	69.0
(in percent of quota)	--	0.2	3.7	5.7	8.7	37.6	44.4	12.5	113.1

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 will finance essential imports for the energy, agriculture and health sectors, and includes a technical assistance component for the support of the economic reform program.

The first World Bank Country Economic Memorandum (CEM) has been distributed to the Bank Board in draft. The CEM provides a comprehensive overview of the Latvian economy, focuses on macroeconomic and systemic reform issues, and presents recommendations for policies and institutional reform. The report also includes an overview and analysis of the main sectors. The CEM will form the basis for Bank dialogue with the Government and for the future cooperation program between the World Bank and Latvia.

The Bank is in the process of preparing lending operations in the energy, agricultural, and social sectors. The Bank is also planning to undertake sector reviews in the areas of public sector management, enterprise development and financial sector reform.

Latvia: Technical Assistance

The following summarizes the technical assistance provided by the Fund to the Republic of Latvia since November 1991:

Depart-ment	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 and money statistics	Mission	February 1992	Latvia Committee of Statistics
FAD	Tax policy and administration, budget and expenditure management, social safety net	Mission	March-April 1992	Ministry of Finance, Ministry of Welfare
MAE	Monetary policy and analysis, accounting, payment system, foreign exchange management, central bank organization	Mission	March-April 1992	Bank of Latvia
STA	Price statistics	Mission	April 1992	Latvia Committee of Statistics
FAD	Tax administration	Mission	June-July 1992	Ministry of Finance and

	and cash management			Customs Department (State Finance Inspection Board)
STA	Balance of Payments	Mission	July 1992	Latvia Committee of Statistics, Bank of Latvia
FAD	Cash management/ Treasury system	Mission	October 1992	Ministry of Finance
STA	Balance of payments compilation	Mission	October 1992	Latvia Committee of Statistics, Bank of Latvia, Customs Department
MAE	Foreign exchange operations, accounting, and banking supervision	Mission	November 1992	Bank of Latvia
STA	Balance of payments compilation	Mission	November 1992	Latvia Committee of Statistics, Bank of Latvia, Customs Department