Ministry of Economics

Republic of Latvia

ECONOMIC DEVELOPMENT OF LATVIA REPORT

Riga, June 2012

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REPORT

RIGA

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Comments, questions or suggestions are welcomed:

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All figures and data, except for specifically indicated cases, have been obtained from the Central Statistical Bureau of the Republic of Latvia. The data of the European Union has been obtained from the Eurostat. The data of the Bank of Latvia and the Financial and Capital Market Commission has been used in the description of balance of payments and the bank and monetary indicators of Latvia. The data of the Treasury has been used in the description of financial indicators.

ISSN 1407-4109

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Dear reader,

The Ministry of Economics has prepared the regular ***Report on the Economic Development of Latvia***. The first Report was published in September 1994 and the following Reports since 1995 were published traditionally twice a year – in June and December. The present Report, just like the previous ones, provides evaluation of the state economic situation and policy, as well as gives forecasted development perspectives of economy.

It should be noted with satisfaction that Latvia keeps recovering from the crisis. In 2011, the GDP increased by 5.5%, which is more than even the optimistic experts expected. Moreover, we have been able not only to grow, but also to implement structural changes in the economy and turn public finances in a more sustainable direction. Over the past few years exports have become the key driver of economy. The export volumes of goods and services have reached the highest level ever. The increase in exports is related to the increase in external demand, and what is more important, also to the improving competiveness of Latvian producers.

At the same time, it should be noted that unfortunately not all inhabitants have felt the effect of the moderate economic growth, which is mainly observed in the manufacturing sector. The unemployment rate is still rather high though keeps decreasing.

Recovery of the Latvian economy has been also recognized internationally as the international rating agencies raised the credit rating of Latvia thus reducing public expenditures for external debt management and borrowing expenses for entrepreneurs. The international loan programme has been successfully completed at the end of 2011, thus confirming that Latvia belongs to the Nordic states which are characterised by responsible attitude towards public administration and finances.

Increasing risks in external markets, especially in the euro zone in the second half of 2011 and the beginning of 2012 have not had any particular impact on the economy of Latvia. Latvia is currently the fastest growing economy in the European Union. Experts of the Ministry of Economics expect the overall GDP to increase by 5% in 2012.

A solid economic foundation or "backbone" is required to ensure sustainable development. The *National Industrial Policy* is a way for Latvia to restore and strengthen this foundation by directing all resources in a coordinated manner towards improvement of our national welfare.

In 2012, the Ministry of Economics plans to develop the preliminary framework for the *National Industrial Policy* and support mechanisms for its implementation in order to foster development of sustainable business in Latvia, production of higher value added products and services, as well as to create better-paid jobs.

The *National Industrial Policy* is basically a work towards eliminating market failures and improving competiveness, fostering production of higher value added products and services and activating regional advantages. At the same time, it provides a base for industrial policy (improving infrastructure, improving tax and education system, etc.) and development of industrial policy (innovations, R&D, cluster development, etc.). The main directions of the industrial policy are oriented towards development of industrial areas, supporting producers, labour tax reform, developing an outstanding business environment, innovation system reform, as well as a new approach to employment policy.

The Ministry of Economics within its competence areas has already launched several activities for the implementation of the industrial policy. A new support programme for investments for construction, reconstruction or modernization of production facilities in the amount of LVL 12 million is going to be offered in a form of a pilot project in the largest cities of Latvia except Riga. The programme for innovative "green" industry in the amount of nearly LVL 8 million will be launched to support new industries, as well as a new venture capital support programme for business start-up and development will be implemented in the amount of LVL 28 million.

Reduction of labour taxes as of 2013 approved by the government is a huge step towards strong business competiveness. Lower labour taxes are important not only for the competiveness of Latvia in relation to neighbouring countries, but also for fostering economic activity, creating new better-paid jobs, investments in development and productivity. Yet, as economic activity and government budget revenues keep growing, a more rapid reduction of the labour tax burden should be carried out in the first place, by carefully assessing fiscal effects and risks. Greater reduction of the personal income tax rate would be a strong encouraging call for the enterprises operating in the grey economy. These reasons should serve as the leitmotif in further changes of the tax policy.

One of the key priorities of the Ministry of Economics is development of an outstanding business environment. Business environment has been significantly improved over the past few years and it has become more clear and business friendly. Achievements are proved also by the World Bank's research *Doing Business 2012*, where Latvia has moved up by ten positions and is ranked 21st in the world. Yet, Latvia must keep targeted work on improving the business environment to enter top twenty countries and keep this position in the long-term. Competition for investments and new jobs keeps growing, and when other countries make one step, we should be ready to make at least two or even run, if necessary. Reaching a position in an international rating is not an objective, it is a flashing light that coordinates and leads us towards achieving the key objective – an outstanding business environment. In particular, one of the most important tasks to improve the business environment is adoption of the *Construction Law* in the Saeima, prescribing simplification of administrative procedures of construction and creation of up-to-date legal regulation for the construction process.

We are successfully and purposefully implementing the management reform of state-owned companies that will bring transparent and clear principles to this process, as well as will ensure higher revenues in the government budget and efficient achievement of capital company objectives. In May 2012, the government approved the concepts prepared by the Ministry of Economics – the *Concept for Commercial Activities of Public Persons* and the *Concept for Management of State Capital Shares*. Management of state companies is one of the fields reasonably criticised by the international organizations and local business organizations. Management of state companies should serve as a good practice. Unfortunately, we are currently lagging behind our closest neighbours who already make the best out of the better management of state capital shares. Therefore, the decision of the Cabinet of Ministers is somewhat historical, because we have made a step closer to good, efficient and professional management of state capital shares.

The Ministry of Economics continues the work on the *Energy Strategy 2030*, which is a top level sustainable development planning document of the energy sector determining the main objectives of the energy policy and outlining the instruments to achieve them in the upcoming decades. The strategy is based on 3 main pillars for energy policy – competitive economy, sustainable energy and safety of energy supply. It also envisages promoting the use of renewable energy and increasing energy efficiency. As regards energy, the Ministry of Economics is currently assessing the support policies for production of electricity from renewable resources implemented in the previous years, in order to implement a reform that would make the state support system more predictable, sustainable, and technology-neutral from the cost aspect and less wasteful from the state support and consumer aspect.

One of the major issues at the government level in 2012 will be the EU budget for the next planning period from 2014 until 2020. Protection of Latvian interests within the EU budget – that is our team work, in which not only the ministries but also non-governmental organizations should be involved. Similarly, the government must also work on cross-sectoral reforms under the Declaration of the Government and the Government Action Plan.

In order to achieve the set objectives, we will continue the dialogue with entrepreneurs and their representing non-governmental organizations.

The present Report provides information on the main economic and social indicators, development of economy sectors and external economic environment, the economic policy of the government for fostering growth and employment, as well as the key instruments for implementing the policy, including utilisation of the EU structural funds.

In the conclusion of the Report, the authors provide recommendations regarding improvement of the state economic policy. The Cabinet of Ministers has not assessed all issues discussed in the report, therefore some conclusions on economic growth of the country and proposals for further activities reflect the opinion of experts from the Ministry of Economics.

I hope that the Report will be useful for economists and entrepreneurs, as well as for everyone interested in the economic development of Latvia, and that it will encourage an exchange of ideas between public institutions, various organisations and interest group representatives, as well as other stakeholders.

I would like to express my gratitude to the authors of the Report!

Daniels Pavļuts,
Minister of Economics
June 2012

CONTENTS

ABBREVIATIONS

Abbreviations

CC	Competition Council
CF	Cohesion Fund
CHP	Combined Heat and Power Plant
CIF	Price of goods created by the value of goods inclusive of freight and insurance costs till the border of the importing country
CIS	Commonwealth of Independent States
CLC	Central Land Commission
CoM	Cabinet of Ministers
CPI	Consumer Price Index
CRPC	Consumer Rights Protection Centre
CSB	Central Statistical Bureau
EAGGF	European Agricultural Guidance and Guarantee Fund
EC	European Commission
ECC	The European Consumer Centre of Latvia
ERDF	European Regional Development Fund
ESF	European Social Fund
EU	European Union
EU-15	European Union Member States before the enlargement on May 1, 2004
EU-27	European Union Member States after the enlargement on January 1, 2007
EU SF	European Union Structural Funds
FDI	Foreign Direct Investment
FIFG	Financial Instrument For Fisheries Guidance
FOB	Price of the goods, including value, and transport and insurance costs to the border of the exporting country

FTA	Free Trade Agreement
GDP	Gross Domestic Product
HPP	Hydroelectric Power Plant
ICT	Information and Communication Technologies
IDAL	Investment and Development Agency of Latvia
IMF	International Monetary Fund
JSC	Joint Stock Company
LGA	Latvian Guarantee agency
LLC	Limited Liability Company
LNAB	Latvian National Accreditation Bureau
LVS	Latvian Standard
NEC	National Economy Council of the Ministry of Economics
NPP	Nuclear Power Plant
NSFD	National Strategic Framework Document
OP	Operational Programme
PJ	Petajoule
SEA	State Employment Agency
SJSC	State Joint Stock Company
SMEs	Small and Medium-Sized Enterprises
SMM	Small and Medium-Sized Merchants
SOLVIT	EU Internal Market Problem Solving System (SOLVIT Network)
SRS	State Revenue Service
TPI	Trade Protection Instruments
TWh	Terawatt per hour
USA	United States of America
WTO	World Trade Organisation

Country Abbreviations

AT	Austria	IE	Ireland
BE	Belgium	IT	Italy
BG	Bulgaria	LT	Lithuania
CZ	Czech Republic	LU	Luxembourg
CY	Cyprus	LV	Latvia
DE	Germany	MT	Malta
DK	Denmark	NL	The Netherlands
EE	Estonia	PL	Poland
EL	Greece	PT	Portugal
ES	Spain	RO	Romania
EU	EU	SE	Sweden
FI	Finland	SI	Slovenia
FR	France	SK	Slovakia
HU	Hungary	UK	United Kingdom

1. Economic Situation: Brief Overview

The huge inflow of foreign capital from 2005 until 2007 fostered a significant increase in private consumption and investments in Latvia. The average annual growth rate of GDP was 10.3% that was one of the highest in the EU. In 2008 and 2009, the inflow of foreign capital halted due to the global financial crisis and the recession began. During the crisis, GDP decreased by ¼, external debt almost doubled, the number of employed decreased by 16%, the real wage dropped by 12 percent.

Since the end of 2009, the economic recession in Latvia is over and growth has resumed. Since the lowest point of the economy in the 3rd quarter of 2009 until the 1st quarter of 2012, the GDP has increased by 12%. Taking into account that the growth resumed from a rather low level, the overall GDP in 2010 was by 0.3% lower than in 2009. However, in 2011, the GDP has already exceeded the level of the previous year by 5.5%. The increasing risks in external markets, especially in the euro zone in the second half of 2011 and the beginning of 2012 have not had any particular impact on the economy of Latvia. The GDP continues growing rapidly. In the 1st quarter of 2012, the GDP increased by 1.1% compared to the previous quarter or by 6.9% compared to the respective period of the previous year.

Although 2012 has begun with positive trends in the economy of Latvia, external risks still remain with regard to further development in the euro zone. Slowdown of growth rates in the main trade partner countries may lead to a moderate increase in Latvian exports, thus reducing the positive impact of exports on the economy in general. However, in general, **the overall growth of the GDP in 2012 will be faster than expected and may reach 5 percent.**

Table 1.1

Latvia: Key Economic Development Indicators

	2008	2009	2010	2011	2012f
(changes in comparison with the previous year, %)					
Gross domestic product	-3.3	-17.7	-0.3	5.5	5.0
Private consumption	-5.8	-22.6	0.7	4.4	3.5
Public consumption	1.6	-9.4	-7.9	1.1	0.9
Gross fixed capital formation	-13.8	-37.4	-18.1	27.9	24.0
Exports	2.0	-14.1	11.5	12.6	5.8
Imports	-10.8	-33.3	11.5	20.7	7.0
Consumer prices	15.4	3.5	-1.1	4.4	2.5
(% of GDP unless indicated otherwise)					
General government sector balance	-4.2	-9.8	-8.2	-3.5	-2.1
General government debt	19.8	36.7	44.7	42.6	44.4
Export-import balance	-13.6	-1.5	-0.8	-1.1	-5.2
Changes in the number of employed (aged 15-74 years)*	*0.5*	*-12.2*	*-4.6*	2.5	1.5
Unemployment rate (share of job-seekers in economically active population aged 15-74 years, %)*	*7.5*	*16.9*	*18.7*	16.2	13.8

f – forecast
* – data since 2011 has been recalculated according to the Population Census. Recalculations of 2008–2010 will be available in the second half of 2013. Until then, all data after 2011 cannot be compared with the previous periods

Exports have become the economic driver in recent years. Export volumes of goods and services have reached the highest level ever. In 2011, exports of Latvian goods and services increased by 12.6%. In the 1st quarter of 2012, despite the strained economic situation in the EU, export volumes increased by 9.9% in comparison with the corresponding period of the previous year.

Further growth opportunities of exports will be affected by changes in external demand and competitiveness of Latvian producers. It should be taken into account that the improvement of Latvian competitiveness so far has occurred mainly due to the cuts in labour costs, however, further improvement of competitiveness will depend on the ability to raise productivity.

Positive tendencies are observed also in the domestic market. An increase in employment and a gradual rise in wages foster an increase in private consumption. In 2011, private consumption exceeded the level of 2010 by 4.4%, while in the 1st quarter of 2012 it exceeded the level of the 1st quarter of the previous year by 5.4%. However, generally, private consumption is increasing at a slightly slower rate than GDP and in the 1st quarter of 2012 it was only approximately 80% of the level of the 1st quarter of 2008 when it started decreasing. More rapid recovery of private consumption is limited by the still high unemployment level and household indebtedness.

In relation to the absorption of the EU structural funds, including public investments in infrastructure and enterprise investments in production equipment, investments are increasing rapidly. In 2011, investments increased by 27.9%, whereas in the 1st quarter of 2012, investments increased by 39% compared to the 1st quarter of the previous year. The increase in investments is based to a great extent on investments in such sectors as energy, wood processing and production of metal articles. The low bank crediting level is still one of the factors hindering investments. Despite the substantial increase, investments are still at a rather low level.

It should be noted that after the substantial decrease of incoming foreign direct investments (FDI) in 2008 and 2009, they have been increasing since 2010. The amount of FDI attracted to the economy of Latvia in 2010 four times exceeded the level of 2009. In 2011, the amount of incoming FDI in the economy of Latvia was almost 3.5 times higher than in 2010. At the end of March 2012 the FDI stock amounted to LVL 6567 million which was by 7% more than a year ago.

Both, the increase of demand for intermediate consumption goods in manufacturing **and improving situation in domestic market foster an increase of imports**. In 2011, the growth rates of imports exceeded the growth of exports, and thus the negative export-import balance increased to 3.9% of GDP. The fast growth of imports is mainly determined by increasing investments. At the same time it should be noted that the volume of imports of goods and services still considerably lags behind the pre-crisis level.

Production volumes of manufacturing continue growing due to the remaining positive export tendencies. In 2011, production volumes of the sector were by 11.7% higher than a year ago, but in the 1st quarter of 2012 they increased by 16.5% in comparison with the corresponding period of the previous year. Production volumes continue increasing in almost all manufacturing sectors, especially in wood processing, metal processing and production of electric appliances, machinery and equipment. In general, manufacturing ensured on average ¼ of the total economic growth in 2011.

Increasing activities of foreign trade has fostered also the growth of transport sector by 8% in 2011 and by 4% in the 1st quarter of 2012 compared to the 1st quarter of 2011.

The increase in revenues from exports has positive impact on the sectors operating mainly in the domestic market. The amount of services provided in trade sector increased by 9.6% in 2011, but in the 1st quarter of 2012 – by 8.1% in comparison with the corresponding period of the previous year. After the substantial decline during the crisis, the construction sector resumed growth in 2011 and grew by 12.4% within a year. In the 1st quarter of 2012, the construction sector continued growing rapidly (by 28.5% year-on-year). However, it should be taken into account that the sector experienced a deep recession during the crisis.

A slight increase is observed also in the agricultural and forestry sector, as well as in the commercial services sector. A decrease in manufacturing volumes is observed only in the rest of manufacturing sectors, mainly due to lower amounts of produced electricity and heat energy due to weather conditions.

After the deflation caused by the crisis when the 12-month consumer price inflation decreased to -4.2% in February 2010, **prices started increasing again**. The consumer price level has increased by 2.5% in 2010, while in 2011 – by 4%. It should be noted that the rise in prices slowed down slightly in the second half of the year after the rapid rise at the beginning of 2011. In 2012, the influence of several factors determining the rise in prices in 2011 (consumption taxes, electricity tariffs, global food prices) on consumer prices decrease. Fuel prices are very uncertain as they are also influenced by the fluctuations of exchange rate of the euro and the US dollar. In six months of 2012, consumer prices increased by 1.9% (12-month inflation) that was twice as slow as in the same period last year. **According to the estimates of the Ministry of Economics, the average consumer price level in 2012 may reach 2.5 percent**.

After facing the financial market crash at the end of 2008 and at the beginning of 2009, the **monetary indicators of Latvia are stabilising**. In the 1st quarter of 2012 compared to the corresponding period of the previous year the balance of deposits attracted by banks increased by 4.2%. It was mainly determined by the increase in the balance of non-resident deposits by 25.3%, while the balance of resident deposits decreased by about 10% (mainly due to the decrease in central and local government deposits).

Since the end of 2009, the **interest rates have stabilised.** The weighted average interest rate of short-term loans granted in lats was 5.5% in the 1st quarter of 2012, but the weighted average interest rate of long-term loans – 8.6%, which are one of the lowest interest rates in the recent years.

In total, 20.5 thousand new loans in the amount of LVL 217.7 million have been granted to residents in the 1st quarter of 2012. Compared to the 1st quarter of 2011 the amount of new loans granted to residents increased by 89%. A half of the new loans have been granted to the transport and storage sector and 15% – to the agriculture and forestry sectors, if evaluated by sectors.

The quality of loan portfolio continues improving and at the beginning of 2012 there were 22% loans with overdue payments. Resident loans with overdue payment of more than 180 days are decreasing (by 39.1%).

Although the amount of loans granted anew is gradually increasing, the total balance of loans is decreasing. In the 1st quarter of 2012, this number was by 11% lower than a year ago. It is mainly based on the decrease in the balance of mortgage loans (by 13.9% in a year).

Deterioration of the economic situation in 2008 and 2009 affected the fiscal situation in the country. In order to prevent the situation in the financial sector from going out of control, since 2008, Latvia has carried out budget consolidation in the amount of LVL 2.3 billion with fiscal impact in the amount of 17% of GDP, out of which about 6.8% of GDP are measures on the revenue side while measures on the expenditure side constitute about 10.2% of GDP. In the result of budget consolidation implemented by the government, the budget deficit in 2010 and 2011 decreased to 8.1% and 3.5% of GDP, respectively.

The Saeima approved the government budget for 2012 with a deficit in the amount of 2.1% of GDP. Fiscal consolidation has been continued also within the budget planning process for 2012. The budget consolidation included solutions both on the revenue side, among them reform of real estate tax and measures to cut budget expenditures – reduced grants for agriculture, transport and sports, reduced funding for defence, state and local roads and public transportation, implementation of social safety net measures, reduced funding for local municipalities.

Adoption of the budget for 2012 with a budget deficit below 3% of GDP creates preconditions for closing the excessive budget deficit procedure proposed by the EU, as well as ensures fulfilment of the Maastricht criterion on budget deficit, thus laying a strong foundation for Latvia to introduce the euro on January 1, 2014.

In order to strengthen fiscal discipline further and avoid excessive budget deficit and development of government debt, in May 2012, the Saeima ratified the EU *Fiscal Discipline Treaty*. The general government deficit is expected to be below 1.4% of GDP in 2013, 0.8% of GDP in 2014 and 0.3% of GDP in 2015.

During the economic recession from 2008 until 2010, the situation in the labour market has deteriorated significantly. **Since the beginning of 2010, the situation in the labour market has been improving along with gradually resuming economic activities –** employment increases, unemployment decreases gradually and the number of vacancies grows.

According to the estimation of the Ministry of Economics, the number of employed in 2011 has increased by approximately 2.5% in comparison with 2010. Within a year, the average unemployment rate in the country has decreased significantly. On average the unemployment rate constituted 16.2% in 2011, which is by 3.3 percentage points lower than in 2010.

According to the labour survey data, in the 1st quarter of 2012, the number of employed reached 858 thousand which is by 2.6% or 21.7 thousand more than in the 1st quarter of the previous year. The unemployment rate in the 1st quarter of 2012 was 16.3% which is by 1.3 percentage points lower than a year ago.

At the end of April 2012, the registered unemployment rate reached the lowest level since May 2009 and was 11.3% or 127.8 thousand unemployed which is by 30 thousand less than in April 2011. The highest unemployment rate at the end of December 2011 remained in the Latgale region (24.1%), but the lowest – in Riga (9%). In April 2012, 44% of the total number of unemployed was long-term unemployed (jobless for more than a year).

The situation in the labour market is expected to continue improving also in the upcoming quarters, however, the main risks are related to growth tendencies of global economy that may affect the situation of the labour market in Latvia. **In total, the number of employed may increase by 1.5% in 2012 and the annual average unemployment rate may decrease to 13.8 percent.**

Further development of the economy of Latvia will be still closely related to the export possibilities, therefore **the highest risk to the growth of Latvia is related to global economic development.** The main political priority in the global economy is still related to the recovery of the financial sector taking into account also secondary impact of the real sector's downturn on it. Financial problems and the need to reduce the excessive government budget deficit of several countries to ensure sustainable finances may have a negative impact on further growth of the EU. The economy of Latvia will grow at a slower pace along with the slowdown of the global growth.

The growth of the economy of Latvia in the medium-term will depend to a great extent on two factors. Firstly, on the solutions that the euro zone countries will manage to adopt for tackling the current tension in the financial sector in order to avoid possible economic stagnation. Secondly, on how efficient the structural policy implemented by the Latvian government for the improvement of economic competitiveness will be under the conditions of limited access to financing, including state budget.

The more rapid development scenario expects that the **growth rate of GDP in Latvia may continue increasing and reach stable growth of 5% per year**. The slower development scenario assumes that the economy of Latvia will recover much slower from the consequences of the crisis due to the remaining weak growth in Europe and being unable to improve competitiveness of tradable sectors.

2. DEVELOPMENT OF THE WORLD ECONOMY[1]

After rather high growth rates in 2011, the growth of global economy has slowed down in 2012. The increasing economic activities in the USA in the second half of 2011 and active policy measures in Europe have eliminated the risk of weakening growth in the world. Yet, high negative risks still remain. The larger developed countries are expected to resume recovering slowly, while the most of the developing countries will experience relatively stable growth.

Table 2.1

GDP Growth

(percent in comparison with the previous year)

	2010	2011	2012f	2013f
World, including:	**5.3**	**3.9**	**3.5**	**4.1**
USA	3.0	1.7	2.1	2.4
Japan	4.4	-0.7	2.0	1.7
EU including:	2.0	1.6	0.0	1.3
Euro zone countries	1.9	1.4	-0.3	0.9
CIS	4.8	4.9	4.2	4.1
China	10.4	9.2	8.2	8.8

Source: *The World Economic Outlook April 2012, International Monetary Fund*; f – forecast.

Due to the weak activities in the second half of 2011 and early 2012, the IMF has lowered the global economy forecasts for 2012 from 4% to 3.5% in comparison with September 2011. The euro zone countries are likely to experience a moderate recession in 2012 mainly because of the national debt crisis and deteriorating confidence, reducing bank crediting resources for the real sector, as well as the impact of fiscal consolidation. Positive growth of the euro zone is expected in 2013.

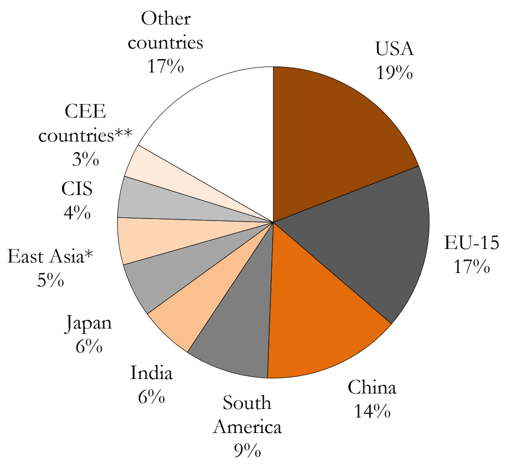
The GDP growth in the developing countries is expected to be 5.7% in 2012, i.e. slightly slower than in 2011, while growth will be faster in 2013 – about 6% due to the stimulating macroeconomic policy and increasing external demand.

Growth of **the USA** in 2012 is slightly faster than it was expected half a year ago, mostly due to higher indicators in 2011 and improvements in the labour market. Risks concerning the growth have been reduced yet, negative risks still exist in relation to the fiscal state of the country, the weak housing market and development of the economic situation in Europe.

Figure 2.1

Breakdown of the World's GDP by Groups of Countries in 2011

(structure, GDP by purchasing power parity units)



Source: *The World Economic Outlook April 2012, International Monetary Fund.*

* South Korea, Malaysia, Singapore, Thailand, the Philippines

** Central and East European countries – Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Malta, Poland, Romania, Serbia, Montenegro, Slovakia, Slovenia, Turkey

Growth of the USA in 2011 was mainly based on internal factors. Although the growth was weak at the beginning of the year, the rates grew faster from quarter to quarter. Inflation is rather slow and a steady increase in employment is observed.

Economic growth of the USA is expected to amount to 2.1% in 2012 and 2.4% in 2013. Although the recent labour market indicators are promising with the unemployment rate reducing to nearly 8% in March 2012, overall the employment in 2012–2013 will grow at a moderate pace. The output gap will determine the reducing inflation from 3% in 2011 and to 2% in 2012-2013.

[1] The preparation of the section is based on periodicals *World Economic Outlook September 2011, International Monetary Fund* and periodicals *European Commission European Economy 6/2011.*

The weak external demand negatively impacts the economic growth of **Asian countries**. At the same time, stable domestic demand in China prevents the negative subordinate effects from spreading in the financial sector. The ability of banks to provide financial resources will maintain a positive growth of the region also in future.

The growth in Asian countries decreased in late 2011 due to internal and external factors. The economic downturn in Europe reflected also in export indicators of the Asia. In some countries, like India, the growth was slowed down by the weak domestic demand, the low investments, as well as the expensive credits.

Expecting strong domestic demand, favourable financial conditions and influence of economic policy the IMF has forecasted growth of 6% in the region in 2012 (China – by 8.2%) and in 2013 – by 6.5% (China – by 8.8%).

Table 2.2

The Main Macroeconomic Indicators of the EU Member States
(percent)

	GDP growth			Consumer prices			Current account balance (% of GDP)			Unemployment		
	2011	2012f	2013f	2011	2012f	2013f	2011	2012f	2013f	2011	2012f	2013f
Austria	3.1	0.9	1.8	3.6	2.2	1.9	1.2	1.4	1.4	4.2	4.4	4.3
Belgium	1.9	0.0	0.8	3.5	2.4	1.9	-0.1	-0.3	0.4	7.2	8.0	8.3
Denmark	1.0	0.5	1.2	2.8	2.6	2.2	6.2	4.8	4.5	6.1	5.8	5.5
Finland	2.9	0.6	1.8	3.3	2.9	2.1	-0.7	-1.0	-0.3	7.8	7.7	7.8
France	1.7	0.5	1.0	2.3	2.0	1.6	-2.2	-1.9	-1.5	9.7	9.9	10.1
Germany	3.1	0.6	1.5	2.5	1.9	1.8	5.7	5.2	4.9	6.0	5.6	5.5
Greece	-6.9	-4.7	0.0	3.1	-0.5	-0.3	-9.7	-7.4	-6.6	17.3	19.4	19.4
Ireland	0.7	0.5	2.0	1.1	1.7	1.2	1.0	1.0	1.7	14.4	14.5	13.8
Italy	0.4	-1.9	-0.3	2.9	2.5	1.8	-3.2	-2.2	-1.5	8.4	9.5	9.7
Luxemburg	1.0	-0.2	1.9	3.4	2.3	1.6	6.9	5.7	5.6	6.0	6.0	6.0
The Netherlands	1.3	-0.5	0.8	2.5	1.8	1.8	7.5	8.2	7.8	4.5	5.5	5.5
Portugal	-1.5	-3.3	0.3	3.6	3.2	1.4	-6.4	-4.2	-3.5	12.7	14.4	14.0
Spain	0.7	-1.8	0.1	3.1	1.9	1.6	-3.7	-2.1	-1.7	21.6	24.2	23.9
Sweden	4.0	0.9	2.3	1.4	2.5	2.0	6.7	3.0	2.9	7.5	7.5	7.7
United Kingdom	0.7	0.8	2.0	4.5	2.4	2.0	-1.9	-1.7	-1.1	8.0	8.3	8.2
Bulgaria	1.7	0.8	1.5	3.4	2.1	2.3	1.9	2.1	1.6	12.5	12.5	12.0
Cyprus	0.5	-1.2	0.8	3.5	2.8	2.2	-8.5	-6.2	-6.3	7.8	9.5	9.6
Czech Republic	1.7	0.1	2.1	1.9	3.5	1.9	-2.9	-2.1	-1.9	6.7	7.0	7.4
Estonia	7.6	2.0	3.6	5.1	3.9	2.6	3.2	0.9	-0.3	12.5	11.3	10.0
Hungary	1.7	0.0	1.8	3.9	5.2	3.5	1.6	3.3	1.2	11.0	11.5	11.0
Latvia	5.5	2.0	2.5	4.2	2.6	2.2	-1.2	-1.9	-2.5	15.6	15.5	14.6
Lithuania	5.9	2.0	2.7	4.1	3.1	2.5	-1.7	-2.0	-2.3	15.5	14.5	13.0
Malta	2.1	1.2	2.0	2.4	2.0	1.9	-3.2	-3.0	-2.9	6.4	6.6	6.5
Poland	4.3	2.6	3.2	4.3	3.8	2.7	-4.3	-4.5	-4.3	9.6	9.4	9.1
Romania	2.5	1.5	3.0	5.8	2.9	3.1	-4.2	-4.2	-4.7	7.2	7.2	7.1
Slovakia	3.3	2.4	3.1	4.1	3.8	2.3	0.1	-0.4	-0.4	13.4	13.8	13.6
Slovenia	-0.2	-1.0	1.4	1.8	2.2	1.8	-1.1	0.0	-0.3	8.1	8.7	8.9

Source: *The World Economic Outlook April 2012, International Monetary Fund;*.
f – forecast.

At the end of 2011, growth in the **European countries** decreased faster than previously expected and some countries experienced a recession. As a result, the growth forecasts for 2012 have been significantly adjusted in comparison with the forecasts in September 2011. The unexpected severe downturn was related to the decreasing competiveness and the debt crisis in several Southern Europe countries and spreading thereof through the banking sector to the entire region.

Further growth in Europe will mainly rely on the situation in the euro zone countries. The overall growth of the region in 2012 is expected to amount to 0.2% (EU countries – about 0%), considerably lower than in 2011 (2%), mainly because of the negative indicators of the second half year of 2011. Growth prospects will still differ from one European country to another.

Growth rates in **the Baltic States** in 2011 were the highest in the EU, despite the decreasing external demand at the end of the year.

Also in 2012, export will be the key economic growth factor. The Baltic States are expected to grow at a moderate pace due to the weak confidence that restricts an increase in private consumption. The labour market indicators are likely to improve in 2012, though the unemployment rate will still remain rather high. At the end of 2011, the increasing food and fuel prices led to the increase in inflation, yet, the total inflation will be moderate in 2012.

Growth of the Baltic States in 2012 is expected to amount to approximately 2-2.5%, while GDP growth might exceed 3.5% in 2013.

Growth of **the CIS countries** was still fast in the second half of 2011 owing to high oil prices, an increase in prices for agricultural products in some countries (Armenia, Belarus, Kazakhstan, and Russia), as well as the strong domestic demand.

Yet, development of the region is affected by the situation in the euro zone, reflected in the increase in export volumes and manufacturing output of the CIS countries.

Considering the economic situation in the EU countries, growth of the CIS countries might slow down to 4.2% in 2012 and 4.1% in 2013, as compared to 5% in 2011, even on a condition that the oil prices remain rather high.

The intensifying crisis in the euro zone countries is considered as the main threat to growth of the CIS region.

Growth of Russia in 2012 will amount to approximately 4% mainly due to the remaining high oil prices. Yet, the expected drop in the oil prices in the second half of 2012 is likely to slow down the growth rates of Russia to slightly below 4% in 2013.

Table 2.3

Main Macroeconomic Indicators of the CIS

(percent)

	2011	2012f	2013f
GDP growth	4.9	4.2	4.1
including Russia	4.3	4.0	3.9
Consumer prices	10.1	7.1	7.7
including Russia	8.5	5.1	6.6
Current account balance (% of GDP)	4.6	4.0	1.7
including Russia	6.2	5.4	2.6

Source: *The World Economic Outlook April 2012*, *International Monetary Fund;*
f – forecast.

3. GROWTH

3.1. Gross Domestic Product and Aggregate Demand

3.1.1. Development Trends

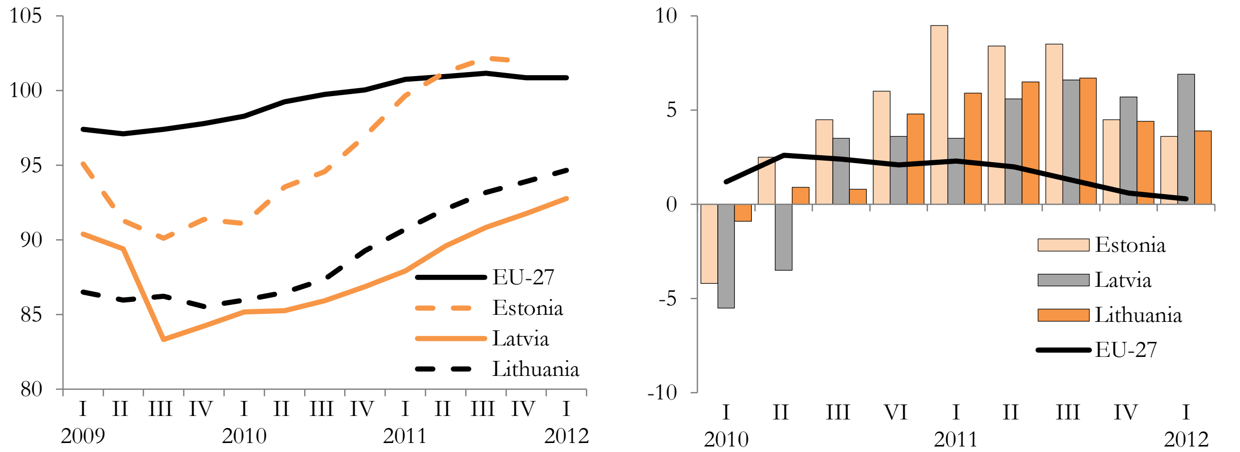
The global financial crisis severely affected the economy of Latvia. During the crisis, gross domestic product decreased by approximately 25%. Since the 4th quarter of 2009, GDP started increasing and in 2010 grew on average by 0.9% every quarter. As a result, the average GDP level of 2010 slightly lagged behind the indicator of 2009. In 2011 the GDP continued growing at a stable pace and exceeded the level of 2010 by 5.5%. In 2011, Latvia was one of the fastest growing economies in the European Union.

In the 1st quarter of 2012 compared to the 1st quarter of 2011, GDP increased by 6.9%. As compared with the lowest point of the crisis in the 3rd quarter of 2009 GDP has increased by 12 percent.

Figure 3.1

Dynamics of GDP by Quarters

Seasonally adjusted data, 4th quarter of 2008 = 100 | Against the respective period of the previous year, %



Exports are one of the main drivers of recovery of Latvian economy. Its demand had a positive impact on the growth of tradable sectors – particularly on the growth of the key industry – manufacturing. The increase in exports during the post-crisis period is based on both a growing demand in trade partner countries of Latvia and the competitiveness of Latvian producers which was improved during the crisis by cutting production costs. In 2011 the volumes of goods and services exports have increased by 12.6%. Overall, exports exceeded the pre-crisis level by 7.8 percent.

Despite the strained economic situation in the European Union, in the 1st quarter of 2012, volumes of exports in constant prices increased by 9.9% compared to the respective quarter of the previous year.

Table 3.1

GDP of Latvia by Expenditure Items

	2008	2009	2010	2011	2012 I	2008	2009	2010	2011	2012 I
	changes compared to the respective period of the previous year, %					contribution to changes, %				
Private consumption	-5.8	-22.6	0.4	4.4	5.4	-4.3	-16.2	0.3	3.0	3.9
Public consumption	1.6	-9.4	-9.7	1.1	1.8	0.2	-1.4	-1.6	0.2	0.3
Gross fixed capital formation	-13.8	-37.4	-12.2	27.9	39.0	-5.1	-12.2	-3.1	5.7	7.1
Inventories	–	–	–	–	–	-2.3	-2.5	4.6	1.8	-3.7
Exports	2.0	-14.1	11.5	12.6	9.9	0.9	-6.3	5.4	6.6	5.7
Imports	-10.8	-33.3	11.5	20.7	9.5	-7.3	20.9	5.9	11.8	-6.3
GDP	**-3.3**	**-17.7**	**-0.3**	**5.5**	**6.9**	**-3.3**	**-17.7**	**-0.3**	**5.5**	**6.9**

Export volumes of goods and services have increased since the 2nd quarter of 2009 and since then have already increased by 40%. Further export development possibilities will be affected not only by the changes of external demand, but also by the competitiveness of Latvian producers. It must be taken into consideration that until now, Latvian competitiveness was mainly determined by the decrease of labour force costs, but in the future the determinant role will be for the capacity to increase productivity.

Increased profits from exports have fostered the growth of domestic demand. Domestic demand has been growing since the beginning of 2010. In 2011, domestic demand continued growing due to the increase in private consumption caused by rapid increase in investments.

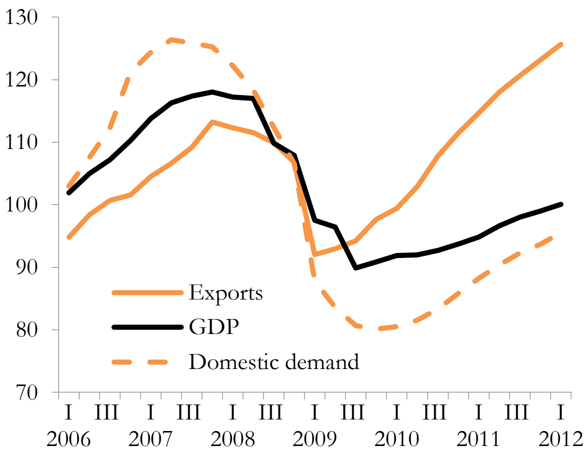
In the 1st quarter of 2012, domestic demand increased by 10.7% (according to seasonally adjusted data) compared to the 1st quarter of 2011. The increase in domestic demand in the 1st quarter of 2012 is related, to a great extent, to the increasing investments and private consumption.

In comparison with the lowest level of domestic demand during the crisis (the 4th quarter of 2009), it has grown by 20% (compared to the 1th quarter of 2012).

Figure 3.2

Quarterly Changes in GDP and Major Expenditure Items

(4th quarter of 2005 = 100, seasonally adjusted data)



As domestic demand decreased during the crisis, also volumes of imports shrunk fast and the export-import balance of Latvia improved significantly. In 2010, the balance was 1.4% of GDP (in 2006 and 2007 the negative export-import balance was approximately 20% of GDP). In 2011, economic activities in domestic market increased, thus fostering also an increase in imports. The increase in imports was particularly based also on the rapid rise in investments. Overall, in 2011, the negative export-import balance was 3.9% of GDP.

In 2011 import increased by 20.7 percent.

In the 1st quarter of 2012 import of goods and services increased by 2.1% (at constant prices, according to seasonally adjusted data) and by 9.5% exceeded the level of 4th quarter of 2010. At the same time it must be noted that export volumes of goods and services are still far behind the pre-crisis level – at the moment import of goods and services at constant prices is by 1.7 lower than in the 1st quarter of 2007, when it reached its highest peak.

In early 2012, volumes of imports continued increasing and at the end of March the negative export-import balance was 4.7% of GDP.

3.1.2. Private and Public Consumption

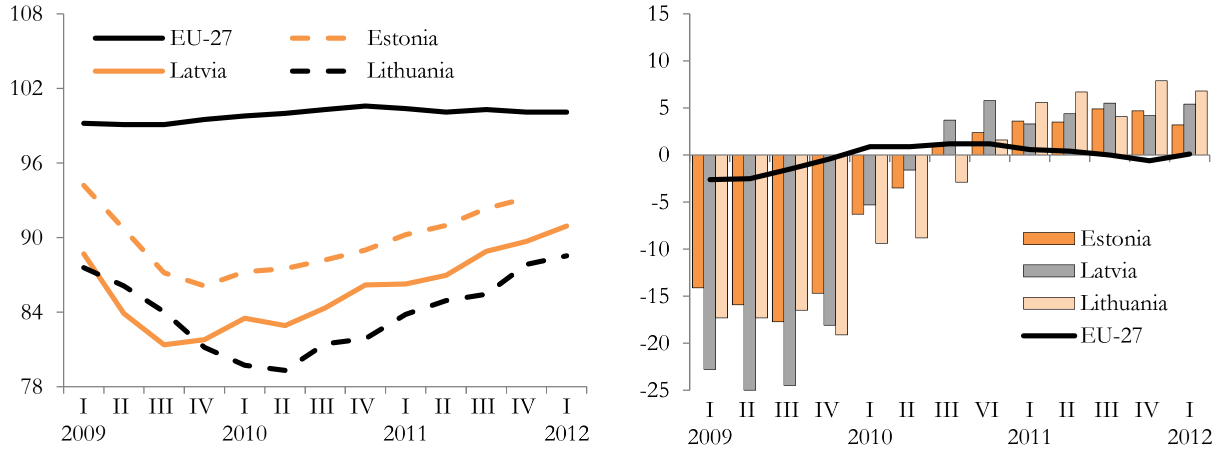
The decrease of **private consumption** started at the beginning of 2008 and reached the lowest point in the 3rd quarter of 2009. During six quarters of the crisis period, private consumption decreased by about 30% (compared with the 1st quarter of 2008). The decreasing private consumption was mainly based on reduced household crediting, decreasing wages and increasing unemployment. At the end of 2009, private consumption stabilised and resumed gradual growth at the beginning of 2010. Overall, private consumption continued growing in 2010. However, since it began growing from a relatively low level, private consumption exceeded the indicator of 2009 only by 0.7 percent.

At the beginning of 2011, private consumption continued increasing mainly because of the improving situation in the labour market – increasing employment and wages. Overall in 2011 compared to 2010 private consumption increased by 4.4 percent.

Figure 3.3

Changes in Private Consumption by Quarters

seasonally adjusted data, 4th quarter of 2008 = 100	changes compared to the respective period of the previous year, %

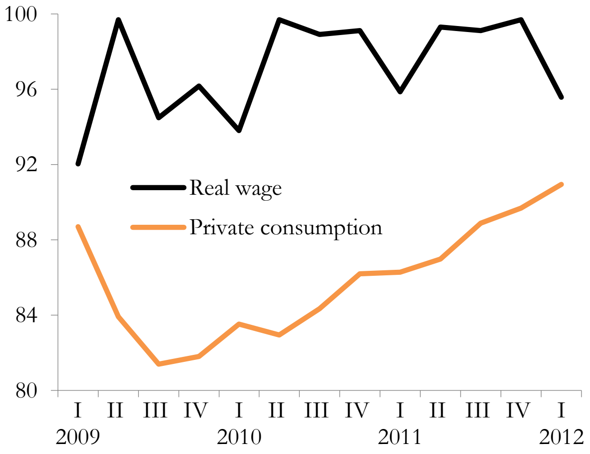


At the beginning of 2012, private consumption continues growing and in the 1st quarter of 2012 increased by 5.4% compared to the 1st quarter of 2011.

Figure 3.4

Dynamics of Real Wage and Private Consumption by Quarters

(4th quarter of 2008 = 100)



Consumer confidence is improving. Since August 2009, consumers have been becoming more optimistic though their confidence is still negative. Yet, it should be noted that consumer confidence has been negative also during the rapid growth years.

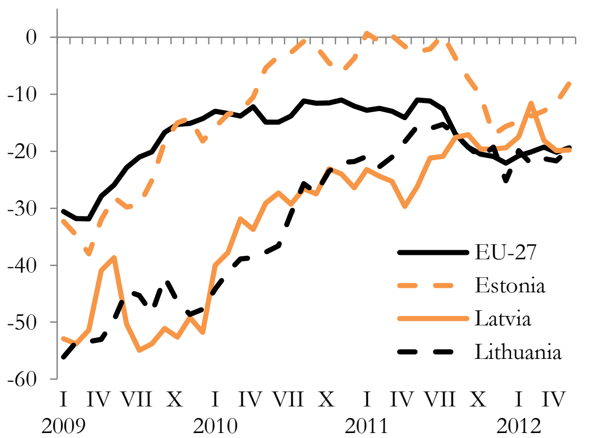
In five months of 2012 consumer confidence in Latvia exceeded the average consumer confidence in the European Union. The difference has been explicitly seen in February, when Latvian consumer confidence exceeded the EU average by 8.5 points. The decrease of consumer confidence in the EU was determined by the strained economic situation in the EU as a whole and in euro zone.

In May 2012 compared to May 2011, consumer confidence has improved by 6.4 points.

Figure 3.5

Consumer Confidence Indicator*

(response balance, seasonally adjusted data)

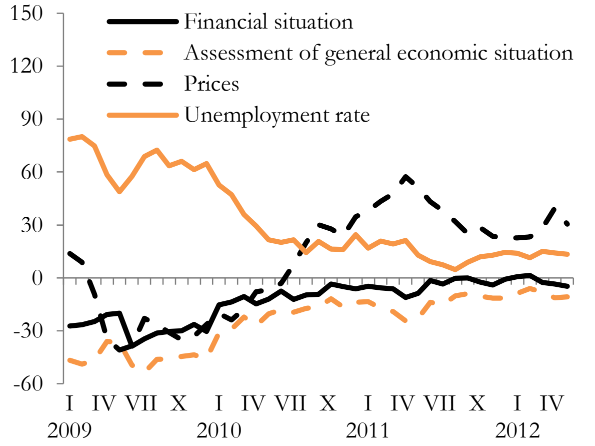


* The consumer confidence indicator is calculated as the average balance amount of responses to 4 questions regarding the financial situation, general economic situation, evaluation of unemployment and savings for the following 12 months.

Figure 3.6

Consumer evaluation for the upcoming 12 months

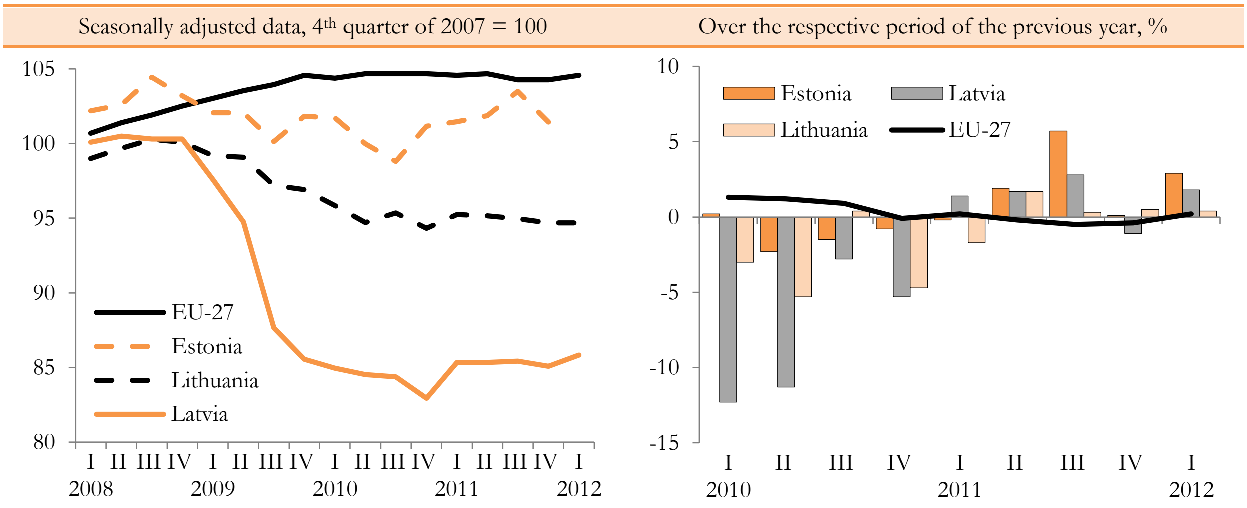
(response balance, seasonally adjusted data)



Public consumption or public services the value of which is determined by the volume of the provided public services amount comprises about 16% of GDP. Its share in the structure of was 20% in 2008, 19.6% in 2009 and 18.4% in 2010. The volumes of public consumption are related to implementation of the state budget consolidation measures. Therefore, public consumption decreased during the crisis. Public services increased by 1.1% in 2011 compared to 2010. In the 1st quarter of 2012, the amount of public services increased by 1.8% compared to the 1st quarter of 2011.

Figure 3.7

Changes of Public Consumption by Quarters



3.1.3. Investments

Investments are characterised by rather strong cyclical fluctuations. During the economic recession investments in the economy of Latvia decreased significantly. However, investment activities are growing rather fast along with the stabilising economic situation. The range of fluctuations in terms of investment volumes in Latvia was much wider than in other EU Member States.

The severity of investment adjustment in Latvia was intensified by substantial debt of enterprises accumulated during the rapid growth years, as well as by worsening solvency of the Latvian banking system. The investment volumes in the economy of Latvia in 2008 decreased by 13.8%, but in 2009 by almost a half in comparison with 2007. The decrease in investments in 2009 was mainly based on low domestic and external demand, as well as to the low manufacturing capacity load. Since the end of 2010, investment activities in Latvia have been gradually increasing though they are still at a very low level. In 2010, investments in the economy of Latvia were almost by a half lower than in 2007 and constituted 18.3% of GDP.

A significant decline in investments was observed also in the EU Member States. Sensitivity of investors to economic fluctuations was to a great extent determined by the worsening financial situation of companies due to a rapidly narrowing market. Since 2008, investments in the EU Member States have decreased on average by 13.4% within three years, i.e. almost ten times faster than GDP.

It should be noted that the only EU Member State with positive investment dynamics was Poland (investments increased by 8.1% in 2010 compared to 2007). However, the decrease of investment volumes in the Baltic States and Ireland has exceeded the EU average almost four times.

Since 2011, the situation has turned the other way round. Investment volumes in the Baltic States increased rapidly within a year (in Latvia – by 27.9%, in Lithuania – by 17.1% and Estonia – by 26.8%), and this indicator put the Baltic States in the leading position among the EU Member States. It should, however, be noted that the rapid increase in investment volumes was to a great extent related to the low base effect and in 2011 investments in the economy of Latvia constituted 60% of the level of 2007.

Also in 2012, dynamics of investments in Latvia is rapid, showing stable positive investing trends. In the 1st quarter of 2012, the economy of Latvia received by 39% more investments than a year ago. In 2011 and in the first half of 2012, investments have greatly contributed to the growth of GDP.

The state plays an important role in the investment process. The state provides significant support to private investments through the EU structural funds co-financing under weak crediting conditions.

Although the amount of public investments decreased during the economic recession, its share in overall investments in the economy of Latvia increased and reached 19.1% in 2010, i.e. by 2.4 percentage points more than in 2007. In 2011, public investments increased by 16.4%, contributing by 4.5 percentage points to the total increase in investments.

Figure 3.8

Changes in Investment Volumes in the Baltic States

(4th quarter of 2007=100)

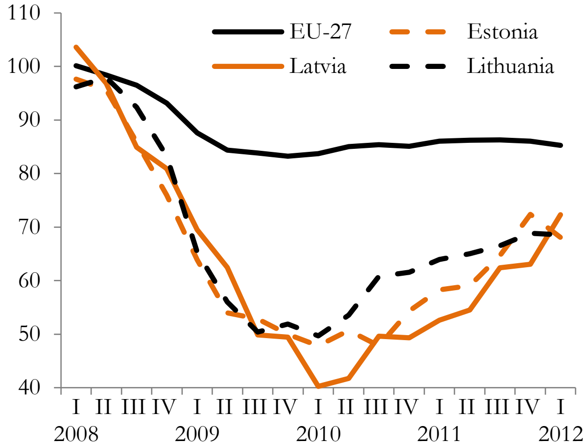


Table 3.2

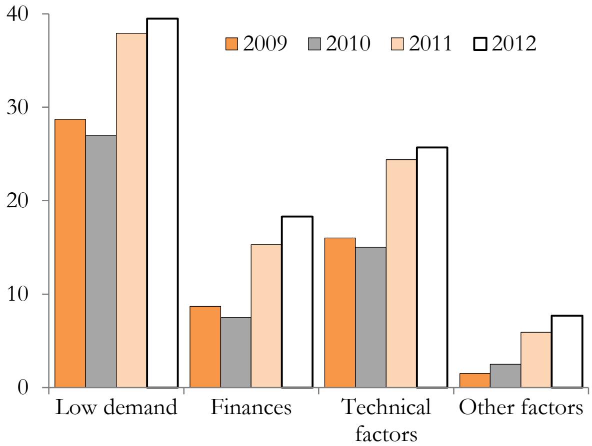
Gross Capital Formation

	2005-2007 average annually	2008	2009	2010	2011	2012 Q1
			changes in percent			
GDP	10.3	-3.3	-17.7	-0.3	5.5	6.9
Gross Capital Formation	12.0	-19.7	-47.1	5.0	35.5	15.6
– gross fixed capital formation	15.9	-13.8	-37.4	-18.1	27.9	39.0
			% of GDP			
Gross Capital Formation	38.0	31.2	20.5	19.9	25.6	23.2
– gross fixed capital formation	32.9	29.7	21.6	18.3	21.5	20.5
– changes in inventories	5.1	1.6	-1.1	1.6	4.1	2.8

Questionnaire results of enterprise managers show that the low demand level is the main factor limiting investments. However, in 2010, the role of technical factors (access to human resources and technologies) has significantly increased compared to the previous years. Yet, in 2012, the role of "access to finance" factor in the investing process is increasing, which is related to the slow restoration of private sector crediting channels.

Figure 3.9

Factors Affecting Investments in Manufacturing*



* Business and consumer surveys of the European Commission

The capacity load level in manufacturing has been gradually increasing since the beginning of 2010 and at the end of 2011 it has reached 69.4%, but at the end of June 2012 it has increased to 70.3%, which is only by 2 percentage points below the level of the end of 2007. It indicates that the current manufacturing volumes are approaching its potential. An increase in demand, as well as entrepreneurs' positive future expectations may foster not only an increase in the capacity load, but also an increase in investments. Positive trends in the investing process to a great extent are expected to depend on access to credit resources and other external financing sources and on the desire to strengthen positions in foreign and domestic markets including by technologically renewing existing capacity loads.

Structure of investments by sectors[1]. Despite the higher decrease of the total investment volumes in 2008 compared to the years before the crisis, the changes, if considered by sectors, appear to be very different.

The majority of sectors have maintained the positive investment dynamics in 2008. In comparison with 2007, investments in agriculture increased by 23.5%, real estate transactions – by 23.2%, investments in the hotel and restaurant business increased almost twice. However, the investment volumes in other sectors were lower in comparison with 2007. A particularly significant decrease of investment volumes was observed in the energy sector – by 28.5%, financial services – by 32.2%, manufacturing – by 23.6% and construction – by 14.7%. In total, investments in manufacturing decreased by 18%, but in the services sector increased by 6 percent.

As the economic crisis intensified, the investment activities continued decreasing in all sectors in 2009, including manufacturing – by 45.6% and in the services sector – by 28% in comparison with 2008. The most significant decrease of investments was observed in the construction sector (by 46.1%), financial and insurance operations (by 55.2%) and manufacturing (by 53.1%).

In general, the investment process in 2010 was weak, especially in the services sectors. If compared to 2009, investments in services sectors decreased by 31%. However, investments in sectors related to production of goods were only by 20% lower. Yet, investments increased in agriculture (by 19.6%), energy sector (by 47%), transport and storage sector (by 8.1%), information and communication services (by 8.2%) in comparison with the previous year. It should be noted that investments in manufacturing increased by 5.5 percent.

Stabilization of economic situation has positively affected the investing process in Latvia. It is recovering rather rapidly. According to provisional data, investment dynamics of goods production sectors is almost 3 times faster than services sectors. In 2011, investments in services sectors increased by 16.6% and constituted almost 60% of total investments in the economy of Latvia. Investments in goods production sectors in 2011 were almost by 42% higher than a year ago. It was mainly due to the substantial investments in the energy sector and manufacturing.

Table 3.3

Dynamics and Structure of Investments by Sectors

	Growth rates					Structure				
	2005-2007 average annually	2009	2010	2011*	2012 Q1	2005-2007 average annually	2009	2010	2011*	2012 Q1
Primary sectors	1.5	-41.0	-16.3	66.0	95.3	4.4	3.8	5.9	6.0	6.3
Manufacturing	15.5	-53.1	5.5	30.7	53.8	16.2	9.3	13.0	17.4	19.1
Electricity, gas and water supply	7.8	-35.3	-9.8	49.3	26.2	7.8	8.2	9.7	14.8	21.3
Construction	22.2	-46.1	-33.3	35.3	77.0	7.2	9.1	8.0	1.6	2.2
Trade	-1.5	-50.6	-24.2	32.0	22.5	13.2	8.0	8.0	7.0	7.1
Transport and communications	3.0	-40.1	8.1	8.9	16.4	13.2	11.5	19.4	18.1	18.9
Other commercial services	21.4	-30.9	-37.7	-7.6	76.5	23.4	25.0	20.6	6.2	8.4
Public services	11.1	0.0	-44.3	25.7	42.2	14.7	25.1	18.5	28.8	16.8
Total	**11.4**	**-34.4**	**-24.2**	**25.5**	**54.2**	**100**	**100**	**100**	**100**	**100**

* estimated based on quarterly data

In the 1st quarter of 2012, investments in the economy of Latvia were almost 1.5 times higher than a year ago. Investments in goods production sectors increased by 85%, i.e. almost 2.5 times faster than in services sectors. In the 1st quarter of 2012, the majority of investments have been made in electricity, gas supply, heat supply and air conditioning sectors – 20.3% of the total investment volumes, which is by 132.1% more than in the 1st quarter of 2011. The largest investing companies in these sectors are the JSC "Latvenergo" (TEC-2 reconstruction), JSC

[1] Investments in sectors are presented according to the non-financial investment statistics.

"Latvijas Gāze" (invested in Inčukalns underground gas storage equipment), JSC "Sadales tīkls" (investments in construction of electricity lines and electric equipment).

Investments in manufacturing have been gradually increasing since the end of 2010. From 2007 until 2009, investments in manufacturing decreased by 64.2% due to the financial crisis. It was determined to a great extent by the decrease of investments in production of consumer goods (including food production – by 44%), as well as production of intermediate consumer goods (including wood processing – by 88% and production of chemical substances and its products – by 77%).

In total in 2010, investments in manufacturing were by 5.5% higher than in the previous year. Investments in production sectors of non-durable consumer goods and investment goods are increasing most rapidly. Wood processing sector, paper industry and publishing, as well as production of pharmaceutics had the largest contribution to the increase in investments in manufacturing. Positive investment trends in 2010 were observed also in metal processing and production of vehicles.

According to provisional data, investments in manufacturing have increased by 30.4% in 2011 compared to 2010. More than half of the investments in manufacturing were made in wood processing and production of metals.

In the 1st quarter of 2012, LVL 68.9 million or 19.1% of the total investment volumes in the economy of Latvia have been invested in manufacturing, which is by 53.8% more than in the 1st quarter of 2011. The largest investing companies were the LLC "Bolderāja LTD" (reconstruction of workshop and installation of new production equipment), JSC "Liepājas metalurgs" (investments in modernising electric furnace), LLC "EAST METAL" (investments in equipment), Liepāja special economic area LLC "ELME MESSER METALURG" (a new factory is being constructed), JSC "Jaunpils pienotava" (construction of a new workshop and investments in equipment), LLC "Kurzemes gaļsaimnieks" (construction of a new workshop).

In the 1st quarter of 2012, investment amounts in almost all industry sectors either increased or remained at the level of the corresponding period of the previous year, except paper and paper article production, vehicle production and production of construction materials. It should be noted that investments in the first two sectors increased considerably in 2010 and 2011. Yet, investment volumes in production of construction materials have decreased annually by almost 20% since 2008 due to deterioration of situation in the real estate market. Investments in this sector constituted 6.5% of total investments in manufacturing in 2011. Also in the 1st quarter of 2012, investments in production of construction materials were also by 63% lower than a year ago.

Table 3.4

Dynamics and Structure of Investments in Manufacturing

(percent)

	Growth rates					Structure				
	2005-2007 average annually	2009	2010	2011*	2012 Q1	2005-2007 average annually	2009	2010	2011*	2012 Q1
Food industry	-1.8	-52.0	-6.1	60.1	82.4	20.4	15.1	13.4	17.7	16.8
Light industry	-13.3	-32.8	-30.0	83.1	-15.4	2.6	2.5	1.7	1.6	0.6
Wood processing	18.2	-88.3	139.6	147.0	155.0	26.4	8.4	19.1	31.0	43.5
Paper industry and publishing	20.2	-71.5	152.6	44.5	-63.2	7.5	2.5	5.9	3.0	0.8
Chemical industry and related industries	24.3	-11.4	16.3	6.9	160.3	7.7	12.2	13.5	8.5	10.0
Production of other non-metallic mineral products**	79.0	-19.7	-51.9	-78.5	-62.8	15.1	39.3	17.9	6.5	4.2
Production of metals and metal articles**	20.5	-59.4	130.1	157.5	-11.3	7.2	7.0	15.2	20.4	12.9
Production of machinery and equipment	9.0	-43.7	90.1	173.7	226.6	2.0	2.0	3.6	1.4	1.4
Production of electrical and optical equipment	7.1	-53.7	15.8	106.9	307.5	2.7	1.1	1.9	1.8	3.4
Production of vehicles	25.0	0.4	43.2	148.2	-51.3	2.4	4.5	3.5	4.4	1.5
Other industries	20.9	-27.0	-23.7	255.3	189.7	6.0	5.4	4.3	4.0	4.9

* estimated based on quarterly data;
** estimation of the Ministry of Economics

According to conjuncture survey results, investments in manufacturing in 2011 were mainly related to replacing used equipment and machinery and extending production capacity – respectively 35% and 24% of total investments in manufacturing. At the same time, it should be mentioned that investments for rationalising the production process have been increasing in recent years.

In the nearest future, investment volumes in the economy of Latvia are likely to increase gradually. However, the dynamics of the investing process to the great extent will depend on access to financial resources, increase of the total demand, and implementation of the state support measures for fostering entrepreneurship.

3.1.4. Exports and Imports

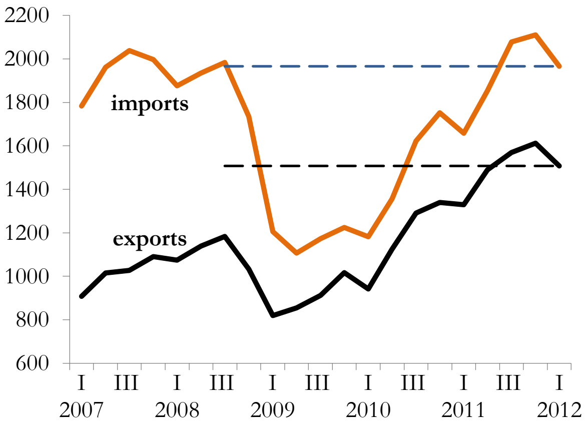
Exports and imports of goods

Although there are certain external risks in relation to further development of the euro zone and slowdown of growth rates in our key trade partner countries, the growth rates of Latvian exports are stable.

In 2011, exports of Latvian goods in current prices increased by 28% (by 14% at constant prices) compared to 2010. Also in 2012, exports of goods continue increasing. In January-April 2012, exports have increased by 11% in current prices compared to the four months of 2011.

Figure 3.10

Exports and Imports of Goods by Quarters
(million LVL)



Like exports, imports of goods have been growing at stable pace in this period.

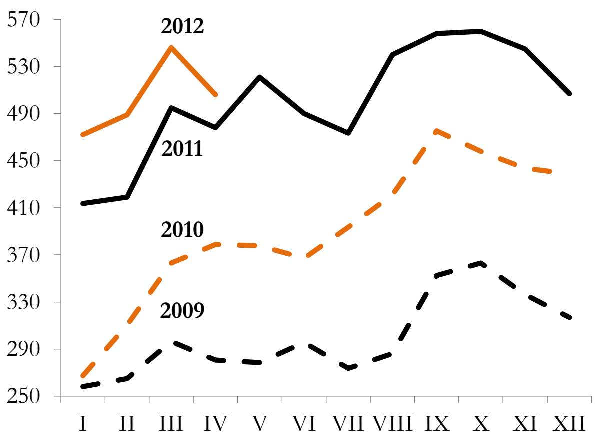
In 2011, imports of goods in current prices increased by 30% (by 23% at constant prices) compared to 2010. Also at the beginning of 2012, imports of goods are also increasing. In January-April 2012, imports in current prices exceeded the level of January-April 2011 by 18 percent.

As imports of goods increased slightly faster than exports, the negative balance of exports and imports of goods has also slightly increased, though it is considerably lower than in the years of rapid growth. In the 1st quarter of 2012, the negative trade balance is slightly over 10% of the foreign trade volume. In 2007-2008, it constituted more than ¼ of all foreign trade volume.

In 2011, changes in the trading conditions positively influenced **exports of goods** and the export unit value index increased by 12%, while that of imports – only by 6%. In the 1st quarter of 2012, the import unit value increased slightly faster than the export unit value.

Figure 3.11

Dynamics of Exports of Goods by Months
(million LVL)



In 2011, prices for exported goods increased most rapidly for metals and metal articles, while prices for machinery products decreased slightly.

In 2011, export volumes of goods increased in all product groups. The largest share in this increase ensured the increase in export groups of mineral products and metal and metal articles. Yet, in the four months of 2012, export groups of agriculture and food products, as well as wood and wood products have increased most rapidly compared to January-April 2011. In total, these groups constituted almost ¾ of the total export increase.

Exports to the EU Member States increased by 29% in 2011, but in January-April 2012 – by 10% compared to the four months of 2011. In 2011, the growth in exports of metal product group traditionally contributed the most to this increase, while in the four months of 2012, agriculture and food product group has also largely contributed to the increase.

Table 3.5

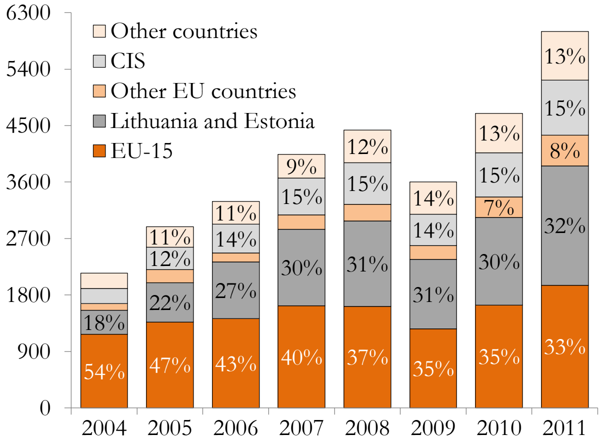
Exports by the Main Commodity Groups
(%, in current FOB prices)

	2011		January-April 2012	
	structure	changes compared to the previous year	changes compared to the respective period of the previous year	contribution to changes in volumes
Total including:	**100**	**27.8**	**11.4**	**11.4**
wood and wood products	16.8	13.5	10.9	2.0
metal and metal articles	16.4	17.2	24.2	3.7
light industry products	14.5	33.6	10.1	1.6
agriculture and food products	12.7	25.2	11.9	1.4
products of chemical industry and related industries, plastics	10.5	25.5	1.1	0.1
machinery products	9.1	93.9	34.3	2.6
minerals	6.7	42.1	-13.5	-0.9
vehicles	4.6	19.0	6.6	0.3
other goods	8.7	27.9	6.0	0.5

In 2011, exports to the CIS countries increased by 25%, but in January-April 2012, slightly slower – by 14% compared to the four months of 2011. The largest contribution to the export's increase in 2011 to the CIS countries was, as usual, by the agricultural and food products group, while in January-April 2012, the agricultural and food products group was accompanied by production of chemicals and machinery product groups.

Figure 3.12

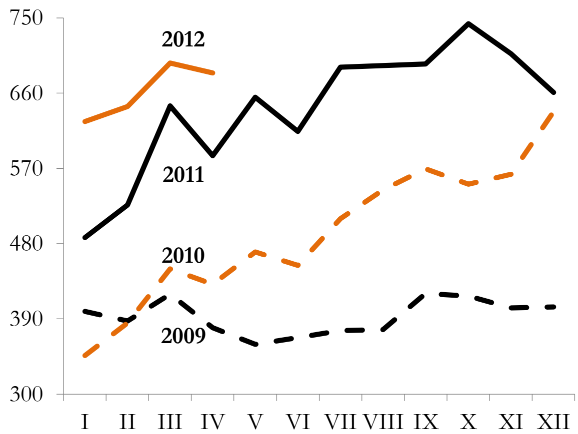
Structure of Latvian Exports by Groups of Countries
(million LVL)



The increase in **imports of goods** in 2011 was mainly influenced by the increase in imports of mineral products and vehicles, altogether constituting 60% of the total increase in imports. Also in 2012, the increase in imports was greatly influenced by mineral products and machinery product import groups compared to the corresponding period of 2011.

Figure 3.13

Dynamics of Imports of Goods by Months
(million LVL)



Imports from the EU Member States have increased similarly to the total imports of goods in the four months of 2012, while imports from the CIS countries have increased slightly faster due to a rapid increase in imports of mineral products.

Table 3.6

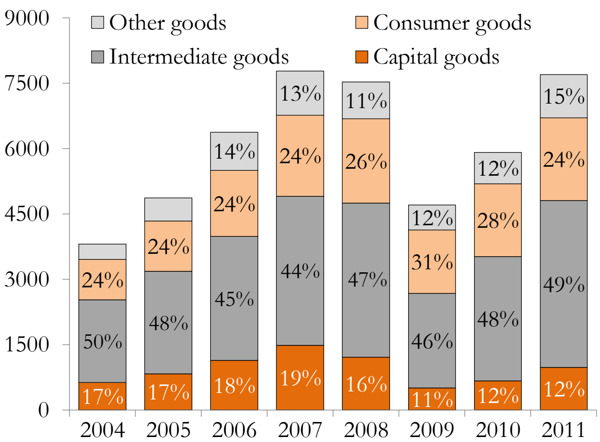
Imports by the Main Commodity Groups
(%, in current CIF prices)

	2011		January-April 2012	
	structure	**changes compared to the previous year**	**changes compared to the respective period of the previous year**	**contribution to changes in volumes**
Total including:	**100**	**30.3**	**18.2**	**18.2**
mineral products	17.4	47.4	42.3	7.0
machinery products	17.2	35.9	31.0	4.7
agriculture and food products	15.1	20.9	12.8	2.0
products of chemical industry and related industries, plastics	15.0	15.8	6.2	1.0
metal and metal articles	11.0	39.3	14.1	1.7
vehicles	9.0	63.6	-0.4	0.0
light industry products	5.3	22.2	0.3	0.0
wood and wood products	1.5	19.9	25.2	0.4
Other goods	8.5	8.2	17.0	1.4

The share of imports of capital goods tended to decrease until 2009, which is related to the decrease of investments. However, an opposite tendency is observed in the post-crisis period. The imports of capital goods and intermediate consumption goods are increasing more rapidly. Nevertheless, it should be noted that import volumes of these goods in 2011 were slightly lower than in the pre-crisis period. The share of imports of consumer goods is decreasing accordingly.

Figure 3.14

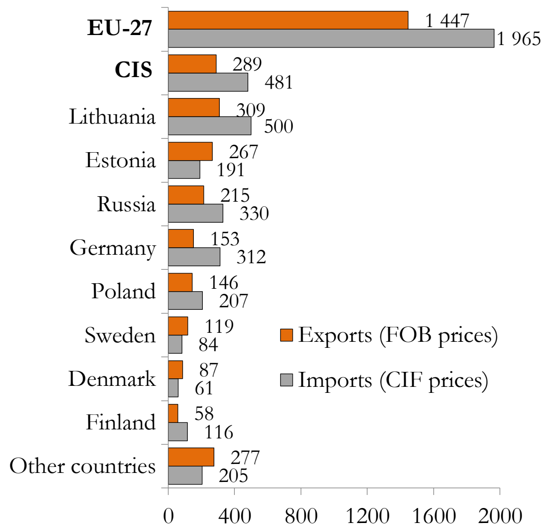
Imports by Classification of the Broad Economic Categories
(related to the basic sections of national accounts, in current CIF prices, million LVL)



The biggest **trade partners** of Latvia from January until April 2012 were Lithuania – 17% of the total foreign trade turnover, Russia – 12%, Germany and Estonia – each 10%, Poland – 8%, Sweden and Finland – each 4 percent.

Figure 3.15

Foreign Trade Turnover of Latvia in January-April 2012
(million LVL)



Significant deterioration of the Latvian trade balance with **Lithuania and Estonia** was observed during the rapid growth of the Baltic States. Yet, as the total import volumes decreased in the second half of 2008, the foreign trade balance with Lithuania and Estonia started improving gradually.

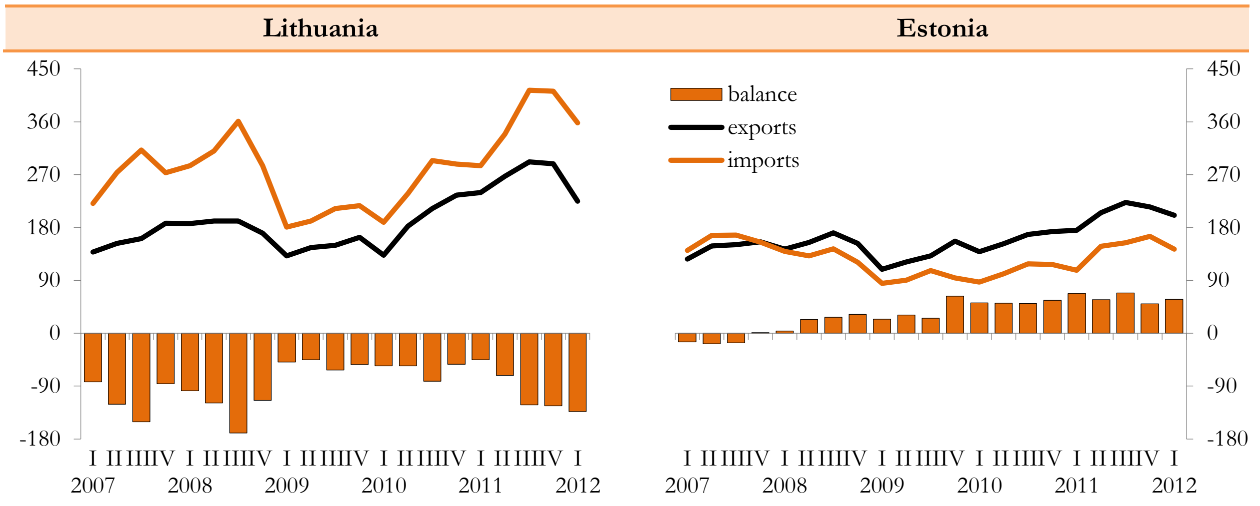
Since 2008, the foreign trade balance with Estonia has been positive and has a tendency of increasing, while with Lithuania it is still explicitly negative. The imports from Lithuania and Estonia in 2011 exceeded exports by 6%, while as the volumes of imports of goods from Lithuania and Estonia increased in January-April 2012, the trade balance with both countries has deteriorated significantly and imports exceeded exports by about 20 percent.

The main groups of products exported to Estonia and Lithuania are traditionally agricultural and food products, machinery products, as well as mineral products. Mineral products, agriculture and food products, as well as metal and metal articles constitute the largest share in imports from Lithuania and Estonia.

Figure 3.16

Foreign Trade Turnover of Latvia with Lithuania and Estonia by Quarters

(million LVL)



Exports and imports of services

The decrease in exports of services during the crisis was considerably smaller than exports of goods. In 2011-2012, exports of services are growing similarly to exports of goods at a stable pace. The positive balance of services in 2011 covered approximately 2/3 of the negative trade balance of goods. Yet, taking into account the rapid increase in exports of goods, the positive balance of services in January-April 2012 covered a little over a half of the negative trade balance of goods.

Table 3.7

Exports and Imports of Services

(percent)

	2011				January-March 2012			
	structure		changes compared to the previous year		structure		changes compared to the respective period of the previous year	
	exports	imports	exports	imports	exports	imports	exports	imports
Services – total	**100**	**100**	**14.4**	**11.0**	**100**	**100**	**19.9**	**13.7**
including:								
Transport services	**50.2**	**31.0**	**16.8**	**16.6**	**54.9**	**32.9**	**21.3**	**14.9**
– sea transport	12.9	7.7	2.1	13.2	15.3	7.8	23.1	15.6
– air transport	7.9	10.2	-2.7	6.9	6.7	11.0	20.0	16.9
– rail transport	13.5	5.1	32.7	29.1	17.1	5.4	29.7	6.5
– road transport	14.8	7.9	33.7	27.0	14.1	8.5	12.3	17.5
– other transport	1.1	0.2	14.2	30.8	1.6	0.2	11.5	20.5
Travel	**17.3**	**29.4**	**14.0**	**12.0**	**14.4**	**26.5**	**15.4**	**15.2**
Other services	**32.5**	**39.5**	**11.1**	**6.3**	**30.7**	**40.5**	**19.6**	**11.9**
– communication services	2.2	4.9	-3.4	15.5	2.4	5.4	24.6	18.6
– construction services	1.9	2.7	5.0	-0.7	1.9	3.7	25.9	39.9
– insurance and financial services	7.6	5.2	25.7	-4.6	6.6	3.9	25.6	0.6
– information and computer services	3.9	4.6	26.2	14.4	4.2	5.2	16.1	20.9
– commercial services	15.4	21.0	4.1	7.7	14.4	21.1	18.0	6.9
– other services	1.4	1.2	22.7	-7.7	1.2	1.3	5.0	12.3

The revenues from transit transport still constitute a half of the exports of services. The increase in exports of this services group ensured the largest part of the total increase in exports of services. Air and road transport constitutes the largest share in transit exports.

In January-April 2012, exports of travel and other commercial services groups have been growing at a stable pace.

Exports of services to the EU Member States constitutes about a half of the total exports of services of Latvia. In the 1st quarter of 2012, its volumes increased by 17%. Transit exports and exports of other commercial services constitute the largest share in exports of services to the EU Member States.

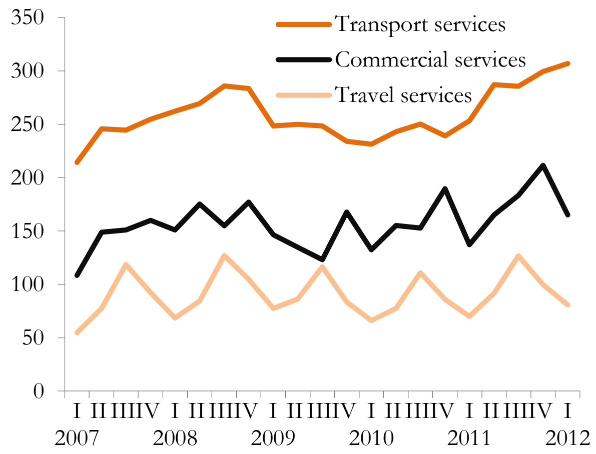
The volumes of exports of services to the CIS countries increased at similar paces as the total exports of services – by 18% in the 1st quarter of 2012. The largest contribution to this increase was on the account of revenues from tourists coming from the CIS countries, while transportation exports decreased.

In January-March 2012, exports of services to Estonia decreased slightly (by 2%), while exports to Lithuania increased only very slightly (by 0.7%).

The main services export groups to both countries are commercial services, as well as services related to transportation.

Figure 3.17

Exports of Services by Quarters
(million LVL)



3.2. Contribution of Sectors

3.2.1. Structure of the Economy and Development Tendencies of Sectors

The economic crisis affected all sectors of the economy. Trade, construction and manufacturing sectors experienced substantial decrease. Narrowing economic activities affected commercial services, while reduction of government expenditures had an impact on the output of public services.

In the mid-2009, along with resuming gradual growth in foreign trade partner countries, as well as restoring competitiveness due to reduced costs, the situation in tradable sectors and especially in the main exports sector – manufacturing – started improving. In 2009, growth had been observed also in other export-oriented sectors like agriculture, forestry, transport and storage.

Table 3.8

Structure of the Economy
(by value added, percentage)

	2000	2005	2008	2009	2010	2011
Agriculture, forestry and fishery	4.5	3.9	3.0	3.8	4.5	4.5
Manufacturing	14.4	12.9	10.8	10.9	13.4	14.1
Other industries	4.2	3.3	4.3	4.9	5.3	5.2
Construction	6.8	7.0	10.1	8.0	5.9	6.1
Trade, accommodation and catering	18.5	21.6	18.8	16.9	18.2	18.6
Transport and storage	9.5	10.5	8.1	11.1	12.1	13.0
Other commercial services	25.1	25.7	28.4	27.5	25.8	24.7
Public services	17.0	15.1	16.5	17.0	14.8	13.8
Total	**100**	**100**	**100**	**100**	**100**	**100**

The paradigm of economic growth has changed in Latvia – the economy has reoriented from domestic demand-based growth to exports. Increase in the total revenues from exports and growth of tradable sectors in the post-crisis period fosters growth of other sectors of the economy. The increasing role of tradable sectors in the economy is proven by the structure of sectors according to the value added. Before the crisis in 2007, agriculture, forestry, manufacturing and transport services sectors constituted only ¼ of the total value added, but in 2011, the share of these sectors had already reached 37% and growth of these four sectors ensured half of the total growth of the economy in 2011.

In 2011, growth was observed in practically all sectors of the economy due to the remaining stable external demand, as well as the gradually growing domestic demand.

The retaining positive tendencies in exports led to 11.7% increase in manufacturing volumes in 2011. Production volumes are increasing in almost all manufacturing sectors, particularly in wood processing, metal processing, production of electronic equipment, machinery and equipment. In total, manufacturing sectors ensured ¼ of the total economic growth in 2011. The increase in foreign trade activities in 2011 has fostered also growth of transport sector (by 8%). In 2011, output increased also in agriculture and forestry sector.

The gradual increase in domestic demand fosters growth of domestic market-oriented sectors. The volume of services provided in trade sector increased by 9.6% in 2011, and taking into account the large share of the sector in the economy, it ensured more than 1/3 of the total growth of the economy.

After the deep recession during the crisis, the construction sector resumed growth in 2011 and increased by 12.4% in a year.

However, the situation in the services sectors is improving at a moderate pace and the output volumes of both public and commercial services sectors in 2011 remained at the level of 2010.

In 2011, a decrease in production volumes was observed only in other industries (electricity, gas supply, heat supply), that is mainly based on lower volumes of produced electricity and heat energy due to weather conditions.

Increasing risks in external markets, especially in the euro zone at the beginning of 2012 did not have any particular impact on the economy of Latvia and GDP continues increasing. In the 1st quarter of 2012, production volumes increased by 16.5% in comparison with the corresponding period of the previous year. Within the same period, agriculture and forestry sector reached an increase of 2.2 percent.

Manufacturing, agriculture and forestry sectors still provide a great contribution to growth, and in the 1st quarter of 2012 these sectors constituted 1/3 of the total GDP growth.

Table 3.9

Dynamics of GDP

(in % compared to the corresponding period of the previous year, seasonally unadjusted data)

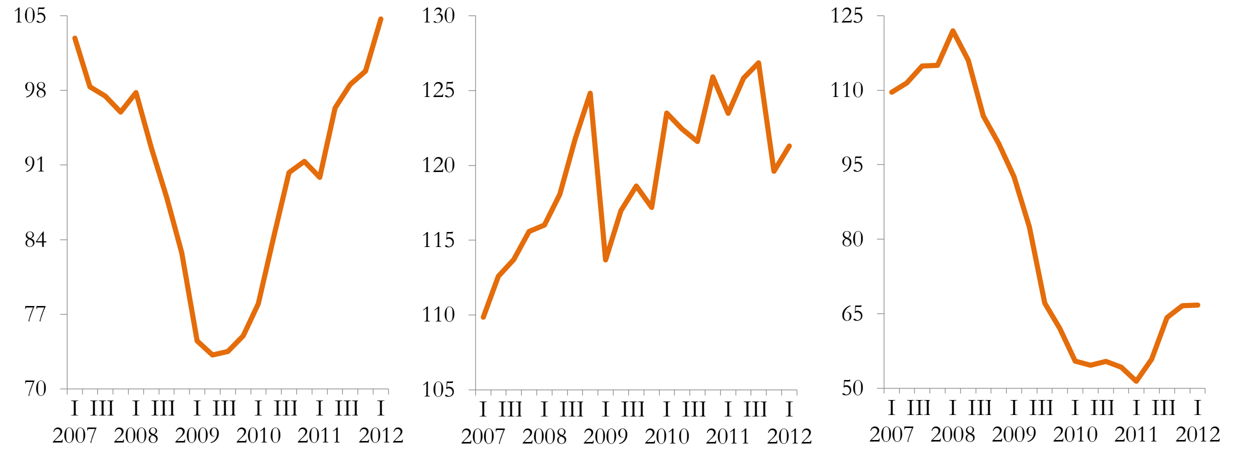
	2005-2007	2008	2009	2010	2011	2011				2012
	average annually					I	II	III	IV	I
					changes in volumes					
Agriculture, forestry	3.9	-2.2	9.1	2.0	2.8	7.4	4.3	0.6	0.0	2.2
Manufacturing	4.1	-8.6	-17.8	16.5	11.7	14.7	14.6	9.3	9.1	16.5
Other industries	3.4	6.0	-3.9	6.2	-0.2	-1.1	3.8	6.2	-6.5	-2.3
Construction	20.3	-3.5	-32.0	-23.9	12.4	-11.8	-0.9	19.6	25.9	28.5
Trade	15.7	-7.0	-25.2	3.1	9.6	10.4	8.4	10.4	9.1	8.3
Transport and storage	10.1	-0.3	1.1	5.6	8.0	7.6	8.1	9.0	7.5	4.0
Other commercial services	9.8	5.4	-14.7	-4.7	0.0	-1.5	2.4	-0.9	0.1	2.3
Public services	3.5	-0.1	-9.3	-6.4	0.6	0.6	1.0	1.6	-0.5	1.3
GDP	**10.3**	**-3.3**	**-17.7**	**-0.3**	**5.5**	**3.5**	**5.6**	**6.6**	**5.7**	**6.9**
					contribution to growth					
Agriculture, forestry	0.3	-0.1	0.3	0.1	0.1	0.2	0.2	0.0	0.0	0.1
Manufacturing	1.2	-2.1	-2.3	1.3	1.5	1.4	1.8	1.3	1.2	2.4
Other industries	0.3	0.4	-0.2	0.2	0.0	-0.1	0.1	0.2	-0.3	-0.1
Construction	3.8	-0.7	-3.6	-1.3	0.7	-0.4	0.0	1.6	1.8	1.0
Trade	7.5	-3.4	-6.5	0.4	2.0	1.7	1.7	2.4	2.0	2.0
Transport and storage	2.4	-0.1	0.1	0.5	1.1	0.9	1.1	1.2	1.0	0.7
Other commercial services	5.4	2.7	-4.5	-0.9	0.0	-0.4	0.6	-0.2	0.0	0.7
Public services	1.0	0.0	-1.3	-0.6	0.1	0.1	0.1	0.2	-0.1	0.1
GDP	**10.3**	**-3.3**	**-17.7**	**-0.3**	**5.5**	**3.5**	**5.6**	**6.6**	**5.7**	**6.9**

Since the 2nd quarter of 2011, construction volumes are growing from quarter to quarter to a great extent due to active absorption of the EU funds and in the 1st quarter of 2012 they exceeded the level of the 1st quarter of 2011 by 28.5%. Although construction volumes are increasing gradually, they have reached only half of the volumes of the pre-crisis level. It should be noted that the construction sector has been quite successful in reorienting to external markets during the crisis. In 2011, the volume of construction works performed by Latvian builders outside Latvia exceeded four times the level of 2008.

Considering the dynamics of the issued construction permits and commenced or planned investment projects, it can be concluded that overall the construction sector will grow fast also in 2012 and may exceed 10 percent.

Figure 3.18

Manufacturing changes in value added, seasonally adjusted data, 4th quarter of 2006 = 100	**Other industries** changes in value added, seasonally adjusted data, 4th quarter of 2006 = 100	**Construction** changes in value added, seasonally adjusted data, 4th quarter of 2006 = 100

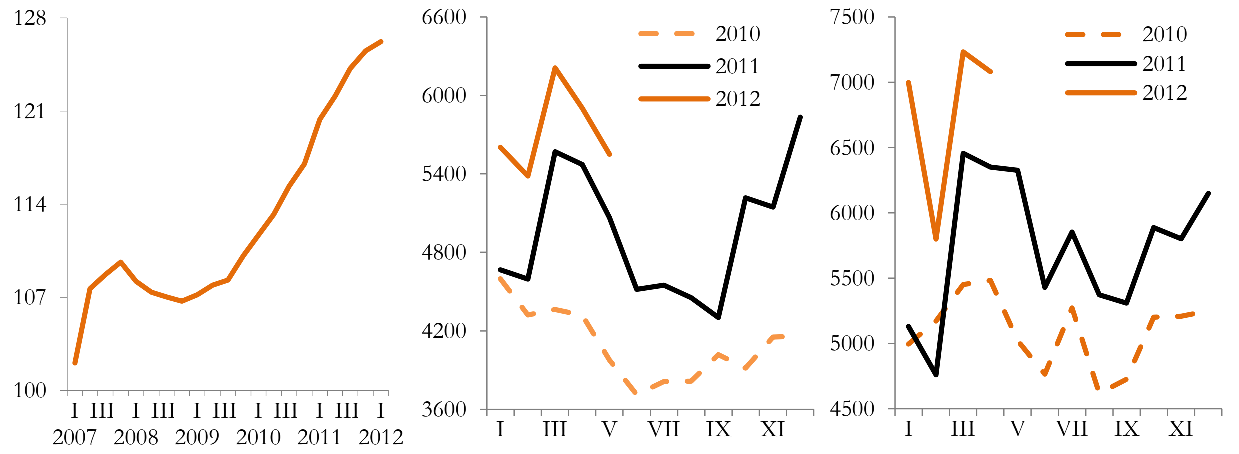


The growth remains stable also in transport and storage sector. In the 1st quarter of 2012, the sector increased by 4% in comparison with the 1st quarter of 2011 and constituted about 1/5 of the total growth of the economy. The growth of the sector is based on the substantial rise in volumes of freight. In January-May 2012, freight in railway exceeded the level of the corresponding period of 2011 by 13%. However, the volumes of the delivered and received freight in ports increased by 18% during this period. The volumes of freight by transport vehicles are increasing also in 2012.

The volumes of services provided in trade, hotels and restaurant sectors continued growing at the beginning of 2012 due to the increasing private consumption (by 8.3% in the 1st quarter of 2012 compared to the corresponding period of the previous year).

Figure 3.19

Transport and storage changes in value added, seasonally adjusted data, 4th quarter of 2006 = 100	**Freight on railroads,** Freight turnover, thousand t	**Delivered and received freight in ports,** Freight turnover, thousand t

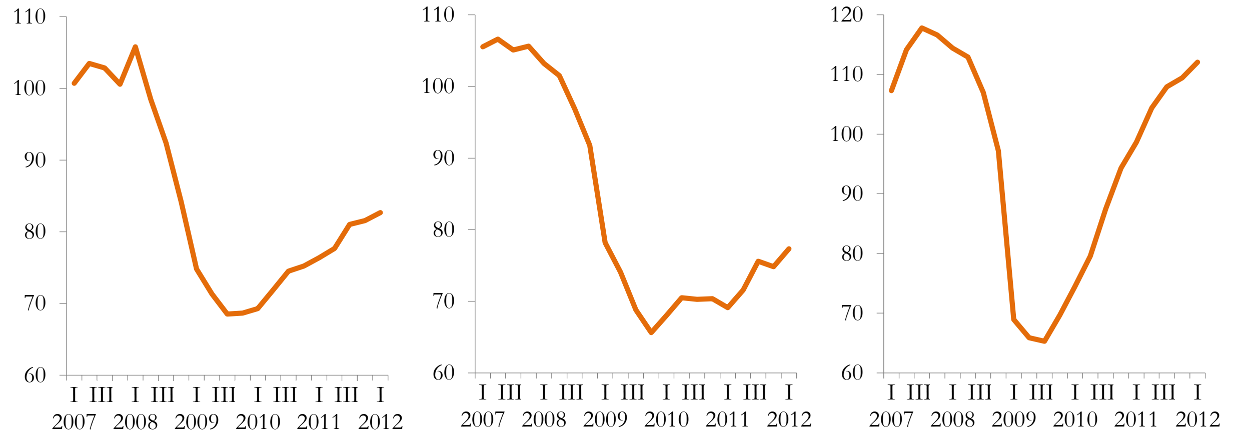


In 2012, the retail trade turnover is growing steady. In May 2012, the retail trade turnover increased by 7.4% in comparison with May 2011 and overall in the first five months of 2012 exceeded the level of the corresponding period of 2011 by 10.1% (in constant prices, unadjusted data). In May 2012, year-on-year retail trade has increased faster in non-food retail trade (by 8.6%). Food retail trade also experienced a significant increase (by 4.9%). Although retail trade volumes are likely to remain high, the highest risk is related to changes in external environment that might have a negative impact on consumer behaviour when planning purchases.

Since the mid-2009, wholesale volumes have been increasing rapidly approaching the pre-crisis level. In the 1st quarter of 2012, wholesale enterprises' turnover was by 14.8% higher than a year ago and exceeded the lowest point of the crisis in the 3rd quarter of 2009 by over 70 percent.

Figure 3.20

Trade changes in value added, seasonally adjusted data, 4th quarter of 2006 = 100	**Retail trade turnover** in constant prices, seasonally adjusted data, 4th quarter of 2006 = 100	**Wholesale turnover** in constant prices, seasonally adjusted data, 4th quarter of 2006 = 100



At the beginning of 2012, moderate growth has been observed also in other services sectors. The volumes of commercial services have increased by 2.3% in the 1st quarter of 2012 compared to the corresponding period of the previous year. However, the consolidation measures of the government expenditures affected the volumes of services provided in the public services sector, which in the 1st quarter of 2012 were only by 1.3% higher than a year ago.

Although 2012 has started on a positive note in the economy, external risks still exist in relation to further development in the euro zone.

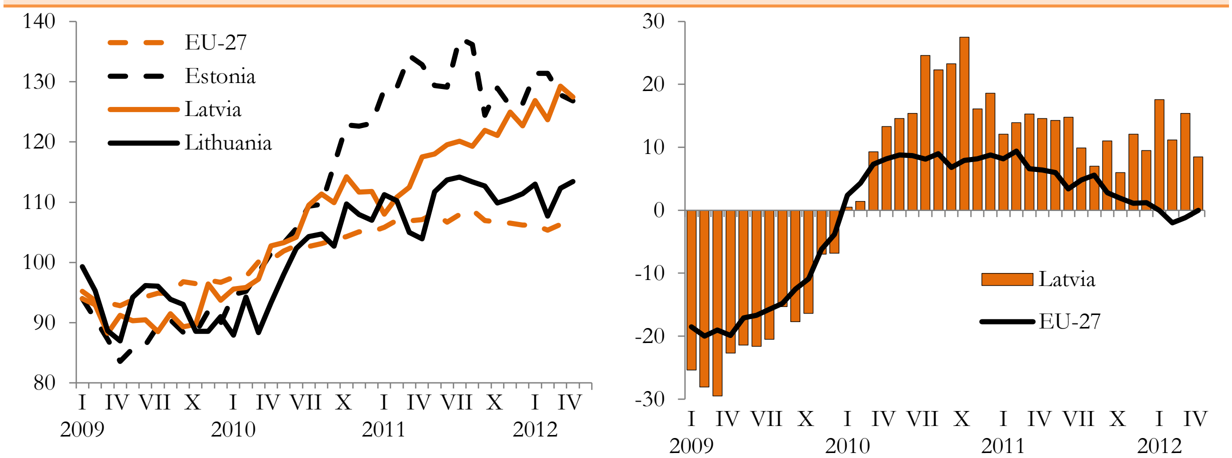
3.2.2. Manufacturing

As the domestic and external demand shrank significantly due to the crisis, production volumes of manufacturing also experienced a rapid decrease – in the 2nd quarter of 2009 production volumes of the manufacturing constituted only 70% of the level of the 1st quarter of 2007. In the second half of 2009 growth resumed in the majority of trade partner countries of Latvia, and the increase in external demand provided positive growth stimuli to the Latvian producers – production volumes have been increasing since the second half of 2009.

Figure 3.21

Manufacturing Production Volume Index

Seasonally adjusted data, December 2008 = 100	Data adjusted by the number of working days, % compared to the corresponding period of the previous year



Recovery from the consequences of the crisis in the sector is rather rapid, and not only the increase of demand in trade partner countries, but also the increase of competitiveness achieved by significant cuts in costs during the crisis plays an important role in growth of the manufacturing.

Table 3.10

Structure of Manufacturing in 2011*

percent

	By turnover	By filled number of jobs	Share of exports in the sales of the sector
Manufacturing – total	**100**	**100**	**60.6**
Food industry	24.9	22.4	30.3
Light industry	4.4	11.6	84.3
Wood processing	23.2	19.7	73.2
Paper industry and publishing	3.9	3.8	56.8
Chemical industry and related industries	7.7	6.5	75.8
Production of other non-metallic minerals	6.2	4.1	43.8
Production of metals and metal articles	14.0	10.9	70.7
Production of electrical and optical equipment	4.5	3.5	85.2
Production of machinery and equipment	2.2	2.8	84.5
Production of vehicles	3.8	3.0	88.7
Other industries	5.2	11.7	52.0

* estimation of the Ministry of Economics

In 2011, production volumes of manufacturing exceeded the level of 2010 by 11.7%. The growth of the sector was mainly based on both high external demand and a gradual increase of demand in the domestic market. In 2011, monthly average production volumes of manufacturing exceeded the level of the corresponding months of 2010 by over 10%. The production volumes increased steadily also at the end of 2011, when the EU Member States, namely the key export markets of Latvia, experienced slower growth rates.

In the first half of 2012, there is a tendency observed that a rapid rise in one month is followed by a slight decline in the following month. In March 2012 compared to February production volumes of manufacturing increased by 4.5%, while in April compared to March they have slightly dropped (by 1.4% according to the seasonally adjusted data). Overall, production volumes of Latvian manufacturing are growing and in the four months of 2012 exceeded the level of January-April of the previous year by 14.2% (according to the seasonally unadjusted data). Such an increase is even slightly faster than in 2011, when production volumes in the same period increased by 13.9 percent.

Table 3.11

Changes of Production Volumes in Manufacturing

(% compared to the corresponding period of the previous year)

	2007	2008	2009	2010	2011	2012 I-IV
Manufacturing – total	**0.3**	**-3.4**	**-20.2**	**16.5**	**11.7**	**14.2**
Food industry	1.3	-2.0	-16.1	-0.1	-0.2	1.0
Light industry	0.3	-12.2	-38.6	19.4	19.4	-4.0
Wood processing	-6.0	-12.1	1.6	33.0	12.6	9.6
Paper industry and publishing	0.2	-3.9	-17.1	19.8	-0.5	5.5
Chemical industry and related industries	3.1	-2.0	-18.5	5.2	4.4	16.1
Production of other non-metallic minerals	-17.1	-14.4	-40.1	17.6	24.2	12.6
Production of metals and metal articles	11.5	1.4	-27.1	24.2	28.3	29.6
Production of electrical and optical equipment	3.8	14.1	-34.8	33.2	29.6	15.0
Production of machinery and equipment	5.0	10.4	-35.5	17.8	37.1	9.7
Production of vehicles	10.7	5.8	-49.7	59.0	37.0	13.3
Other manufacturing industries	3.0	-5.5	-20.1	-4.9	9.5	63.0

As usual the largest sectors – metal processing and wood processing have contributed the most to the growth of manufacturing. Production volumes of both sectors in the four months of 2012 have increased by 30% and 9.6%, respectively, in comparison with January-April 2011. Production volumes of chemical substances and chemical products have increased by almost 40% in the same period. Production volumes continue growing also in production of electric and optical equipment, as well as production of non-metallic minerals.

At the same time, production volumes of textile articles and clothing, as well as paper industry and publishing are growing at a slower pace. While production volumes of food industry and pharmacy in the four months have remained at the level of the corresponding period of the previous year.

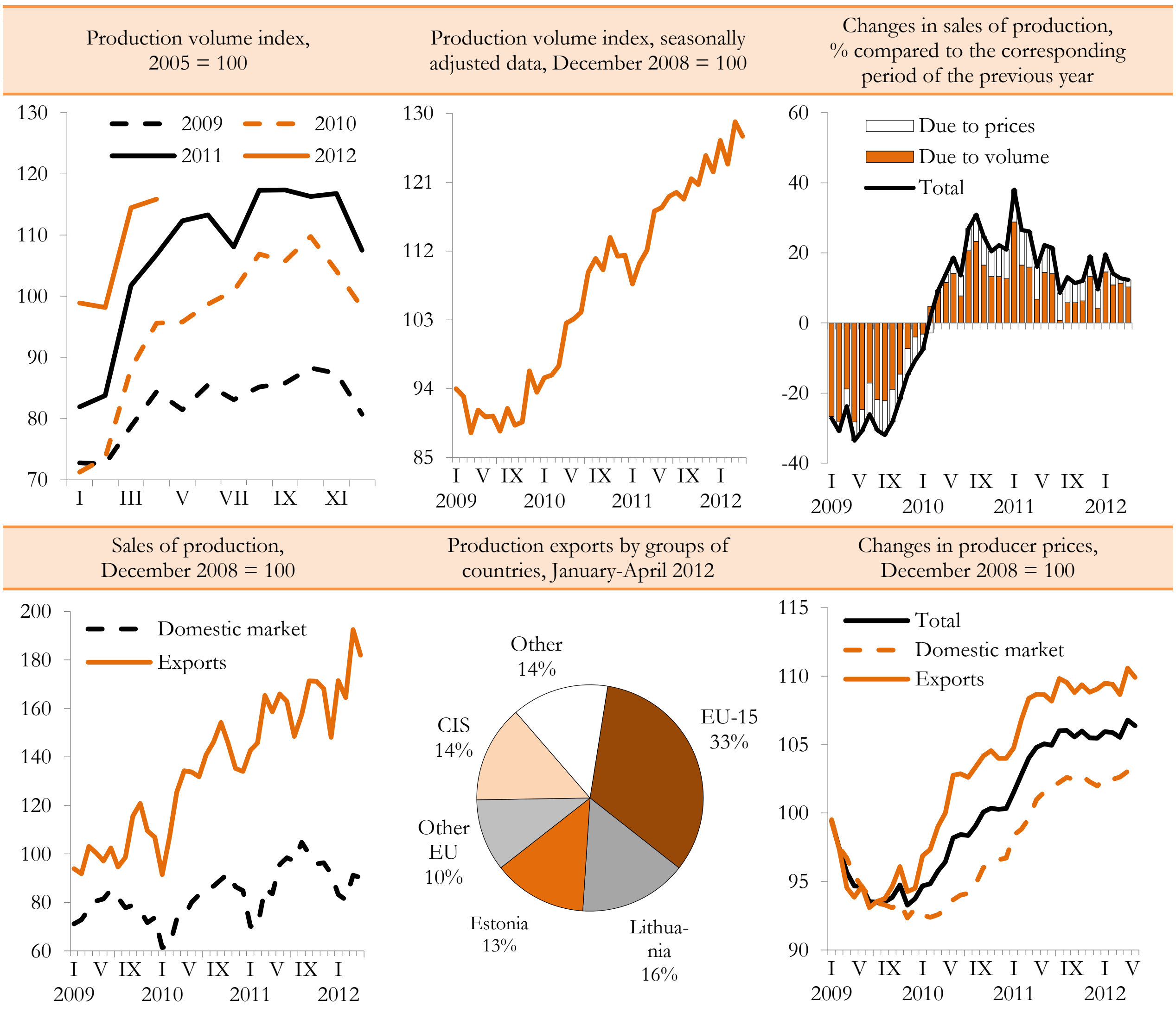
In 2011, turnover of manufacturing production increased steadily (by 17.8%) determined not only by the increase in production volumes, but also by the rise in producer prices. Wood processing, metal processing, production of electric and optical equipment, as well as machine building industries have contributed the most to the increase in manufacturing turnover in 2011.

In January-April 2012, turnover of manufacturing production has increased by 14.5%, including exported production by 16% and production sold in domestic market by 11.9% in comparison with the corresponding period of the previous year. It means that the demand for Latvian manufacturing products is still high, especially in external markets.

The increase in turnover of manufacturing production in 2012 was based to a greater extent on an increase in the production volumes, while the price effect has decreased as producer prices for both exported production and production sold in domestic market have increased at a very moderate pace during a year.

Figure 3.22

Indicators Characterising Manufacturing



Over 60% of the total production of the sector is being exported. About ¾ of the total exported production are sold in the EU markets. 14% are sold in Lithuania and Estonia, while exports to the CIS countries constitute 16 percent.

In four months of 2012 compared to January-April 2011, exports turnover increased most rapidly for production of chemical industry, production of electrical equipment, as well as metal processing. Turnover of production sold in the domestic market this year is increasing rapidly for production of rubber and plastic articles, non-metallic minerals, as well as wood processing.

As a large part of manufacturing production is sold in export markets, producer prices have a bigger impact on tendencies in external markets. Since the second part of 2011 Latvian producer prices for exported production have increased at a moderate pace due to the weakening total demand in the EU countries (by 1.1% in May 2012 compared to May 2011). The weak demand in external markets affects global price tendencies – prices for food, metals, etc. have been decreasing over the past few months.

Although the demand in the domestic market is gradually growing, it is still rather low and has no particular pressure on producer prices. Producer prices for production sold in the domestic market have increased by 1.4% during a year. It should be noted that in May producer prices for production of non-metallic mineral articles were by 7.5% higher than in May 2011, which is to a great extent related to the recovery of construction sector from the crisis and to a gradual increase in demand. Furthermore, a rather rapid increase has been observed in producer prices for production of electrical equipment (by 8.4%) and publishing (by 8.9%) during a year. In the same period, producer prices for production sold in the domestic market have shrunk in beverage production, wood processing, production of clothing, as well as metal production.

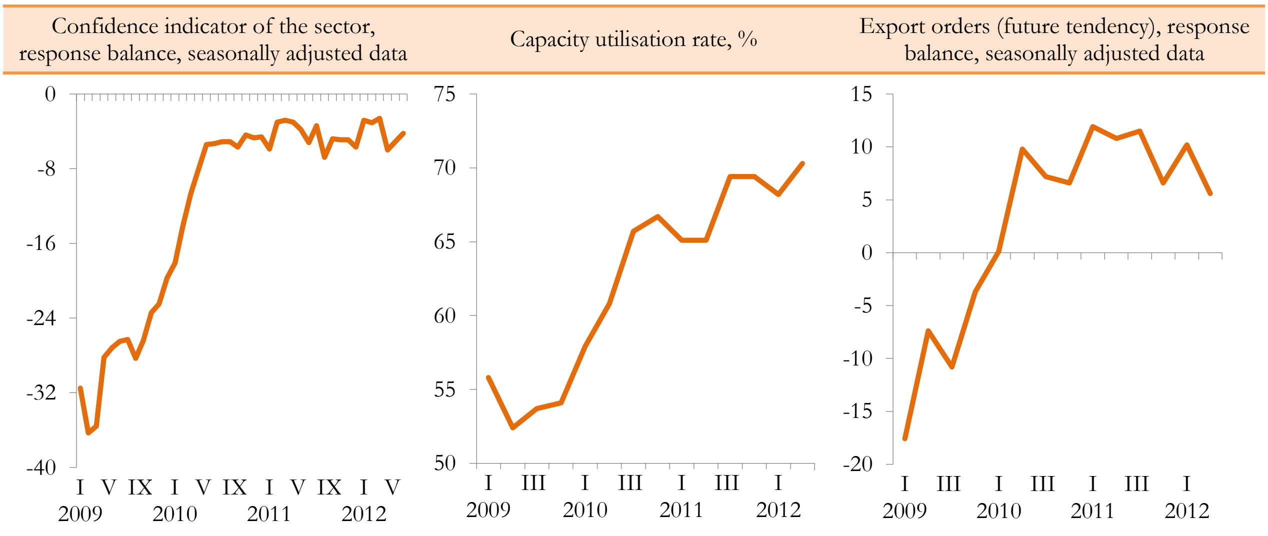
In the 1st quarter of 2012, volumes of new orders remained stable in such sectors as light industry, production of vehicles and machinery. Volumes of new orders are increasing not only in export markets, but also in domestic market.

The load of production capacity keeps increasing in line with the increase of production volumes. In the 2nd quarter of 2012, the level of the load of production capacity was 70.3% exceeding the level of the 2nd quarter of 2011 by 5.2 percentage points. It should be noted that the load of production capacity in some sectors, for example, wood processing (82.6%) has already reached the highest indicators ever.

The results of conjuncture surveys of Latvian manufacturing enterprises show that in general evaluation of entrepreneurs regarding further growth possibilities is not changing. However, at the same time entrepreneurs are more optimistic about export development possibilities. The overall confidence indicator of manufacturing in June 2012 was -4.2 points, yet, it is by 1 point better than the indicator in June 2011. Overall, manufacturing confidence is affected by uncertainty about development perspectives of the main trade partner countries.

Figure 3.23

Development Trends of Manufacturing



The food industry is the largest manufacturing industry by both turnover and the number of employed. The sector is mainly oriented towards the domestic market where slightly more than 70% of all production is sold. Therefore along with the decreasing domestic demand during the crisis, production volumes of the sector decreased rapidly, and the sector recovery is slow. During the crisis production volumes of food and beverages decreased by a fifth and that was slower than average in the manufacturing.

However, the recovery of the food industry is rather slow due to moderate increase of demand in domestic market. In 2010 and 2011, production volumes remained at the level of 2009. The situation is not significantly improving in 2012 – in four months output of the food industry exceeded the level of January-April 2011 just by 1 percent.

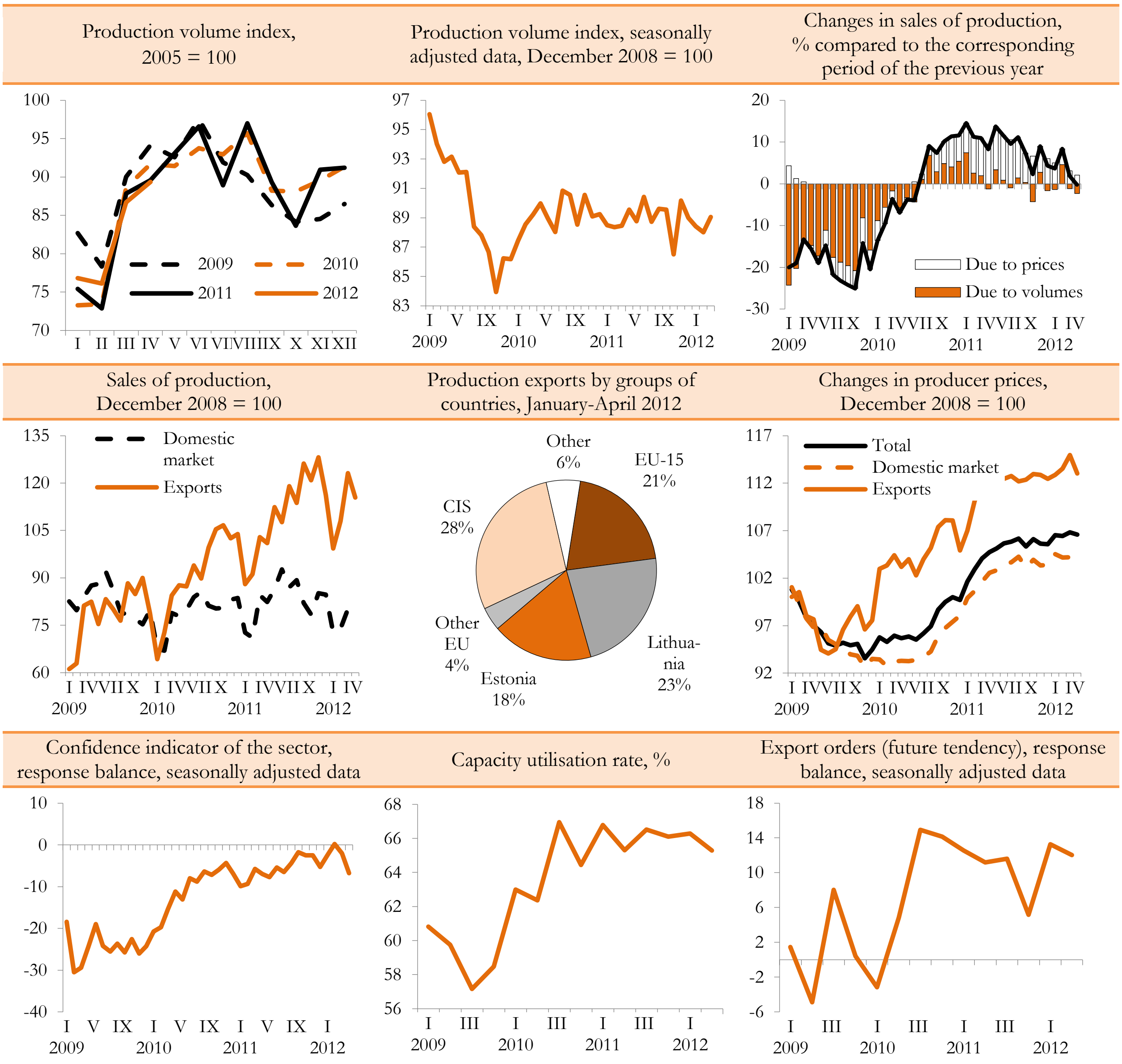
Despite the low production volumes, the turnover of food industry has increased considerably. In 2011, it increased by 9.3%, the rise in production sold in export markets (by 21%) contributed the most to the increase in turnover, while revenues from sales in the domestic market increased by 5 percent.

The increase in industry turnover in 2010-2011 was mainly determined by the rise in producer prices due to the rise in food prices worldwide. In 2011, the producer prices in food industry were by 5.9% higher than a year ago.

In 2012, food prices in the world are decreasing and producer prices in the industry are not increasing significantly and in April 2012 they were only by 1.8% higher than in April 2011. Therefore, also the total turnover of the industry has become moderate. In the four months of 2012, turnover exceeded the level of January-April 2011 only by 3.2 percent.

Figure 3.24

Indicators Characterising Food Industry



The sector of **light industry** is mainly oriented to exports, therefore, production volumes of the sector significantly narrowed when external demand decreased. A particularly rapid decline in production volumes was observed at the end of 2008 and at the beginning of 2009. Overall, production volumes of the sector have decreased by almost a half during these years.

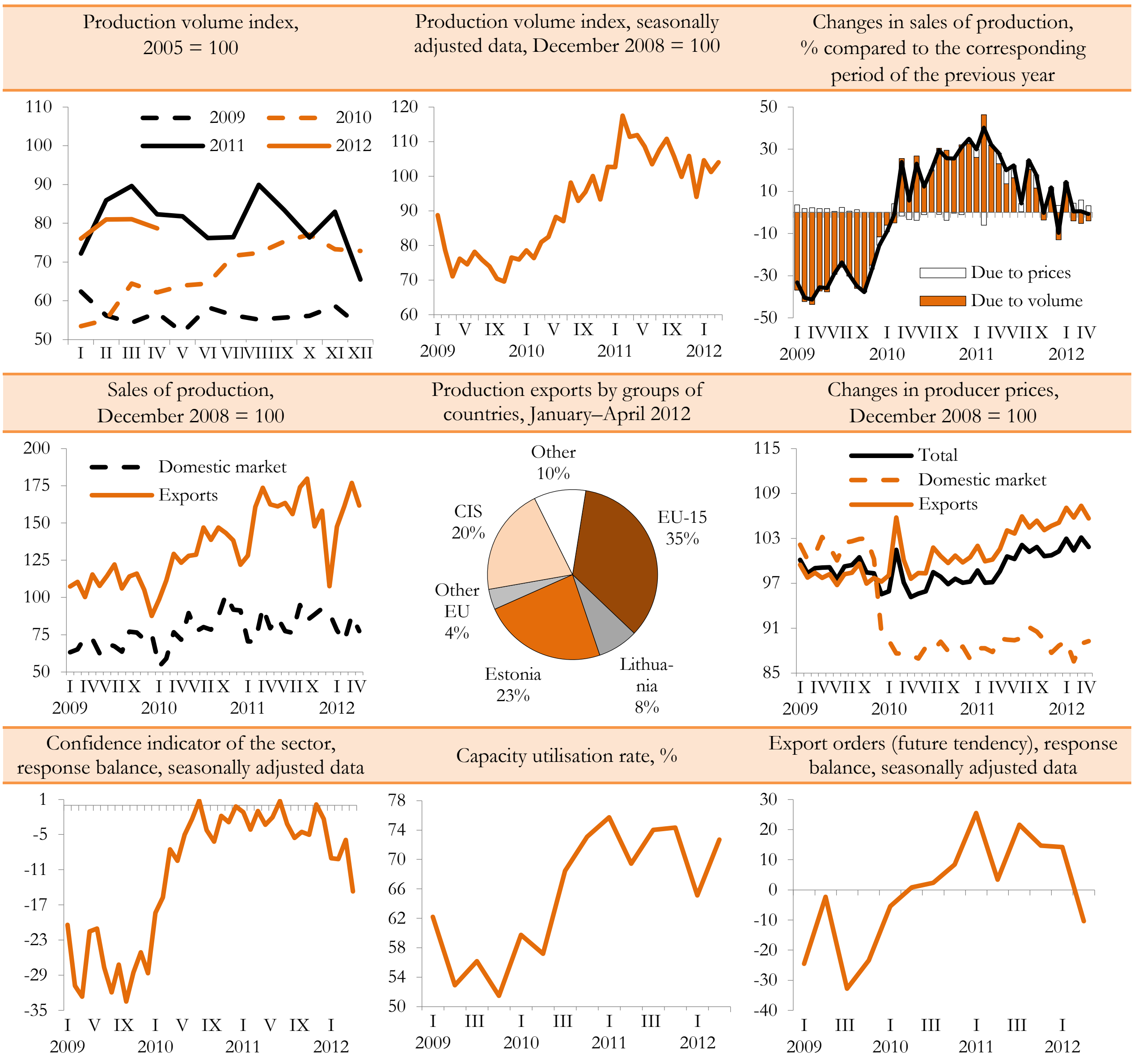
The light industry was recovering quite rapidly since the end of 2009 due to resuming external demand by being able to enter new market niches (increase in 2010 and 2011 by almost 20%). However, output volumes of the industry have been shrinking since the mid-2011 due to the deteriorating economic situation in the main sales markets and in four months of 2012 they were by 4% lower than in the corresponding period of the previous year. The decline in production volumes is to a great extent determined by the decrease in production volumes of clothing (by 9%), while production volumes of textiles have increased by 6.5 percent.

In 2011, the turnover of the sector increased by 17.5%, including sales revenues from exported production – by 20%. Yet, the turnover dynamics is quite moderate in 2012 due to dropping production volumes. In four months of 2012, the turnover is by 3.5% higher than in January-April 2011. The increase is still ensured by exports – sales revenues from exports have increased by 16.4% during this period, while sales volumes in domestic market have shrunk by 2 percent.

Total dynamics of producer prices in the sector depend on the changes in producer prices for exported production which were by 4% higher in April 2012 than they were a year ago. Yet, producer prices for production sold in the domestic market have remained the same since the end of 2009 and still considerably lag behind the pre-crisis level.

Figure 3.25

Indicators Characterising Light Industry



Wood processing is one of the largest manufacturing sectors, and it plays an important role in the economy of Latvia. Overall, the sector constitutes ¼ of the total exports and ensures 1/5 of all jobs in manufacturing. Wood processing is one of the first sectors that resumed growing after the huge decrease in manufacturing and in 2010, the output of the sector already exceeded the pre-crisis level.

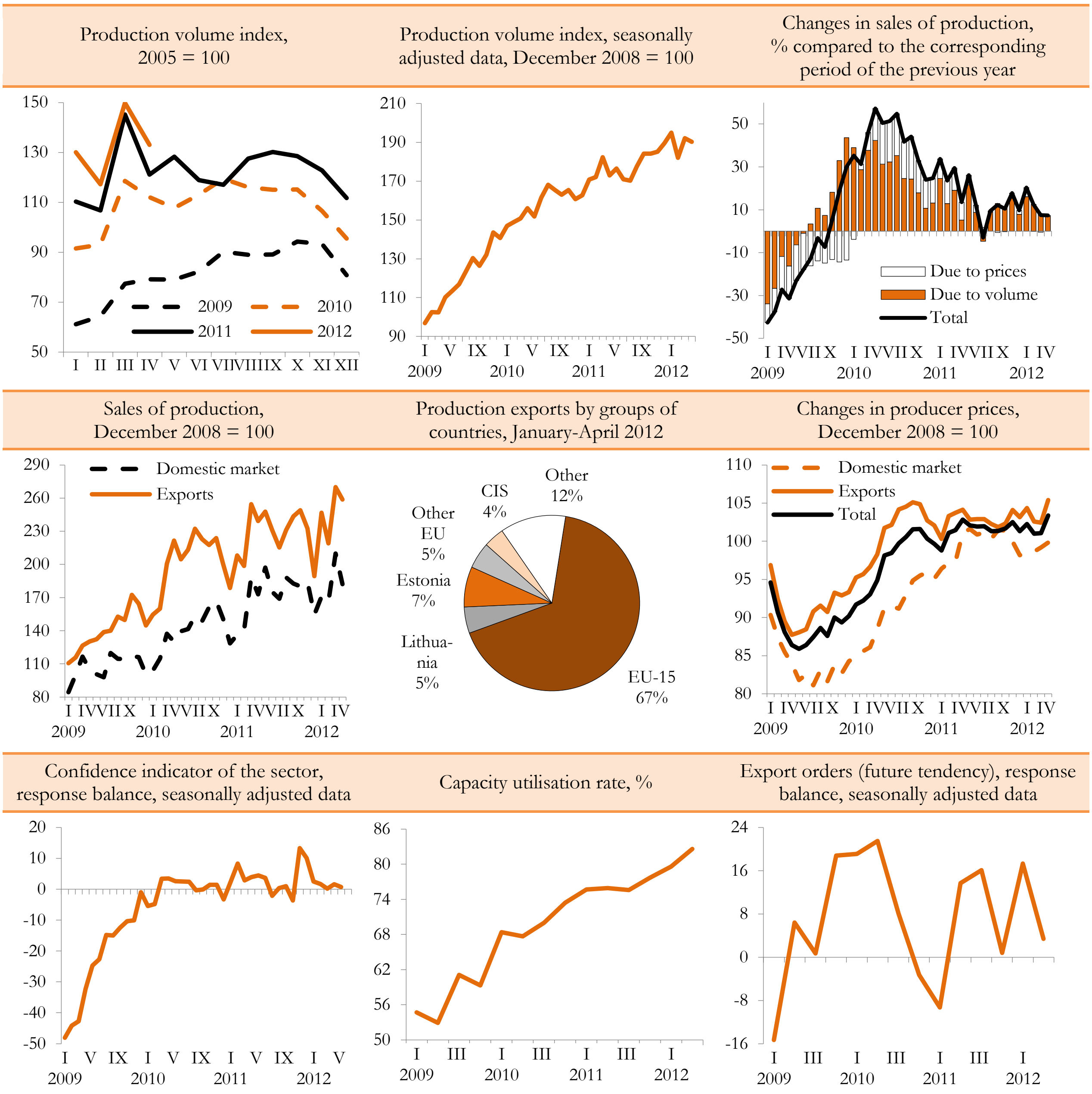
Production volumes of the sector continue increasing. In 2011, output increased by 12.6%, while in four months of 2012 – by 9.6%. At the same time, it should be noted that in the 2nd quarter of 2012 the load of production capacity of the sector has reached the highest level ever (83%), and that is the highest indicator among other manufacturing sectors.

The sales revenues of the sector are also growing steadily mainly due to the expanding export possibilities. About 75% of the total production in the sector is being exported and ¼ of wood and timber product exports is considered to be exports of high or medium high value added goods – veneer and plywood, cellular wood panels, etc.). Sales volumes of exported products in 2011 increased by 13% but in January-April 2012 – by 10% in comparison with the corresponding period of the previous year. The demand for wood production is increasing also in the domestic market – in 2011, the turnover increased by 23%, while in January-April 2012 – by 14 percent.

After a significant rise in prices in 2010, the producer prices have become stable. In April 2012, producer prices exceeded the level of April 2011 only by 0.5 percent.

Figure 3.26

Indicators Characterising Wood Processing



The paper production and publishing industry constitute on average 4% of the total turnover of manufacturing and of the number of employed. In the pre-crisis period, the sector was mainly oriented towards the domestic market. Approximately 40% of the total production was exported. After the crisis the growth of the sector is mainly related to export possibilities and currently about 60% of all production are being exported. The key export markets of the sector are Lithuania and Estonia.

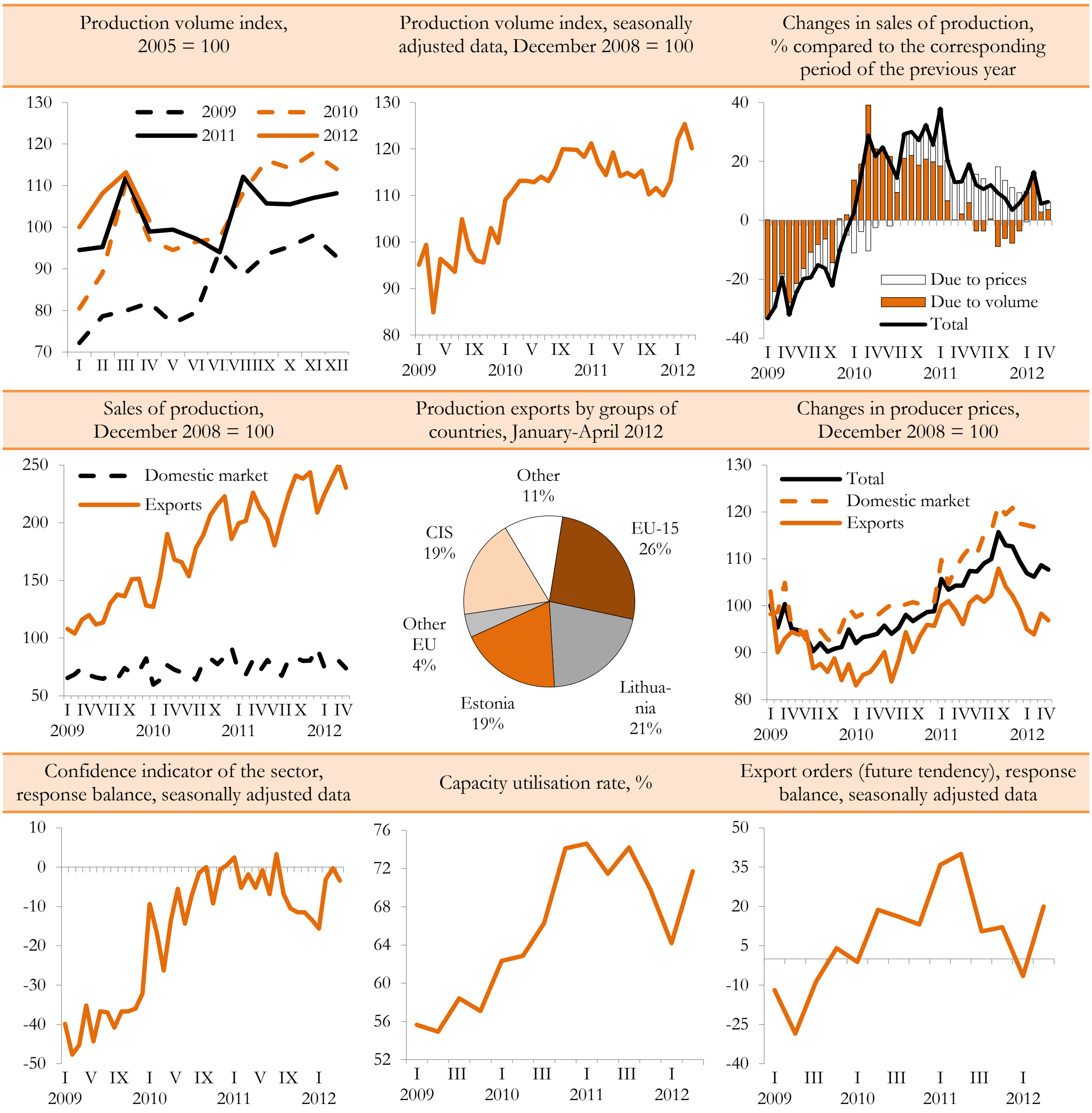
Development of the paper industry and publishing has been uneven over the past years. After a rapid increase in production volumes in 2010, the output shrank by 0.5% in 2011. Yet, in four months of 2012, production volumes are by 5.5% higher than in the corresponding period of the previous year.

Despite the decreasing production volumes in 2011, the rising producer prices determined an increase in sales revenues of the sector. In 2011, the turnover of the sector increased by 12.7% – sales revenues from exports increased by 20%, while in the domestic market – by 5%. In January-April 2012 – by 9% and the increase in revenues from exports constitutes the largest contribution.

Producer prices of the sector in 2011 increased by almost 11%. Moreover, despite the weak domestic demand, prices for production sold in domestic market grew faster than those for exported production. In 2012, the dynamics of producer prices are moderate and in April 2012 producer prices were by 3.2% higher than a year ago.

Figure 3.27

Indicators Characterising Paper Production and Publishing Industry



The ***chemical industry*** includes production of chemical substances and chemical products, production of basic pharmaceutical products and pharmaceutical preparations, as well as production of rubber and plastic articles.

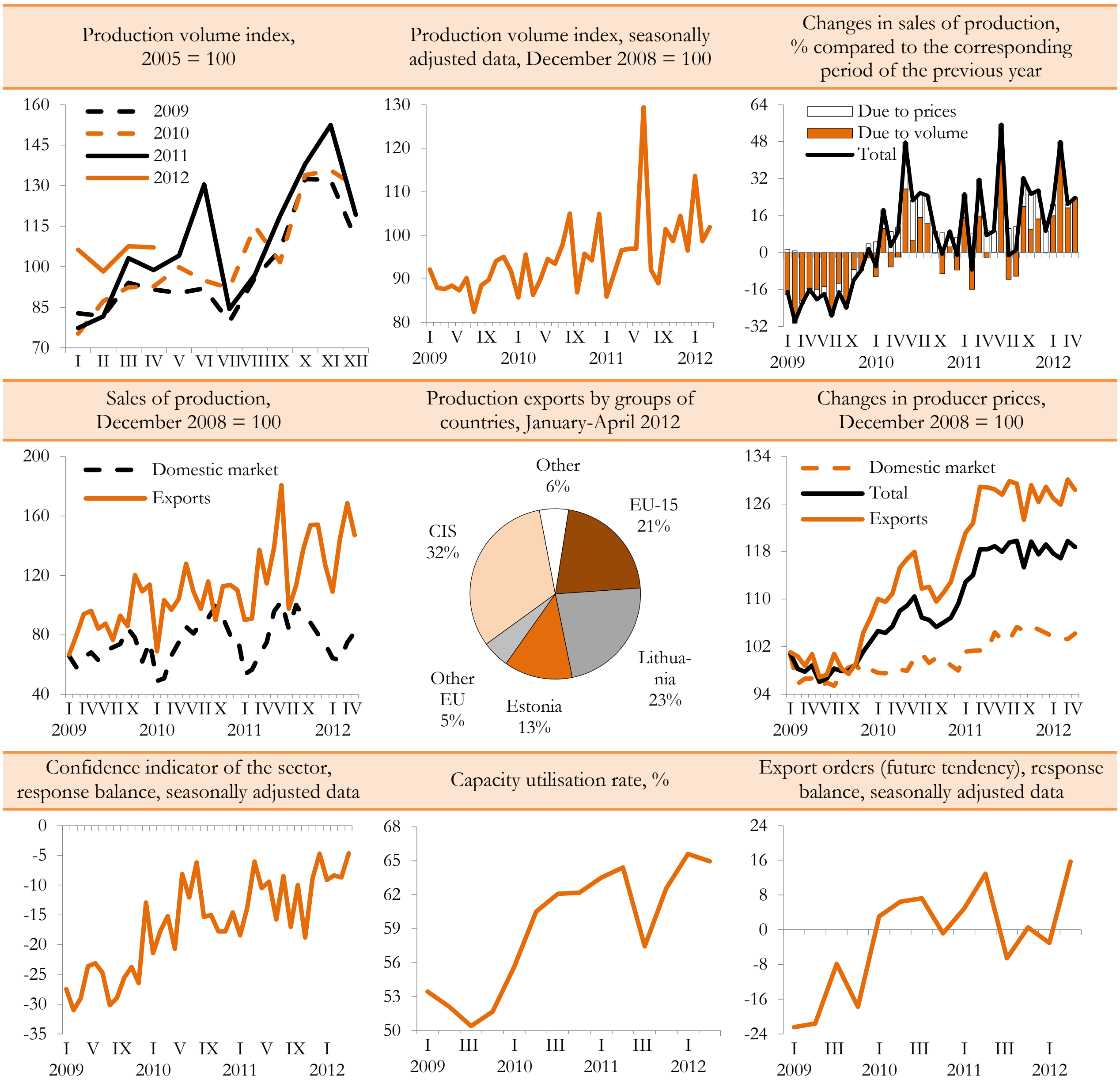
During the crisis production volumes of the chemical industry have decreased by one fifth. The sector is recovering from the crisis very unevenly and development tendencies differ among the chemical industry subsectors. In 2011, the output increased in pharmacy (by 12%), as well as in production of rubber articles (by 2%), while volumes of production of chemical substances shrank by 3%. Yet, in January-April 2012, production volumes of pharmacy sector practically have not increased in comparison with the corresponding period of the previous year, while production of rubber articles continue increasing at a moderate pace and production volumes of chemical substances have increased by 37 percent.

Due to the increase in sales of exported production, the total turnover of the sector continues growing. In 2011, the turnover of chemical industry increased by 18% (exports – by 23%, in domestic market – by 3%). Similar tendencies remain also in 2012. In four months 2012, the turnover has increased by 27% in comparison with January-April 2011. The turnover of exported production has increased by 31% within the same period.

A rapid increase in producer prices was observed in 2010 and 2011. Besides, it should be taken into account that producer prices decreased at a moderate pace during the economic recession. Like in other sectors, the producer prices have stopped growing since the mid-2011 and in April 2012 prices were by 0.3% higher than in April 2011.

Figure 3.28

Indicators Characterising Chemical Industry



The sector of **production of other non-metallic minerals** during the pre-crisis period was mainly oriented towards the domestic market and growth rates of the sector were mainly based on the high demand for construction materials. Therefore, during the economic crisis, when construction volumes significantly decreased, the production of non-metallic minerals decreased considerably – in 2009, the production output of the sector shrank by almost a half in comparison with 2007.

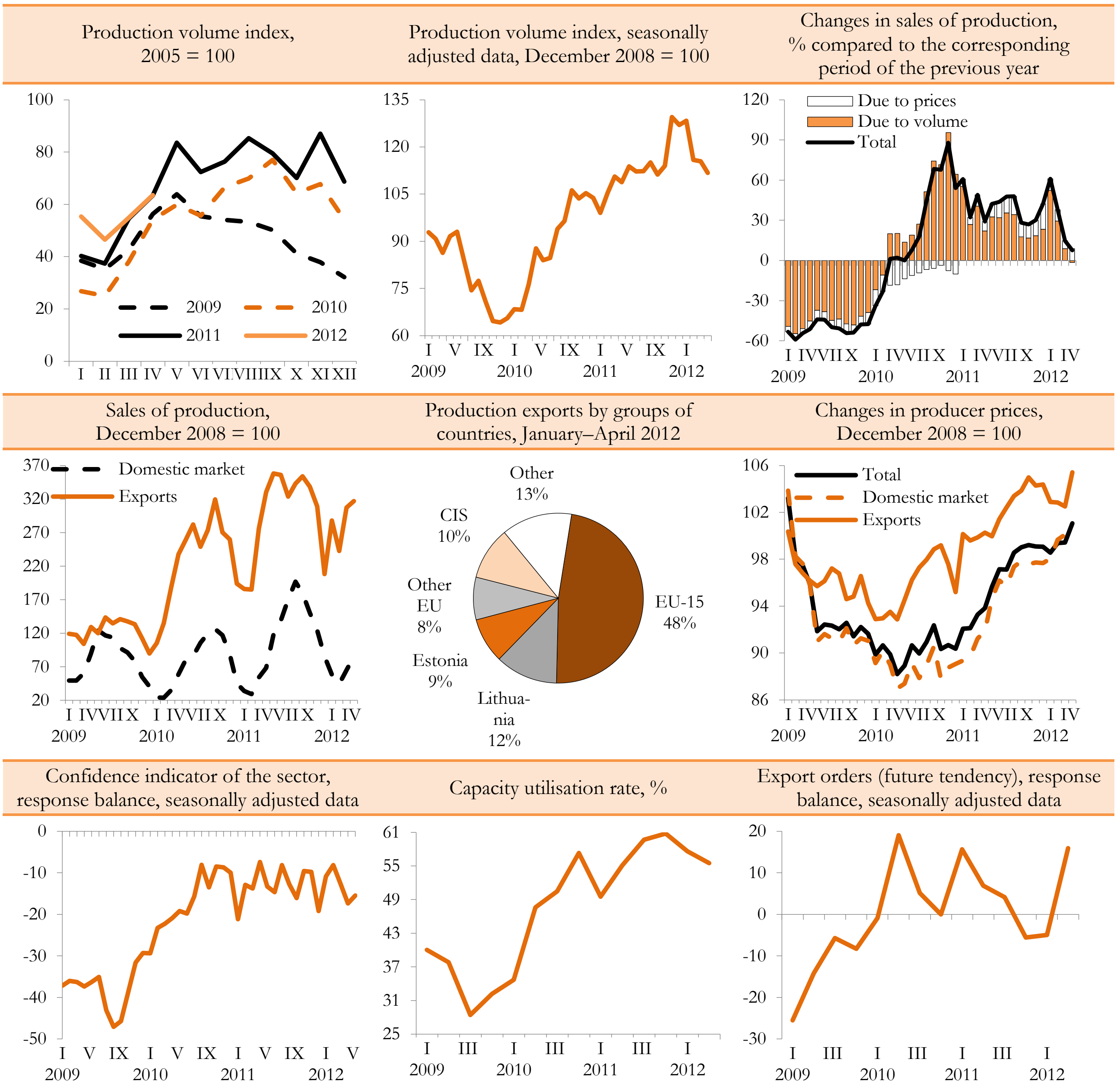
Production volumes have been increasing since 2010 and in 2011 were by 20% higher than in 2009. The recovery of the sector after the crisis is mainly related to the ability to focus on foreign markets – mainly to the old EU Member States and gradual resuming activities in the domestic market. In 2012, production volumes continue increasing – in four months, the volumes have increased by 13% in comparison with the corresponding period of the previous year.

The turnover of the sectors has been growing rapidly over the past few years. The increase in sales revenues from exports has contributed greatly to the turnover – in 2011 the revenues were one and a half times higher than in 2009. In 2012, the share of exported production has reached almost 60% of the total turnover of the sector. As the economic situation gradually improved, the turnover in the domestic market has significantly increased (in 2011 – by almost 50% and in four months of 2012 – by over 36%).

After the huge drop in producer prices during the crisis, they resumed increasing in the mid-2010. In April 2012, producer prices increased by 7.7%, including prices for production sold in the domestic market – by 9.5%, but for exported production – by 5 percent.

Figure 3.29

Indicators Characterising Production of Other Non-Metallic Minerals



Production of metals and metal articles is the third largest manufacturing industry by turnover. Since on average 70% of production is sold in external markets, the dynamics of the sector is closely related to the global economic development tendencies.

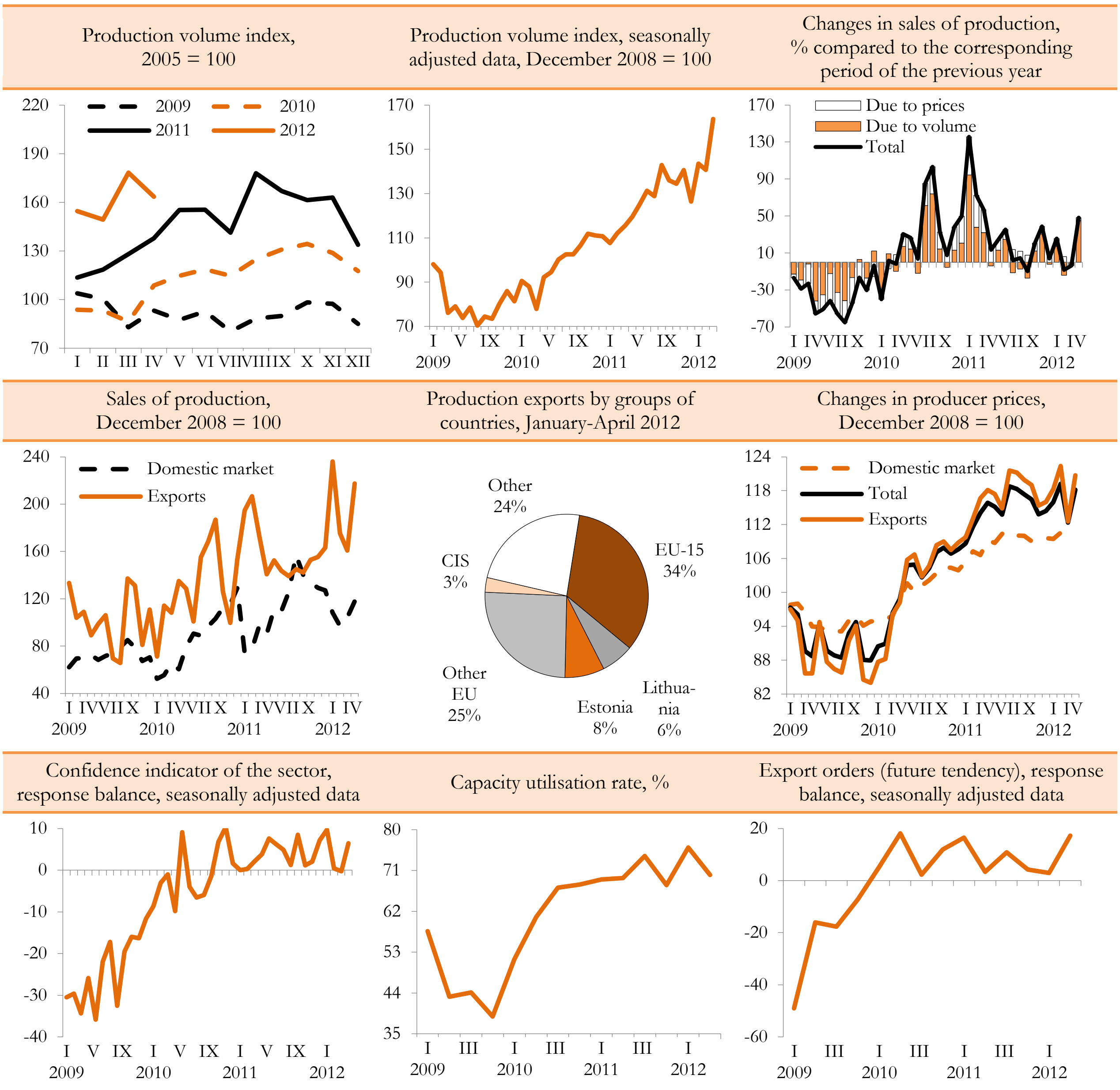
As the economic situation in the main trade partner countries stabilised, production volumes of the metal processing sector have been increasing since the mid-2009. In 2011, production output volumes increased by 28% and a rapid growth of the sectors is observed also in 2012. Production volumes have increased by almost by 30% in four months of 2012 compared to January-April 2011. Overall, the metal and metal articles production sector provides one of the greatest contributions to the total growth of manufacturing industry in the post-crisis period.

The turnover of the sector has been increasing significantly since 2010 determined by both the increase in production volumes and the rise in producer prices. It should be noted that not only the turnover of exported production has increased within this period (in 2011 – by 54% compared to 2009), but also the turnover of the production sold in the domestic market (by 55%). Also in 2012, the turnover of the sectors is growing and in four months of 2012 exceeded the level of the corresponding period of 2011 by 14 percent.

The world prices for metal resumed growing at the beginning of 2010 and slowed down only at the end of 2011. It is reflected also in the dynamics of producer prices for production sold in the domestic market and exported production. In 2011, producer prices increased by 6.3%, while in April 2012 producer prices were by 2% higher than a year ago.

Figure 3.30

Indicators Characterising Production of Metals and Metal Articles



Production of electrical and optical equipment is developing rather successfully after the decrease in production volumes during the economic crisis. Overall, the sector exports almost 85% of production.

Production volumes have been growing since the mid-2009 along with the increasing external demand. In 2011, the output of the sector exceeded the level of 2009 by over 70%. Increase in production volumes of electronic equipment has contributed the most to the growth of the sector, but the production volumes of computer, electronic and optical equipment are increasing at a slightly slower pace.

The output volumes are increasing quite rapidly also in 2012 – in the four months they exceeded the level of the corresponding period of 2011 by 15 percent.

The turnover of the sector is increasing in line with the increase in production volumes. Sales revenues from exported production in 2011 increased by 30%, while revenues from sales in the domestic market – by 23 percent.

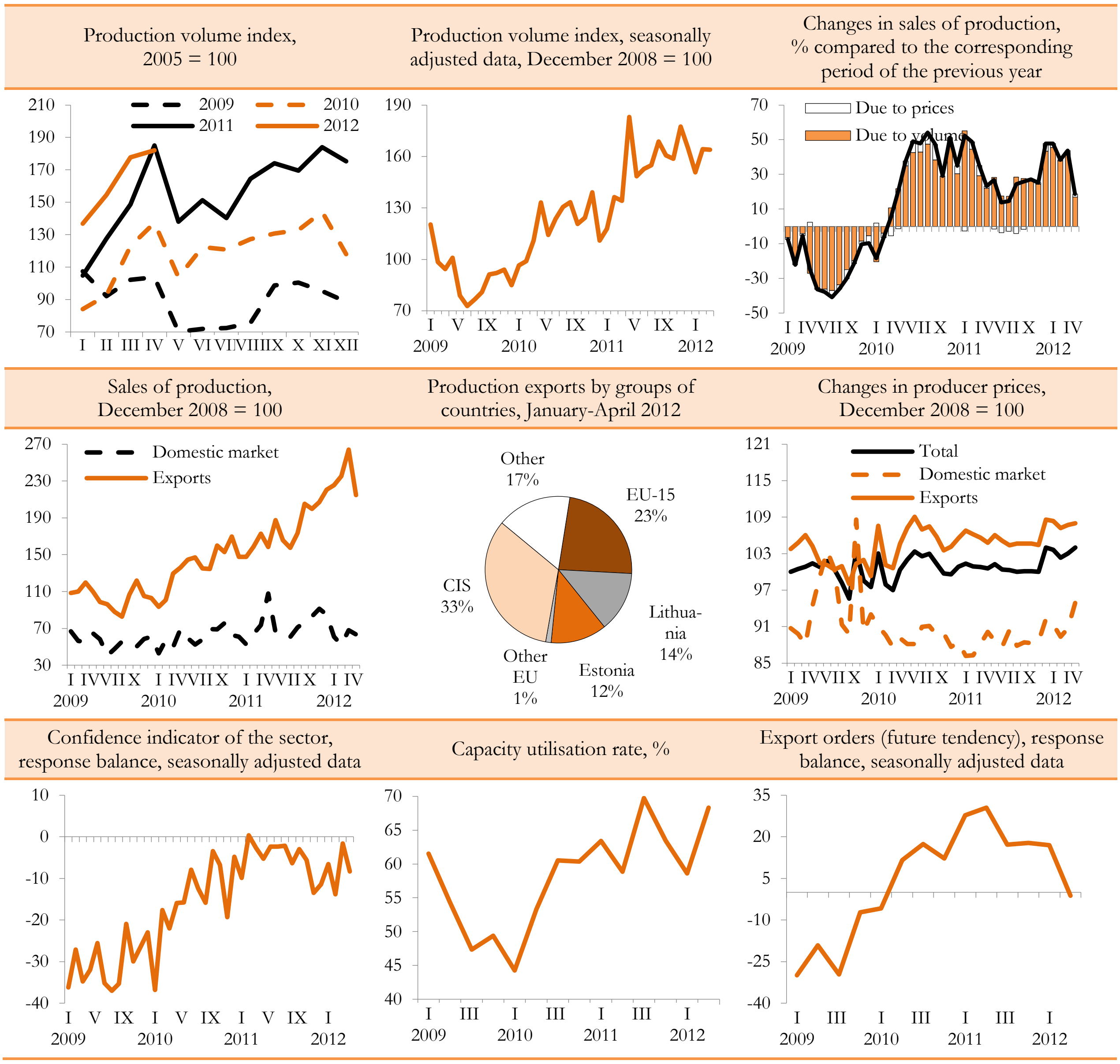
In 2012, the turnover of the electrical and optical equipment production sector continued increasing, particularly for exported production. Revenues from exported production in four months of 2012 have increased by almost 50% in comparison with the corresponding period of 2011.

Taking into account the rapid growth of the sector over the past few years, the load of production capacity has increased significantly reaching 70 percent.

After substantial fluctuations during the crisis, the producer prices have been stabilising since the beginning of 2010 and the rise in prices is moderate. In April 2012, the producer prices have increased by 3.4% in general within a year, including the increase in producer prices for production sold in the domestic market by 5.4 percent.

Figure 3.31

Indicators Characterising Production of Electrical and Optical Equipment



The sector of ***production of machinery and equipment*** is the supplier of production means and technologies to other sectors. Over 85% of all production of the sector is sold in foreign markets – mainly to Estonia and Lithuania. As a result of the economic recession, the turnover of the sector has equally rapidly shrunk both for exported production and for the production sold in the domestic market. The situation in the sector has been gradually improving since the end of 2009.

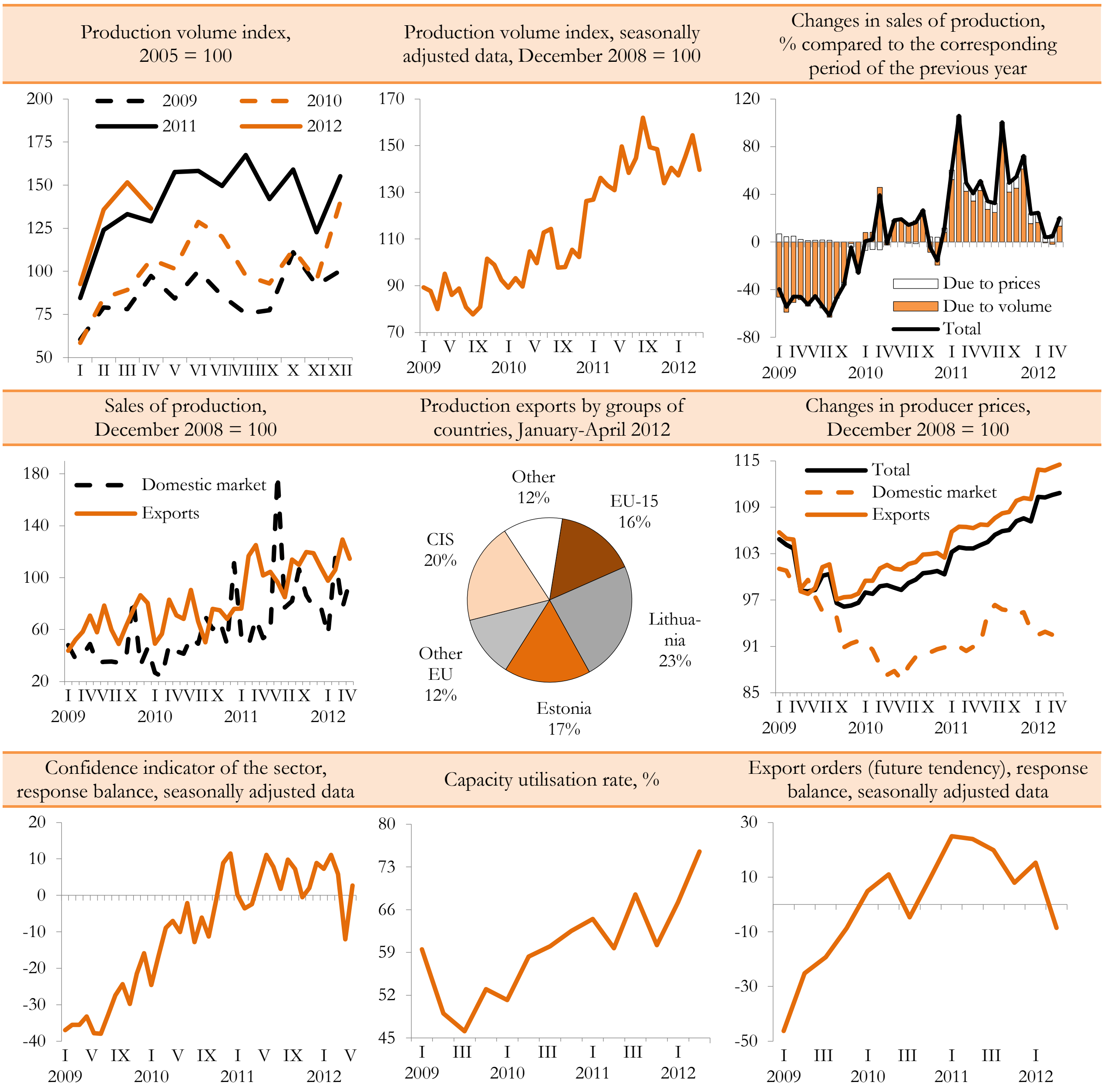
The production output of machinery and equipment in 2011 increased by 18% and already exceeded the pre-crisis level. In 2011, a considerable increase in turnover was observed in the sector – the turnover of both exported production and production sold in the domestic market exceeded the level of 2010 by more than 50 percent.

At the end of 2011 and the beginning of 2012, the growth of the sector was negatively affected by the deteriorating situation in certain trade partner countries. Despite that, the increase in production volumes reached almost 10% in four months of 2012 in comparison with January–April 2011. Yet, the turnover increased by 12% within the same period, including for production sold in the domestic market – by over 50 percent.

Since the end of 2009, when the demand in global markets increased, producer prices for exported production have been growing. In April 2012, producer prices for exported production were by 7.7% higher than a year ago. While producer prices for production sold in the domestic market have increased at a moderate pace – in April 2012, they were only by 1.4% higher than a year ago.

Figure 3.32

Indicators Characterising Production of Machinery and Equipment



Production of transport vehicles is characterised by marked fluctuations of production volumes closely related to changes in new orders. As approximately 90% of production is exported, fluctuations of external demand have a significant impact on development of the sector. Almost ¾ of all exported production is sold in the EU market. The output volumes of the sector have been increasing since 2010.

The volumes of new orders in the domestic market and external markets increased rapidly in the second half of 2010 and in 2011. As a result, the output of the sector in 2011 exceeded the level of 2011 two times.

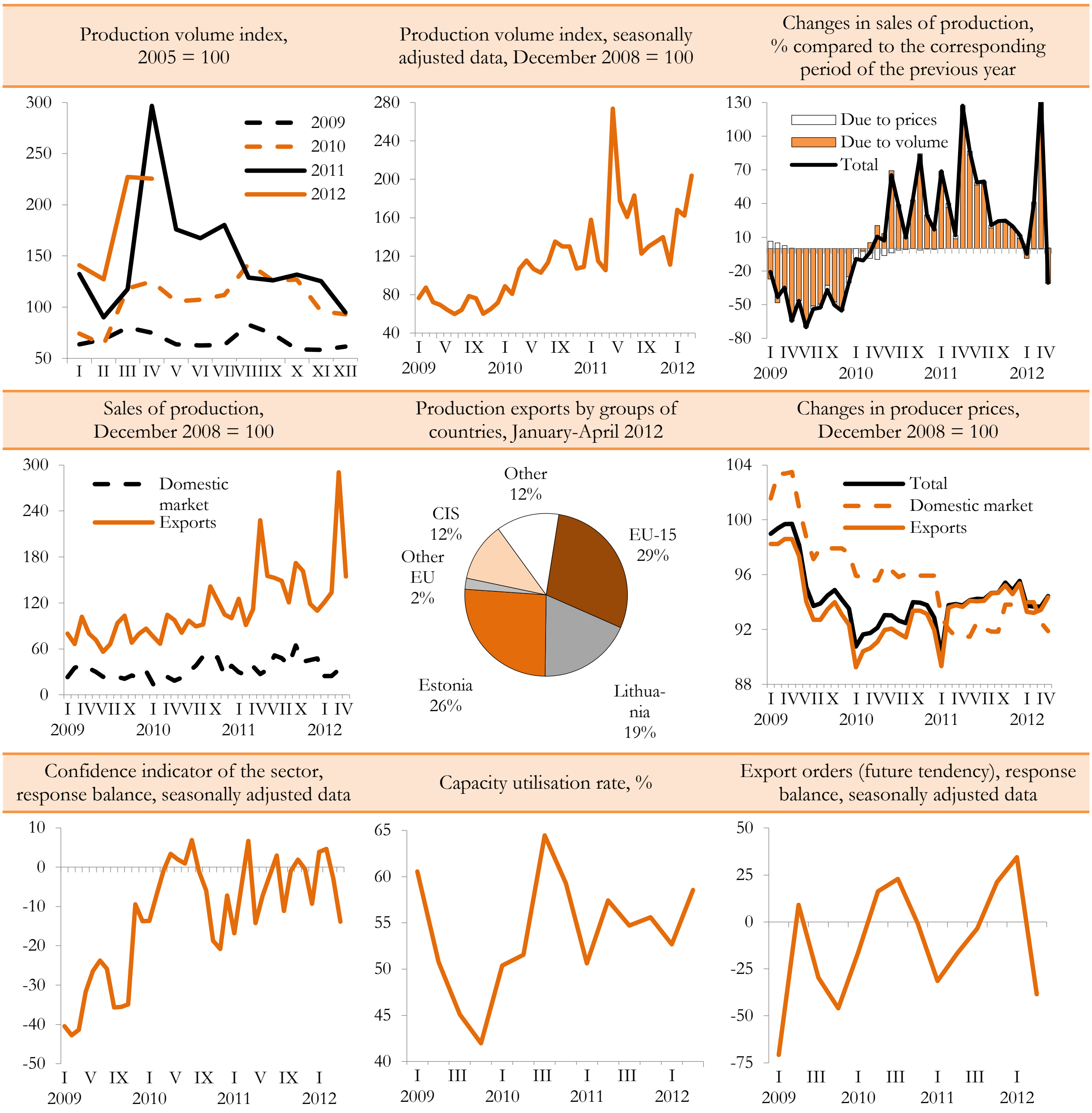
The turnover of the sector has increased in line with the increase in production volumes. The increase in production sold for exports has contributed the most to the total growth of the sector's turnover in 2011 – by 45%. At the same time, revenues from sales in the domestic market increased by 33%. In four months of 2012, the turnover has increased by 23% and the increase in revenues from production sold for exports still contributes the most to the turnover of the sector.

It should be noted that despite the rapid increase in volumes, the load of production capacity in the 2nd quarter of 2012 was 59%, which is by 17 percentage points lower than at the beginning of 2007.

Although the demand has been gradually growing over the past few years, producer prices have not increased practically. Producer prices for production sold in the domestic market even dropped in 2011. In April 2012, producer prices were by 0.7% higher than a year ago.

Figure 3.33

Indicators Characterising Production of Transport Vehicles



3.3. Forecasts

The Ministry of Economics has prepared medium-term forecasts of economic development until 2016. The basic assumptions of the more rapid and slower development forecasts are based on various global economic recovery scenarios in a medium-term and on the ability of Latvian producers to further maintain competitiveness restored during the crisis. Forecasts of the European Commission, as well as of the International Monetary Fund as of June 2012 were used in developing forecasts of the Ministry of Economics for the analysis of external markets and evaluation of global economic development tendencies.

Economic Development in 2012 and 2013

Further development of Latvian economy will be still closely related to export possibilities. Therefore, the highest risk to the growth of Latvia is related to global economic development. At the beginning of 2012, the EU's economic activity in general is low, although some short-term indicators show stabilising trends, uncertainties still remain about further growth perspectives of the EU.

Meanwhile, the economy of Latvia has so far been resistant to external collapses – despite the weakening EU growth in at the end of 2011 and beginning of 2012, a stable increase in exports, manufacturing, transport, retail and tax revenues has been observed in the economy of Latvia in the first half of 2012. The confidence of population and entrepreneurs has not deteriorated. The largest trade partners of Latvia, for example, Germany, Sweden, Russia and other Baltic States continue developing better than expected.

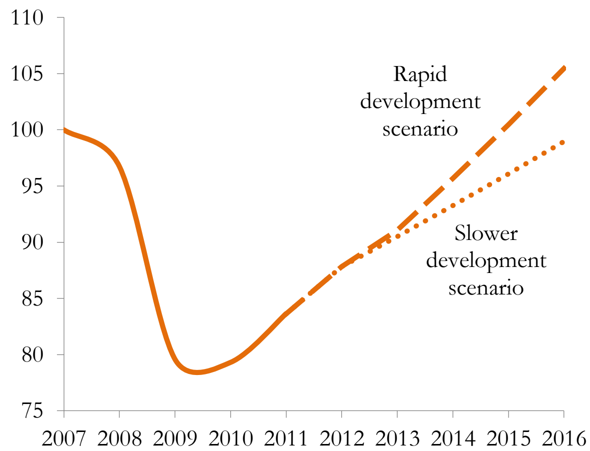
Considering the export tendencies of Latvian goods, as well as growth perspectives in the key partner countries, the increase in Latvian exports will be moderate and reach 5.8% in 2012 compared to 2011. The positive impact on the economy will also become slightly more moderate as the growth of exports becomes slower. In 2012, domestic demand continues gradually increasing. More rapid increase in consumption will be still limited by high indebtedness of households and a relatively high unemployment rate despite the gradually improving situation in the labour market. Yet, the overall dynamics of investments will be affected by cautious crediting policy of commercial banks, whereas private sector investments will be influenced by the awaiting behaviour of entrepreneurs regarding future perspectives.

Looking from production side, the majority of economy sectors will keep growing in 2012 and 2013, though at a slower growth rate than in 2011. Export-oriented sectors – mainly manufacturing – will still greatly contribute to the growth. The growth of this sector is expected to be considerably faster than average in the economy. Rather rapid growth is expected in construction sector, although it should be taken into account that the sector has recently begun to recover from the deep recession. The volume of trade services will increase along with the growing private consumption. Like in 2011, commercial services sectors are expected to grow at a rather slower pace. The need to achieve the budget deficit targets set by the government will limit rapid growth of public services sectors.

Despite the possible weakening of the growth rates in the second half of the year, the overall growth of GDP will be more rapid than expected and may reach even 5% in 2012. In 2013, taking into account high downside risks to the growth, the international organizations forecast rather slow growth of the EU. It will have a certain impact also on the development of the economy of Latvia, and the growth in 2013 may be slightly slower than in 2012, reaching an increase of 3.7 percent.

Figure 3.34

Forecast of Latvian GDP *
(2007 = 100)



Development Perspectives in 2013-2016

The medium-term growth of the economy will depend to a great extent on the structural policy implemented by the Latvian government for improvement of competitiveness, as well as on the solutions the euro zone countries will be able to adopt to eliminate the tension in the financial sector in order to avoid possible economic stagnation.

The main medium-term objectives of the structural policy of Latvia are related to certain structural changes in allocating resources of the economy in favour of production of higher value added goods and services, export-oriented sectors, higher investments in new technologies, innovation and ICT, as well as improvements in the education system and supporting science. Implementation of these measures will strengthen economic growth potential, thus boosting industrial growth and increasing productivity of the economy.

Table 3.12

Forecast of Latvian GDP by Expenditure Items

	2011 fact	2012	2013	2014-2016 average annually*
		growth rates, % over the previous year		
Gross domestic product	**5.5**	**5.0**	**3.7**	**3.0.. 5.0**
Private consumption	4.4	3.5	3.3	3.0..4.9
Public consumption	1.1	0.9	1.8	2.4.. 3.3
Gross fixed capital formation	27.9	24.0	4.4	2.0.. 5.4
Exports	12.6	5.8	4.1	3.2.. 5.3
Imports	20.7	7.0	3.5	3.4.. 5.0
			structure, %	
Gross domestic product	**100**	**100**	**100**	**100**
Private consumption	62.1	61.1	61.0	60.0.. 60.9
Public consumption	16.2	15.8	15.5	15.1.. 15.2
Gross fixed capital formation	21.5	26.3	26.9	23.4.. 27.6
Changes in inventories	4.1	2.0	1.5	3.8.. 0.7
Exports	59.3	60.4	60.7	58.7.. 61.0
Imports	63.2	65.6	65.6	61.0.. 65.5
Export-import balance	-3.9	-5.2	-4.9	-2.3.. -4.5

* structure at the end of the period

The more rapid development scenario foresees stable medium-term growth and economic development of the EU. The more rapid development scenario foresees that growth rates of manufacturing (and respectively also of exports) will remain comparatively high also after 2013, based mainly on both the increased competitiveness of Latvian producers and on the growth of external demand. The weaker development scenario is based on an assumption that the global economy will develop unevenly at slower growth rates, including slower recovery of the EU from the debt crisis, since the EU member states fail to timely agree on all difficult issues regarding the financial sector.

Table 3.13

Forecast of Latvian GDP by Sectors

(real growth, % in comparison with the previous year)

	2011 fact	2012	2013	2014-2016 average annually
Gross domestic product	**5.5**	**5.0**	**3.7**	**3.0.. 5.0**
Agriculture, forestry	2.8	4.1	1.8	1.4.. 1.5
Manufacturing	11.7	7.9	6.9	3.5.. 5.8
Other industry	-0.2	-0.6	3.3	2.0.. 2.5
Construction	12.4	14.3	8.3	4.0.. 6.8
Trade, accommodation	9.6	5.7	3.7	3.1.. 4.1
Transport and storage	8.0	3.1	3.3	3.2..5.4
Other commercial services	0.0	2.1	1.7	2.8.. 4.5
Public services	0.6	1.3	0.7	1.4.. 3.2

The growth in the medium-term will be not as rapid as it has been in 2005-2007, because it will no longer be driven by the large financial inflows that have stimulated domestic demand and mainly fostered the development of services sectors.

4. Macroeconomic Stability

4.1. Public Finances

4.1.1. Fiscal Policy and Public Debt

Deterioration of the economic situation in 2008 and 2009 affected by the global financial crisis has considerably worsened the Latvian fiscal position (see Table 4.1). In order to prevent the situation in the financial sector from going out of control, since 2008 Latvia has carried out budget consolidation in the amount of LVL 2.3 billion with a fiscal impact in the amount of 17% of GDP, out of which about 6.8% of GDP are measures on the revenue side while measures on the expenditure side constitute about 10.2% of GDP. On average, Latvia has carried out annual fiscal consolidation measures in the amount of 3.4% of GDP from 2008 until 2012.

In the result of budget consolidation implemented by the government, the budget deficit in 2010 and 2011 decreased to 8.1% and 3.5% of GDP, respectively.

Table 4.1

General Government Budget

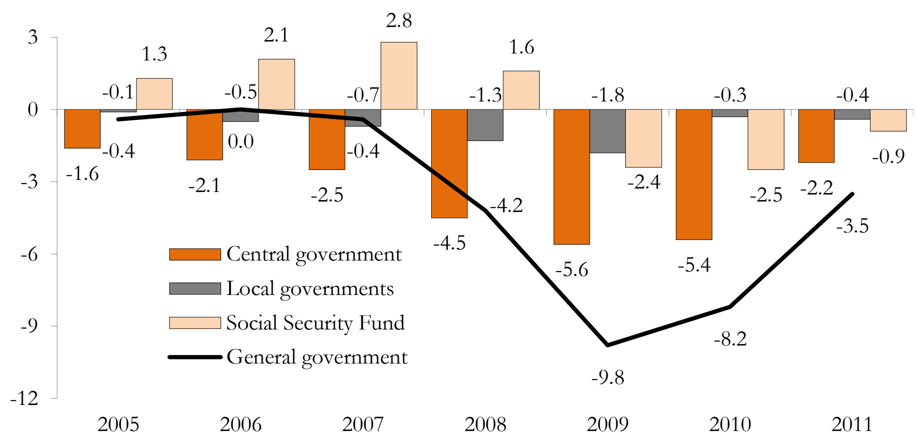
	2006	2007	2008	2009	2010	2011
Revenues (million LVL)	4208.0	5235.5	5605.8	4534.0	4550.0	5039.6
(% of GDP)	37.8	35.6	34.9	34.7	35.7	35.6
Expenditures (million LVL)	4263.2	5292.3	6286.9	5804.0	5586.5	5535.0
(% of GDP)	38.3	36.0	39.1	44.4	43.9	39.1
Balance (million LVL)	-55.1	-56.8	-681.0	-1270.0	-1036.5	-495.4
(% of GDP)	-0.5	-0.4	-4.2	-9.7	-8.1	-3.5

Over the past few years, the general government budget deficit is comprised by the deficit in both, the central government budget and the local government budget, as well as in the Social Security Fund (see Figure 4.1). Until 2008, the social insurance budget had a surplus, however, the deficit has appeared over the last three years.

Figure 4.1

General Government Budget Balance by Sub-Sectors

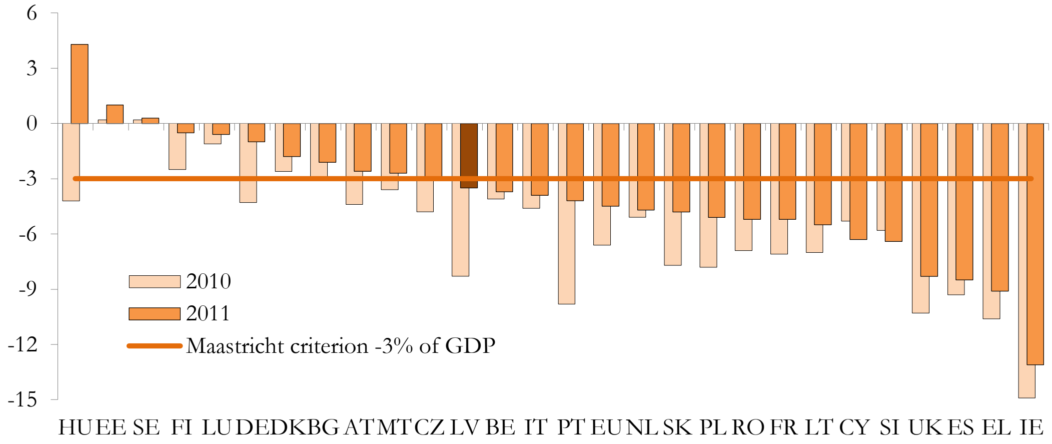
(% of GDP)



The level of the average budget deficit of the EU Member States in 2011 was 4.5% of GDP (in 2010 – 6.5% of GDP, in 2009 – 6.9% of GDP). The budget condition of 21 EU Member States has worsened in 2010. The budget deficit had been observed in 2011 almost in all 24 EU Member States. Ireland, Greece, Spain and the United Kingdom had the highest general government budget deficit against GDP in 2011. The budget deficit in these countries exceeded 8% of GDP. Only Hungary, Estonia and Sweden had a budget surplus.

Figure 4.2

General Government Budget Balance in the EU Member States in 2010 and 2011
(% of GDP)



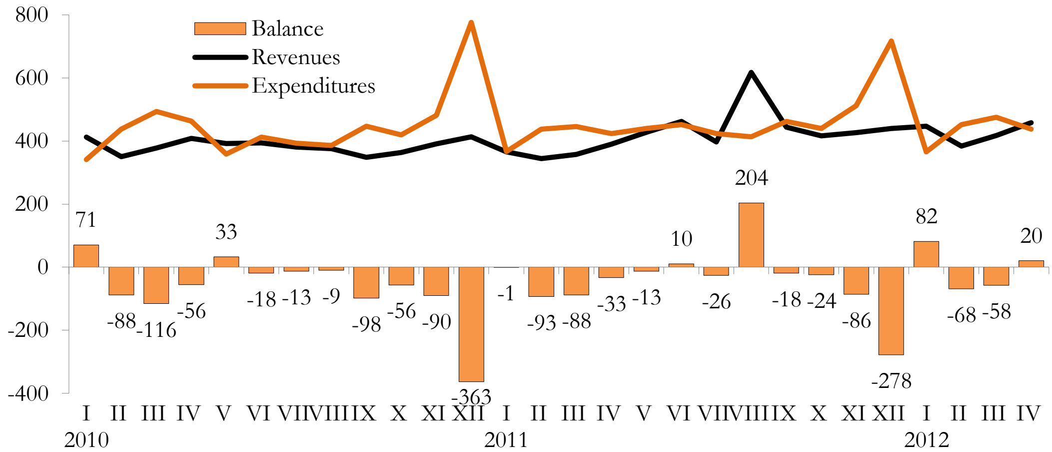
According to the forecasts of the European Commission published in spring 2012, the budget situation in the EU Member States is expected to continue improving both in 2012 and 2013. In 2012, the level of the average budget deficit of the EU Member States is forecasted to be in the amount of 3.6% of GDP, but in 2013 – 3.3% of GDP. In 2012, the highest budget deficit that could exceed 6% of GDP is expected in Ireland, Greece, the United Kingdom and Spain.

The Saeima approved the government budget for 2012 with a deficit in the amount of 2.1% of GDP. Fiscal consolidation was continued also within the budget planning process for 2012. The budget consolidation included solutions both on the revenue side, among them reform of real estate tax and measures to cut budget expenditures – reduced grants for agriculture, transport and sports, reduced funding for defence, interior affairs, culture and health care, state and local roads and public transportation, implementation of social safety net measures, reduced financing for local governments.

Adoption of the budget for 2012 with a budget deficit below 3% of GDP creates the preconditions for initiating the closing of the excessive budget deficit procedure proposed by the EU, as well as ensures fulfilment of the Maastricht criterion on budget deficit, thus laying a strong foundation for Latvia to introduce the euro on January 1, 2014.

Figure 4.3

Financial Indicators of the Government Consolidated Budget
(million LVL)



Dynamics of financial indicators of the general government consolidated budget is shown in Figure 4.3.

The general government deficit is expected to be below 1.4% of GDP in 2013, 0.8% of GDP in 2014 and 0.3% of GDP in 2015.

In order to ensure development of sustainable and counter-cyclical fiscal policy, the *Draft Law on Fiscal Discipline* (FDL) has been developed stipulating binding fiscal conditions for both the annual state budget and the medium-term budget. In order for these systemic new approaches towards development of fiscal policy and observing discipline to be sustainable without being constantly amended or even cancelled, amendments to the Constitution (*Satversme*) have been prepared.

The FDL and *the Draft Amendments to the Constitution of the Republic of Latvia* were submitted to the Saeima on December 6, 2011. On January 12, 2012, the FDL was approved in the first reading at the Saeima and the period for submission of proposals for further consideration of the draft law in the 2nd reading is closed. Requirements of the new *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union* have been introduced in the FDL for the 2nd reading at the Saeima, thus ensuring improved compliance with the EU level requirements. The consideration of *Amendments to the Constitution* continues at the Saeima committees. On January 17, 2012, it was considered by the Saeima Legal Affairs Committee and forwarding of the amendments to *the Constitution* for further consideration was postponed until the working group of the Saeima Legal Affairs Committee finishes its work on developing alternative draft amendments to the fundamental law.

In addition to these proposed laws in order to improve the quality of the budget and ensure its link with planning documents, the Saeima adopted amendments to the *Law on Budget and Financial Management* on December 15, 2011. The amendments envisage preparation of the annual *Law on the Medium-Term Budget Framework* for three-year period, which contains the key medium-term budget targets and priority development directions, as well as the main national macroeconomic and budget indicators. There have been defined also the succession principles of planned financial indicators, thus ensuring legally binding regulation basis for medium-term planning. The first *Law on the Medium-Term Budget Framework for 2013-2015* will be prepared and submitted to the Saeima by the end of September 2012 together with the annual *Law on the Budget for 2013*.

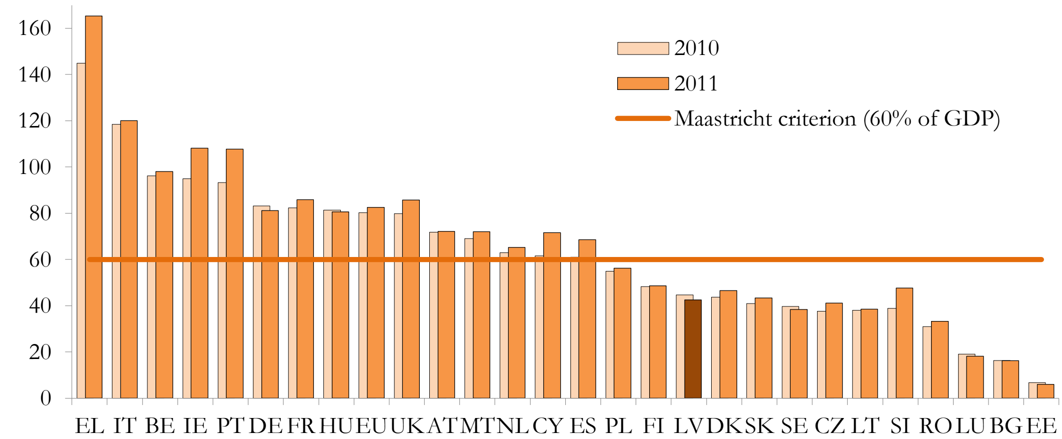
The level of **the general government debt** in Latvia is still one of the lowest in the EU (see Figure 4.4).

In 2011, the EU average level of the public debt was 82.5% of GDP (80% of GDP in 2010, 74.8% of GDP in 2009). The public debt exceeded the Maastricht criterion that is 60% of GDP in 14 EU Member States in 2011. In 2011, the highest public debt was observed in Greece, Italy, Ireland, Portugal and Belgium, while the lowest general government debt was registered in Estonia, Bulgaria and Luxembourg. According to the European Commission's forecasts published in spring 2012, the average level of the general government debt in the EU will reach 86.2% of GDP in 2012 and continue increasing also in 2013.

Figure 4.4

General Government Debt in the EU Member States in 2010 and 2011

(% of GDP)



The general government debt in Latvia has gradually increased until 2007. Since 2008, it has been growing rapidly to ensure the financial obligations of the government and reached LVL 5694.6 million or 44.7% of GDP at the end of 2010 (see Figure 4.5). At the end of 2011, it was LVL 6028.2 million or 42.6% of GDP. The level of the general government debt is mainly influenced by the central government debt.

It should be noted that the three-year international loan programme has been successfully completed at the end of 2011. The programme earmarked EUR 7.5 billion loan to Latvia. Taking into account that the economic situation and financial condition of Latvia had improved, Latvia did not need the full amount of the available financing. Latvia has used EUR 4.4 billion.

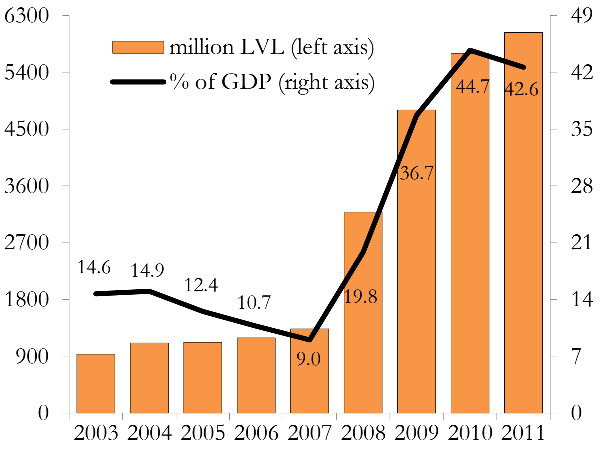
In June 2011 and February 2012, Latvia successfully returned to the international financial markets by issuing 10-year bonds worth USD 500 million and 5-year bonds worth USD 1 billion. These bonds prove Latvia's ability to finance its budget needs independently and lay a strong

[1] It should be noted that at the end of May 2012 the Saeima supported the draft law ratifying the EU Fiscal Discipline Treaty.

foundation for successful refinancing of loans in public financial and capital markets over the coming years.

Figure 4.5

General Government Consolidated Gross Debt by Nominal Value at the End of the Year



Taking into consideration the planned borrowing strategy, the debt level of the general government in the medium term is likely not to exceed 60% of GDP, which is the criterion under the *Maastricht Treaty*.

4.1.2. Budget Revenues

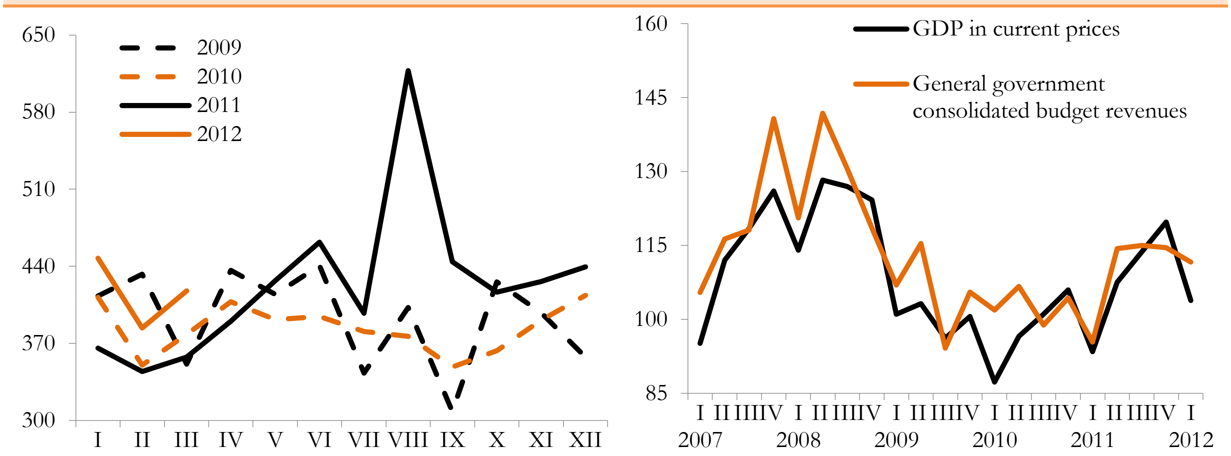
Revenues of the general government consolidated budget in 2011 were LVL 5087.3, which was by LVL 480 million or 10.4% more than last year. In January-May 2012 revenues of the general government consolidated budget increased and were LVL 2175.1 million, which is by LVL 290.4 million or 15.4% more than in the corresponding period of 2011.

Increase in revenues of the general government budget is mainly related to increase in tax revenues.

Figure 4.6

General Government Consolidated Budget Revenues by Months*
(million LVL)

GDP in Current Prices and General Government Consolidated Budget Revenues by Quarters
(4th quarter of 2006 = 100)



* According to official data of monthly reports of the Treasury

Almost 80% of all tax revenues consist of three taxes – mandatory state social insurance contributions, personal income tax and value added tax.

Taxes collected in 2011 constituted 76.2% of all budget revenues, while in the 1st quarter of 2012 the share of tax revenues in total revenues has increased to about 80% of the total budget revenues. It is mainly related to the increase in tax revenues along with the remaining economic growth tendencies. The total tax revenues increased by 13.6% and constituted LVL 3878.2 million in 2011 compared to the previous year. In January-May 2012, the tax revenues were LVL 1726.5 million, which is by LVL 221.4 million or 14.7% more than in the corresponding period of the previous year.

Increase in taxes in 2011 was determined mainly by the increase in revenues from mandatory state social insurance contributions, value added tax and corporate income tax.

Table 4.2

Budget Revenues*
(% of GDP)

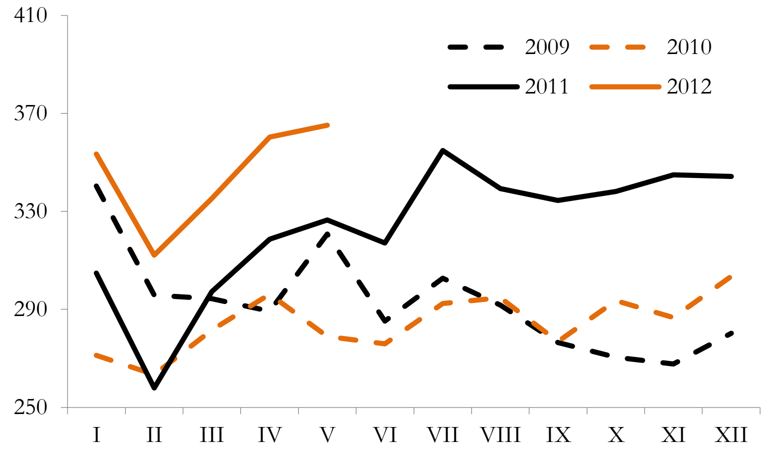
	2007	2008	2009	2010	2011
General government consolidated budget revenues	**36.3**	**35.6**	**36.2**	**36.2**	**35.9**
I Tax revenues	**29.6**	**29.4**	**26.9**	**26.8**	**27.4**
1. Indirect taxes	11.4	10.5	10.1	10.2	10.3
– value added tax	8.2	6.9	6.1	6.5	6.8
– excise tax	3.0	3.4	3.9	3.6	3.4
– customs duty	0.2	0.2	0.1	0.1	0.1
2. Income taxes and property taxes	9.3	10.0	7.6	7.8	7.8
– corporate income tax	2.7	3.1	1.5	0.9	1.4
– personal income tax	6.0	6.4	5.6	6.2	5.6
– real estate tax	0.5	0.4	0.6	0.7	0.8
3. Social insurance contributions	8.6	8.7	8.9	8.6	8.7
4. Other taxes	0.4	0.3	0.2	0.2	0.6
II Other revenues	6.7	6.2	9.3	9.4	8.5

* Data of the Treasury

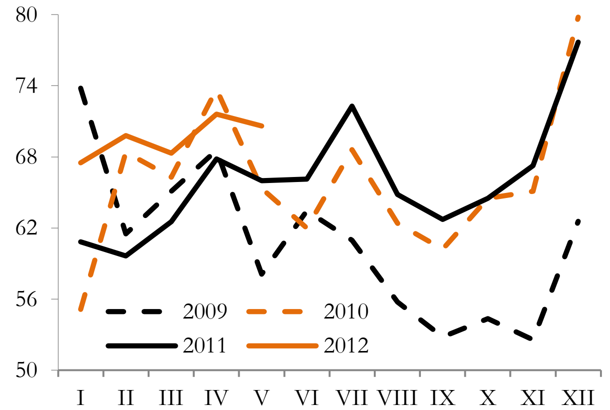
Corporate income tax payments increased most rapidly. At the beginning of 2012, the increase in the total tax revenues was determined by the increase in revenues from corporate income tax and value added tax.

Figure 4.7

Tax Revenues by Months*
(million LVL)



Personal Income Tax



Mandatory State Social Insurance Contributions
(excluding resources of state funded pension schemes)

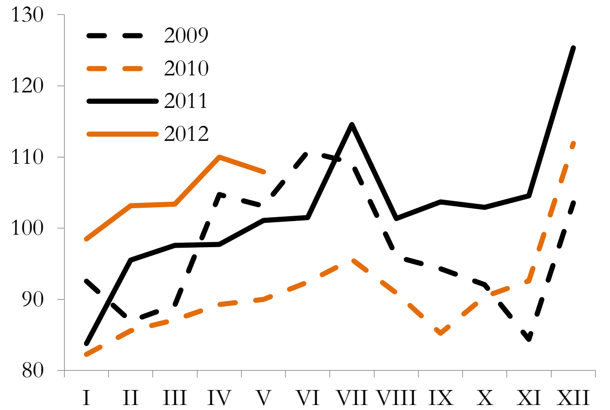


Figure 4.7 continued

* According to official data of monthly reports of the Treasury

The share of **employment taxes** in January-May 2012 constituted 50.4% of all tax revenues which is slightly less than in 2011.

As of January 1, 2012, laws are defined more precisely by setting down an exemption of benefits from personal income tax paid from the budget also of other EU and European Economic Area countries.

As of January 1, 2013, the personal income tax standard rate will be reduced from 25% to 24%, but in 2014 to 22% and in 2015 to 20 percent.

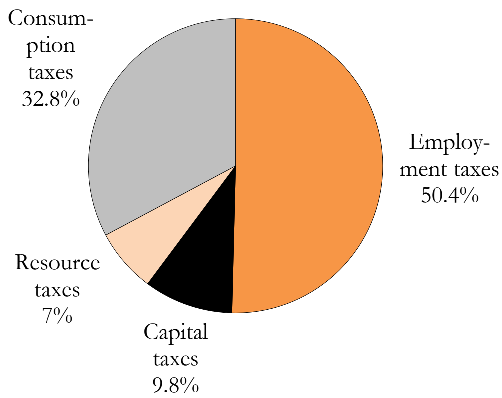
In January-May 2012, the collected personal income tax amounted to LVL 347.8 million, which is by LVL 31 million or 9.8% more than in the corresponding period of 2011.

In January-May 2012, the revenues from mandatory state social insurance contributions were LVL 522.9 million, which is by LVL 47.2 million or 9.9% more than in the corresponding period of 2011. The increase in revenues is related to the increase in the number of employed.

The maximum amount of the object for social insurance contributions is cancelled until December 31, 2013, i.e. persons must make social insurance contributions from all labour income within this period.

Figure 4.8

General Government Consolidated Budget Tax Revenues by Tax Groups in January-May 2012



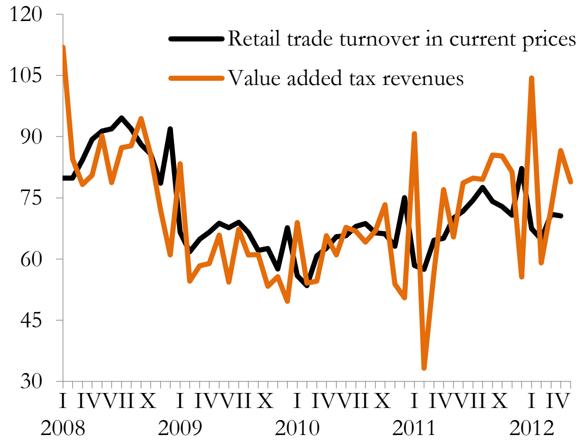
The share of **consumption taxes** in the tax structure in January-May 2012 was 32.8% and has remained unchanged compared to 2011.

As of January 1, 2012, the reverse value added tax application is introduced for construction services, which means that the recipient of these services will pay the value added tax for the provided construction services into the state budget, thus limiting fraud in the construction sector. As of July 1, 2012, the value added tax standard rate will be reduced by 1 percentage point – from 22% to 21%. This reduction is expected to improve regional competiveness of Latvia and lower inflation pressure on population and bring Latvia closer to the applicable rates in other Baltic States (in Lithuania – 21%, in Estonia – 20%).

Figure 4.9

Retail Trade Turnover and Revenues from Value Added Tax

(December 2007 = 100)



Consumption tax revenues increased significantly during the rapid growth period. It was promoted by the growing domestic demand and high inflation. Since the end of 2008, due to the decreasing domestic demand and consumer price pressure, the consumption tax levy started decreasing. Due to the increase in import volumes and changes in retail trade turnover volumes, the value added tax increased in 2010. In 2011, revenues from the value added tax were LVL 958.6 million, which is by LVL 133.4 million or 16.2% more than in the respective period of the previous year. The revenues from the value added tax continued growing also at the beginning of 2012 and were LVL 442.9 million in January-May, which is by 24.2% more than in the respective period of the previous year.

As of January 1, 2012, the amendments to the *Excise Duties Law* are in force. Changes apply to the criterion for regular movement of goods to be imported from the third countries by natural persons by replacing the existing definition "not more than once a day" with "not more than once in seven days". Thus, the risk of abuse of exemption from the excise duty under the law will be reduced.

Since 2011, the revenues from the excise duty have been increasing and amounted to LVL 481.5 million, which is by LVL 23.5 million or 5.1% more than in the corresponding period of the previous year. The revenues continued increasing also in 2012 and were LVL 195.6 million in January-May, which is by LVL 17.8 million or 10% more than in the corresponding period of the previous year.

The share of **capital taxes** in the total tax revenues increased from 7.9% in 2011 to 9.8% in January-May 2012.

The decreasing business activities and the increasing number of insolvent enterprises in 2010 caused a significant decrease of the corporate income tax levy (by 43.1%). However, in 2011, the situation improved considerably and the corporate income tax levy amounted to LVL 196.4 million, which is by 75.1% more than in the corresponding period of 2011. An increase in the corporate income tax levy is mainly related to the reduction in the amount paid. Also in January-May 2012 compared to the corresponding period of the previous year, the corporate income tax levy increased most rapidly (by LVL 119.5 million or 31%).

As of January 1, 2013, dividends paid by non-residents (capital companies) and received by non-residents will no longer be subject to the corporate income tax. This law does not apply to low tax or tax-free country payments.

The real estate tax levy has increased significantly (by 23%) in both 2010 and 2011. The real estate tax levy increased also in January-May 2012 reaching LVL 68.2 million, which is by LVL 7.2 million or 11.9% more than in the corresponding period of the previous year.

Since 2012, the amendments to the *Law on Real Estate Tax* provide the local governments more rights to define tax objects (for example, applying tax to auxiliary buildings of residential buildings). The amendments entitle also local governments to decide on the application of limitation for an increase in the amount of the real estate tax for land in 2012.

The share of **resource tax** group was 7% in January-May 2012, which is similar to the share in 2011.

In January-May 2012, revenues from the excise duty for oil products increased by 6%. The revenues from the excise duty for natural gas amounted to LVL 9.3 million.

Annual revenues from the natural resources tax in 2011 have increased by 18.5% exceeding the plan by 0.4%. In January-May 2012, the excise duty revenues were LVL 195.6 million, which is by LVL 17.8 million or 10% more than in the corresponding period of the previous year. The highest tax revenues in this category are from the tax on oil products.

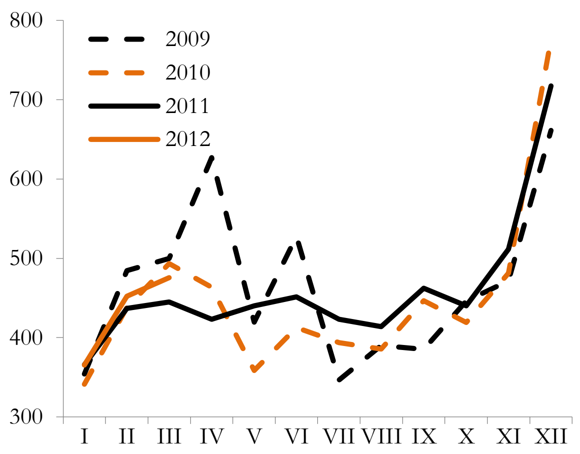
4.1.3. Budget Expenditures

In 2011, the government consolidated budget expenditures were LVL 5322.2 million, which is by 2.3% or LVL 122.5 million less than last year, while in January-May 2012, the total government consolidated budget expenditures were LVL 2143.3 million, which is by LVL 30.9 million or 1.5% more than in the corresponding period of 2011.

Figure 4.10

General Government Consolidated Budget Expenditures by Months*

(million LVL)



* according to official monthly report data of the Treasury

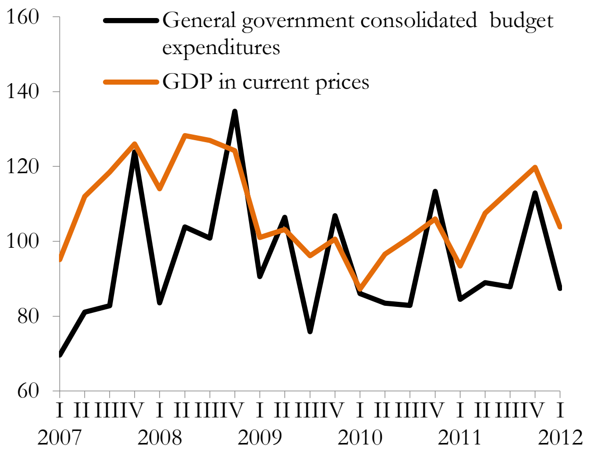
In the 1st quarter of 2012 in comparison with the same period of 2011, the expenditures for subsidies and grants increased by 3.7%, but current expenditures – by almost 18%, while capital expenditures and revenues decreased by 9% and 11%, respectively.

Current expenditures, subsidies and grants have a high share in expenditures.

Figure 4.11

GDP in Current Prices and General Government Consolidated Budget Expenditures by Quarters

(4th quarter of 2006 = 100)

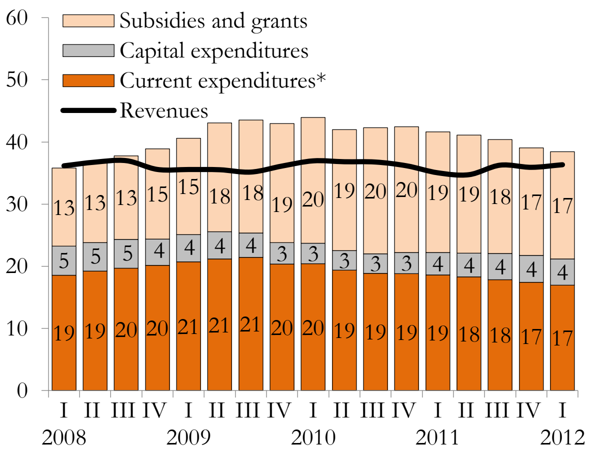


According to the expenditures by functional categories, the highest share in 2011, was for social security (30.6% of all expenditures) followed by economic affairs (17.4%), education (16.9%) and expenditures for general government services (12.5%), but the lowest share of all expenditures was for defence (1.8%), environmental protection (2.2%) and management of municipal territories and housing (2.7%).

Figure 4.12

General Government Consolidated Budget Revenues and Expenditures

(moving average of 4 quarters, % of GDP)



* including payments for loans and credits, as well as payments to the EU

Table 4.3

Expenditures of the General Government Consolidated Budget by Functions*
(percent)

	2008		2009		2010		2011	
	structure	against GDP	structure	against GDP	structure	against GDP	structure	against GDP
Expenditures – total	**100**	**38.9**	**100**	**43.0**	**100**	**42.5**	**100**	**27.3**
General public services	13.6	5.3	14.8	6.4	13.4	5.7	12.5	3.4
Defence	3.5	1.4	2.4	1.0	2.0	0.9	1.8	0.5
Public order and safety	5.0	1.9	4.5	1.9	4.4	1.9	4.5	1.2
Economic affairs	18.1	7.0	15.7	6.7	16.0	6.8	17.4	4.7
Environmental protection	2.4	0.9	2.2	0.9	1.1	0.5	2.2	0.6
Management of municipal territories and housing	3.6	1.4	2.1	0.9	2.5	1.1	2.7	0.7
Health	8.1	3.1	7.5	3.2	7.2	3.1	8.3	2.3
Recreation, culture and religion	4.0	1.6	3.4	1.5	2.9	1.2	3.2	0.9
Education	20.2	7.9	19.6	8.4	16.7	7.1	16.9	4.6
Social security	21.5	8.4	27.9	12.0	33.8	14.4	30.6	8.3

* according to the official data of the Treasury

The public demand consists of public consumption or public services, the value of which is determined by the volume of the provided public services, as well as of public investment, i.e. capital investments using the budget resources.

The public demand decreased most rapidly in 2009 (by 13.3%). A significant decrease was observed also in 2010, when the public demand decreased by 10% in comparison with the previous year. In 2011, the public demand increased mainly due to increase in central government expenditures for the total fixed capital formation (by 63.4%).

Table 4.4

Public Demand

	% of GDP				Changes in comparison with the previous year, %			
	2008	2009	2010	2011	2008	2009	2010	2011
Public demand	**24.9**	**23.8**	**22.2**	**20.4**	**-3.5**	**-13.3**	**-9.7**	**5.6**
Public consumption	20.0	19.6	18.4	16.2	1.6	-9.4	-7.9	1.1
– central government*	10.9	10.5	10.7	9.2	0.7	-8.7	-0.5	-1.6
– local governments	9.1	9.1	7.7	7.1	2.5	-10.3	-16.5	4.8
Gross fixed capital formation	4.9	4.3	3.7	4.2	-15.4	-24.1	-15.8	22.2
– central government*	1.8	1.5	1.2	1.8	-38.1	-25.4	-26.1	63.4
– local governments	3.1	2.7	2.6	2.4	7.5	-23.3	-10.0	3.1

* including Social Security Fund

4.2. Prices

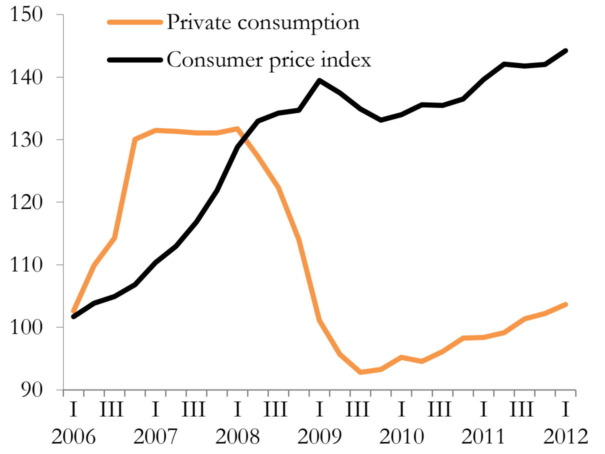
4.2.1. Consumer Prices

The decline in consumer prices, which started at the end of 2008 and continued in 2009, was mainly determined by the rapid decrease in private consumption. Since the end of 2009, the prices began increasing gradually, as private consumption no longer declined and was not a factor that could reduce the total price level. However, price level was more significantly affected by external factors.

Figure 4.13

Private Consumption and Consumer Price Index

(4th quarter of 2005 = 100)



In 2011, consumer prices began increasing rapidly and reached 4% (12-month inflation), and the average price level was by 4.4% higher than a year ago. It was determined by both the rise in prices worldwide and the situation in the domestic market. The rise in prices was mainly based on the increase in administratively regulated prices that increased the overall price level by 1.3 percentage points while the rise in food prices increased the level by 1.2 percentage points and rise in transport costs – by 0.8 percentage points. It should be noted that during the summer the rise in prices in Latvia slightly slowed down due to the influence of seasonal factors and decline in prices worldwide.

Table 4.5

Consumer Price Changes by Months

(percentage)

		Compared to the previous month	Compared to the respective month of the previous year	Average during the year
2011	January	1.3	3.7	-0.5
	February	0.3	4.0	0.2
	March	0.7	4.2	0.8
	April	1.1	4.5	1.5
	May	0.4	5.0	2.1
	June	0.3	4.8	2.6
	July	-0.3	4.3	3.0
	August	-0.3	4.7	3.4
	September	0.4	4.6	3.8
	October	0.2	4.4	4.1
	November	0.0	4.2	4.2
	December	0.0	4.0	4.4
2012	January	0.8	3.6	4.4
	February	0.1	3.4	4.3
	March	0.6	3.3	4.2
	April	0.6	2.8	4.1
	May	-0.2	2.2	3.8

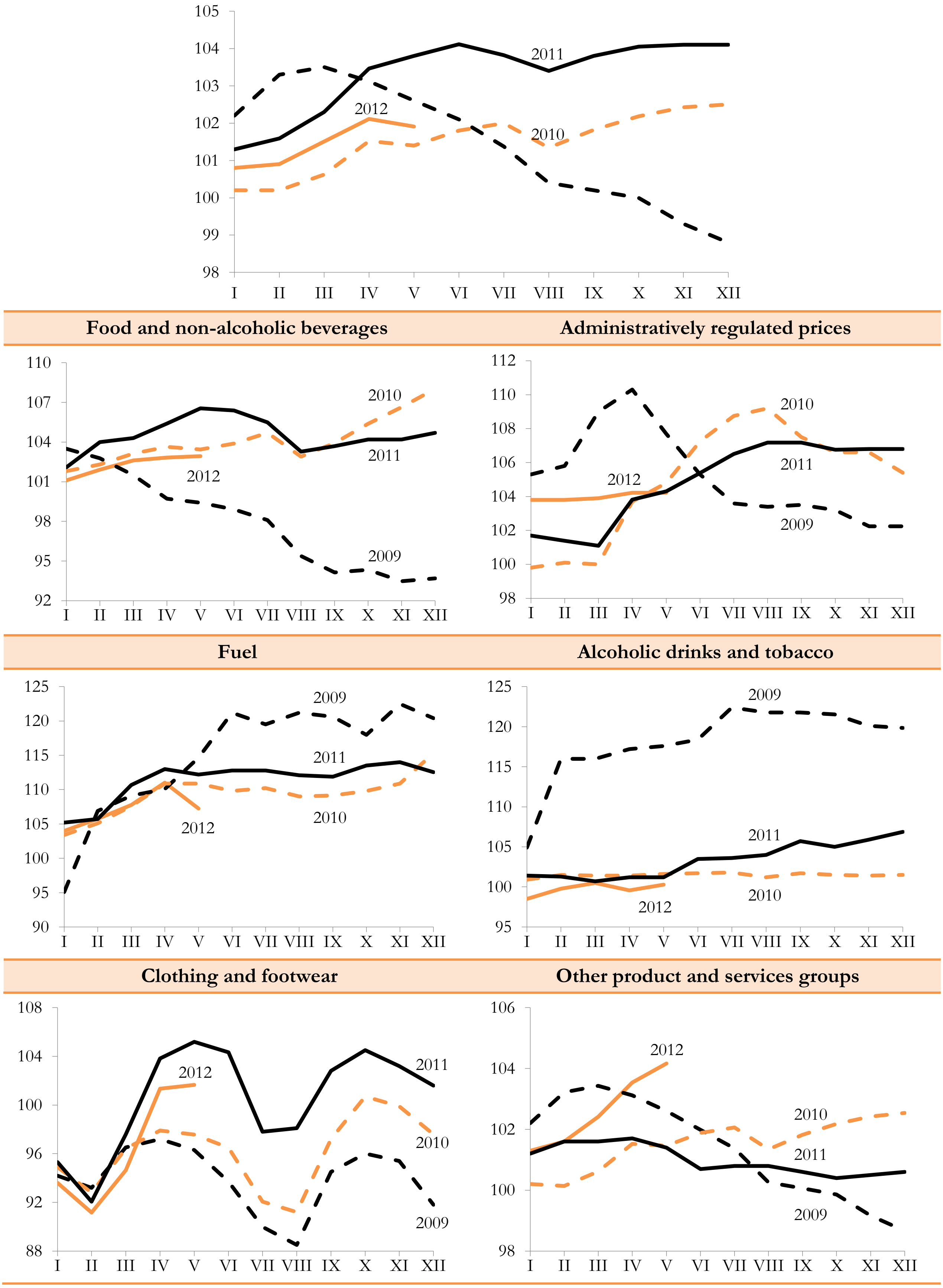
At the beginning of 2012, consumer prices continued increasing at a moderate pace. In five months of 2012, consumer prices have increased by 2.2% (12-month inflation) that was twice slower than in the same period of the previous year. However, taking into account the rapid increase in prices in 2011, the average price level in May 2012 was by 3.8% higher than last year.

Factors influencing prices in five months of 2012:

– The rise in prices for food products that since December 2011 have increased by 2.9%. Changes in prices for food products depend mainly on world price fluctuations. The rise in prices for food products affects the overall rise in world prices, yet it has no longer the influence it has had in 2011;
– The rise in world prices for oil products in January-March affected the rise in fuel prices significantly. In April 2012 compared to December 2011 the rise in fuel prices in Latvia reached 11%. However, the fall of fuel prices in May 2012 (by 3.4% during a month) was one of the factors that most of all influenced the decrease of average price level in May. The observed decrease of oil prices in the world determined fuel price tendencies in April-May. However, the positive effect of the decrease in fuel prices is hindered by the appreciation of the US dollar against the euro;
– Increase of tariffs for natural gas, that comprised about 12% during a year and determined the increase of administratively regulated prices for heating and gas, had the overall impact by 1 percentage point on the changes of the average price level during a year;
– The rise in prices for clothing and footwear in March-May was one of the highest in this period since the 1990's (the highest rise has been observed in the respective period of 2011). It is based to a great extent on the increasing private consumption and rise in prices for raw materials;
– Inflation expectations due to the strained economic situation in both the European Union and the euro zone.

Figure 4.14

Consumer Price Index by Groups and Sub-Groups
(December of the previous year = 100)



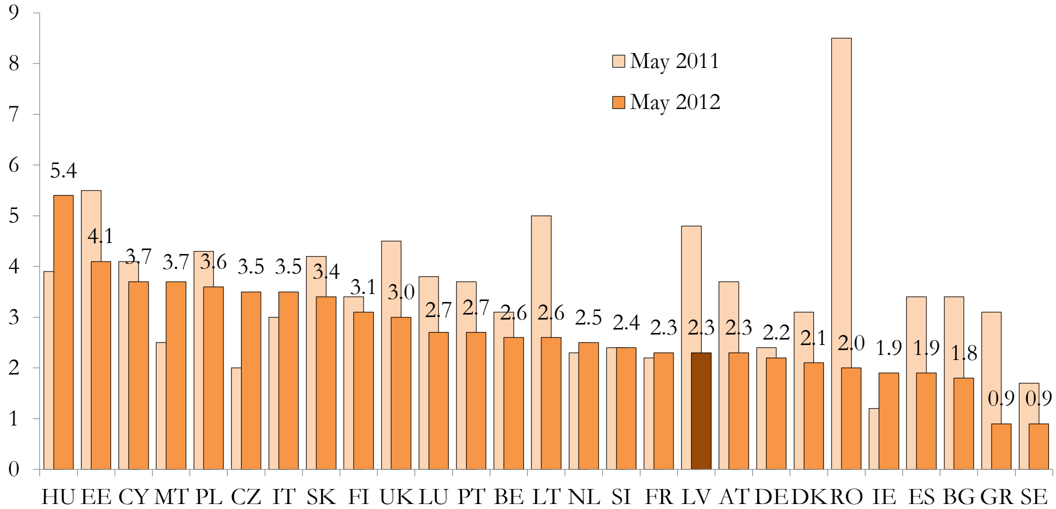
In 2012, the influence of several factors, which determined the rise in prices in 2011 (consumption taxes, electricity tariffs, food prices in the world), on consumer prices is reducing. Yet, the increase in natural gas tariffs by 3-5% as of July 1 will continue having a certain impact on consumer prices at the beginning of 2012, thus raising the prices for heating energy.

The reduced VAT as of July 1, 2012 might have significant impact. Therefore the total price level is expected to decrease by 1 percentage point.

Figure 4.15

Changes of the Harmonised Consumer Prices in the EU Member States in May 2012 and May 2011

(12-month inflation, %)



Source: *Eurostat*

Fuel prices are rather uncertain as they are also influenced by the exchange rate fluctuations of the euro and US dollar. The Ministry of Economics forecasts a more moderate rise in prices in 2012 than it was in 2011. The average consumer price level in 2012 may reach 2.5 percent.

In 2011 compared to 2010, the average price level in the European Union has increased by 3%. Just like in Latvia, it was determined by the rise in prices for food products and energy. The rise in prices for oil products had an indirect impact on the increase of producer prices in manufacturing.

In May 2012 compared to May 2011, the price level in the EU member states has increased faster than in Latvia – by 2.6%. The price inflation rose most rapidly in Hungary, Malta and the Czech Republic, thus becoming the countries with the highest inflation rate in the EU. Meanwhile, the inflation decreased most rapidly in Romania, Latvia and Lithuania.

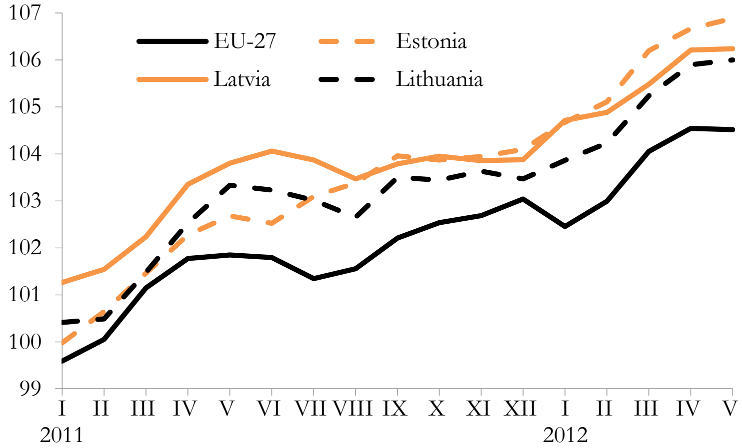
In May 2012 compared to May 2011, the consumer prices in the Baltic States continued increasing significantly for food product group and energy. Considering the drop in the prices for food products and oil products worldwide, the rise in food prices became more moderate since April and even a drop in fuel prices was observed in May.

The highest increase in prices for food product group and energy among the Baltic States was observed in Estonia – by 2.9% and 11.8%,respectively, prices for these groups in Latvia increased by 2.1% and 8.5%, respectively, while the lowest increase in prices was experienced in Lithuania – by 1.4% and 8.1%, respectively.

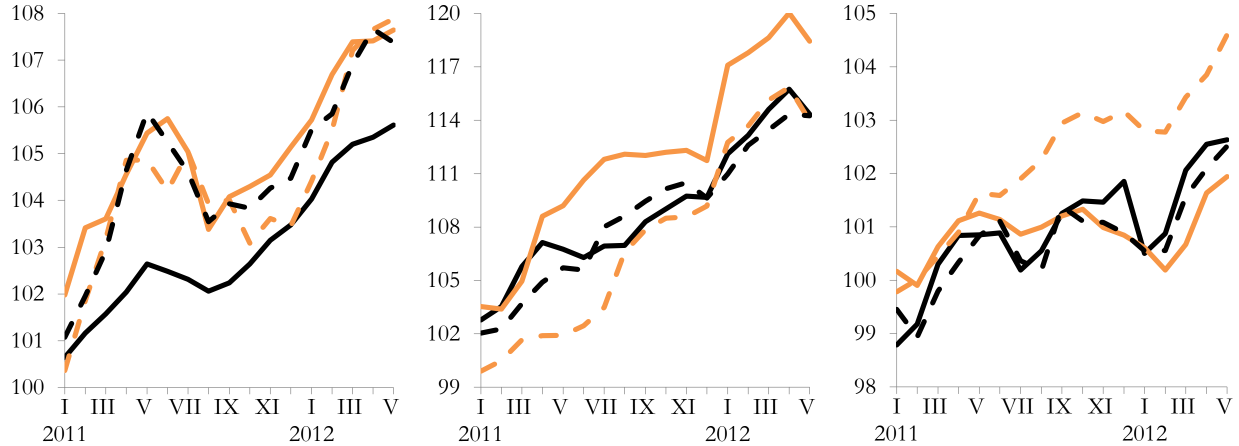
It should be noted that in May 2011 compared to May 2010, prices in Estonia and Lithuania for the services group increased faster than in Latvia – by 3.1% in each of both countries (in Latvia – by 2.3%).

Figure 4.16

Harmonised Index of Consumer Prices in 2011–2012 by Months
(December 2010 = 100)



Food products (including alcohol and tobacco)	**Energy**	**Total price index excluding energy and food products** (including alcohol and tobacco)



4.2.2. Producer Prices

After the decrease in 2009, **producer prices** started growing again in 2010. In general, prices continued rising also in 2010, although the rate of price increase became more moderate in the last months of the year. Prices rose for both products sold in the domestic market due to the stabilizing domestic demand and for exported products, which mainly depended on the rise in prices in the world markets for the main export goods of Latvia, including wood and timber products, metal articles and food.

At the beginning of 2011, the increase in producer prices remained fast. Producer prices increased for both exported products and products sold in the domestic market. Since the mid-2011 producer prices have stabilised. The price changes in manufacturing in 2011 were most significantly influenced by the production of metals and food products. Producer prices increased significantly in 2011 also for production of chemicals and chemical products. Yet, producer prices for production of electronic, electric and optical equipment in 2011 remained at the level of 2010. Producer prices increased also in one of the main export sectors of Latvia – wood processing.

Figure 4.17

Producer Price Changes
(December 2009 = 100)

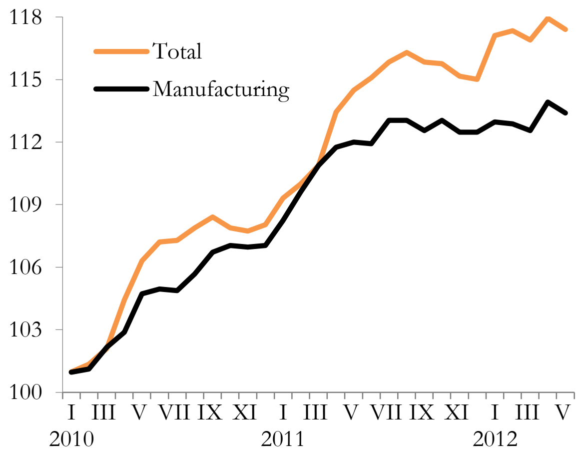
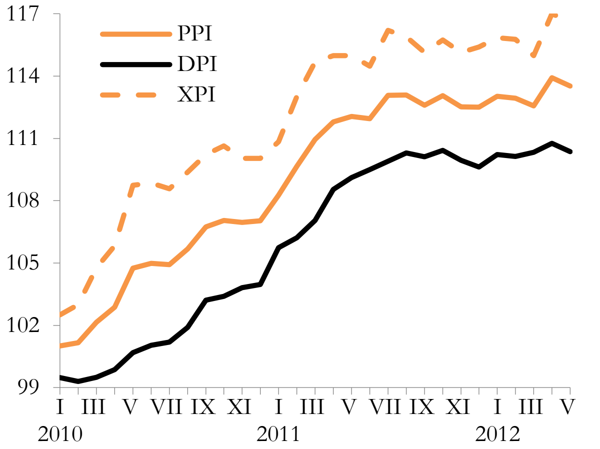


Figure 4.18

Dynamics of Producer Price Changes in Manufacturing

(December 2009 = 100)



PPI – producer price index
DPI – producer price index for products sold in the domestic market
XPI – producer price index for exported products

Slightly over 60% of manufacturing products is being exported, therefore the overall dynamics of producer prices is to a great extent affected by fluctuations of producer prices for exported products. Yet, prices for exported products are mainly determined by the halt in price increase in the world markets for the main export goods of Latvia, including wood and timber products, metal articles and food. The rise in prices for products sold in the domestic market was affected by the stabilising domestic demand.

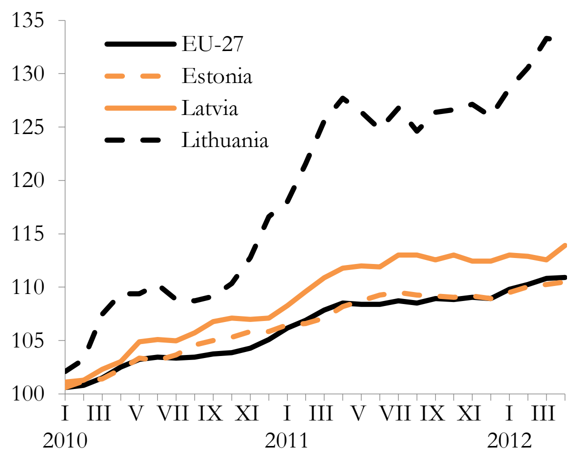
In 2012, producer prices increased along with the increasing demand in the domestic market – in May 2012 compared to May 2011, prices have increased by 2.6%. Within a year, producer prices for products sold in the domestic market have significantly increased for the following products – by 6.3% for electricity, gas supply and air conditioning, by 1.7% for production of food products, by 6.5% for production of non-metallic minerals and by 8% in mining and quarrying.

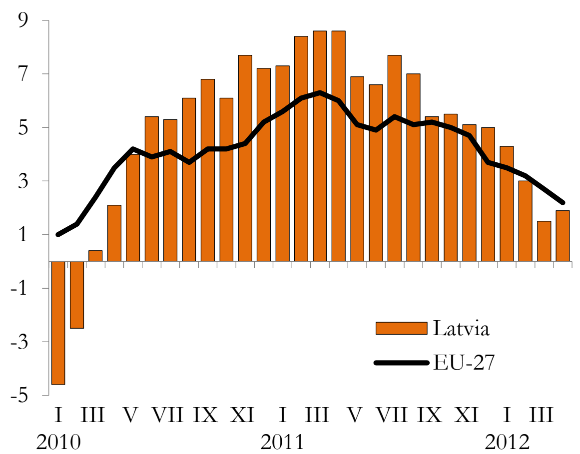
Yet, producer prices for exported products are determined to a great extent by the weakening overall demand in the key sales markets. In May 2012, as compared to May 2011, producer prices for exported products have not changed basically (increase by 1.1%).

Figure 4.19

Producer Price Index by Months in Manufacturing

December 2009 = 100	Changes in comparison with the corresponding period of the previous year,%





The overall producer price level in Latvian manufacturing in May 2012 compared to May 2011, has increased by 1.2%. After the rapid increase in producer prices in 2010 and the first half of 2011, producer price changes in general were moderate further on. Whereas the first months of 2012 brought different tendencies in producer price changes in exported products and products sold in the domestic market.

Overall, the producer prices in the EU stabilised in 2010 and continued rising in the first half of 2011, however the producer prices began declining in the mid-2011 also in the European countries. It was mainly based on the decrease in food and agricultural prices, as well as on the decrease in prices for raw materials and metals, which to a certain extent was due to the decreasing demand worldwide in relation to the escalating debt crisis in the euro zone, worsening economic situation in the USA, as well as slowdown of the world trade growth rate, and uncertainty about expected fiscal consolidation in the majority of developed countries.

Overall, in early 2012, producer prices in the EU are growing at a moderate pace.

If comparing the Baltic States, the most rapid increase of the producer price index in 2011 was observed in Lithuania, the most moderate – in Estonia.

In general, at the beginning of 2012, slightly higher increase in producer prices has been observed in

Lithuania, whereas the tendency of increase is similar in Latvia and Estonia.

4.2.3. Foreign Trade Unit Value Indices

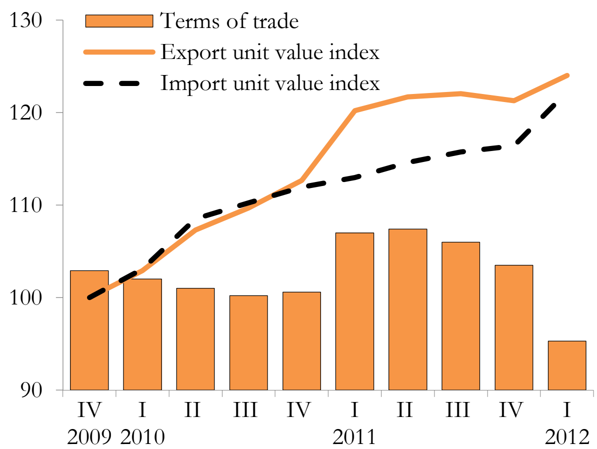
At the beginning of 2011, in comparison with the respective period of the previous year, the terms of trade improved considerably as import prices increased at almost half the speed as those of export. Taking into account the rapid increase in the unit value, at the beginning of 2012 the terms of trade have worsened and in the 1st quarter of 2012 compared to the respective period of 2011, the unit value for exported goods increased by 3.1% and that of imported goods – by 8.2 percent.

The average export unit value level in the 1st quarter of 2012 was mainly raised by the increase in the unit value for mineral products, textiles and textile articles, as well as for vegetation and animal products, while plastic, rubber products and their articles had the highest impact in a year. The unit value increase for electric equipment, transport vehicles, plastic, rubber products, as well as vegetation products had the biggest impact on the average unit value level.

Figure 4.20

Export and Import Unit Value Indices and Terms of Trade

(export and import unit value indices 4th quarter of 2009 = 100; terms of trade, % to the respective quarter of the previous year)

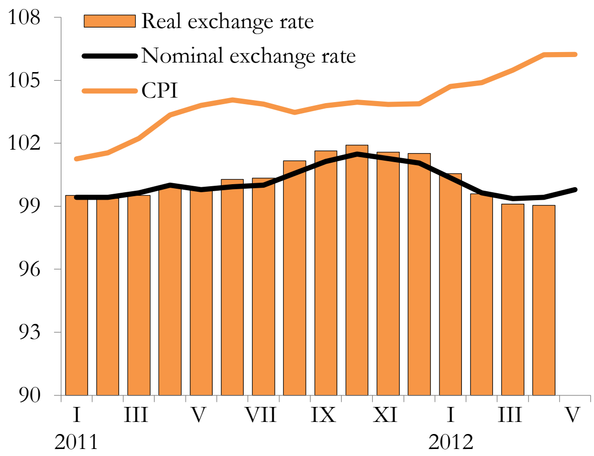


As competiveness of Latvian entrepreneurs improved, the real effective exchange rate of the Latvian lats continued decreasing in 2010 and at the beginning of 2011. Despite the slight increase at the end of 2010 and in April 2011, generally it is at a low level. At the beginning of 2011, the decrease of the real effective exchange rate of the lats has been determined by the low nominal effective exchange rate of the lats, but at the end of the year, the increase of the real effective exchange rate of the lats was determined by the rise in consumer prices (see also Chapter 4.4.1). As the nominal effective exchange rate continues decreasing also at the beginning of 2012, it can be concluded that the competiveness of Latvian entrepreneurs is maintained.

Figure 4.21

Effective Exchange Rate of the Lats*

(December 2010 = 100)



* Effective exchange rate of the lats has been calculated in relation to the main trading partner countries. The real exchange rate has been calculated by applying the consumer price index.

4.3. Balance of Payments

4.3.1. Current Account

The adjustment in the current account caused by the global crisis is over. As the economic situation has stabilised, the surplus of the current account, which reached the highest level ever in the 2nd quarter of 2009, namely 13.6% of GDP, is gradually decreasing, and in the 4th quarter of 2010, there was a slight deficit in the balance of the current account (0.8% of GDP). The total balance of the current account was still positive in 2010 (3% of GDP).

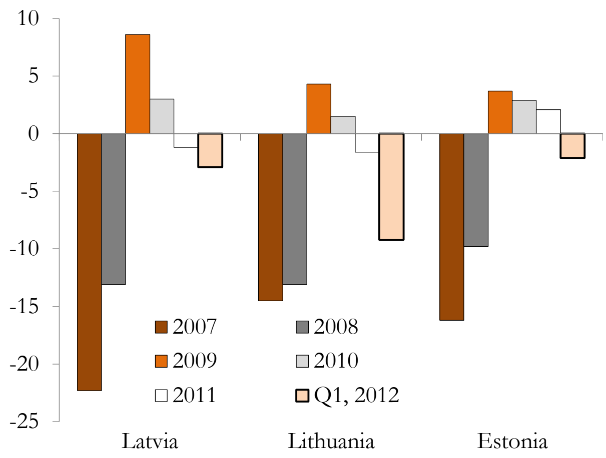
In the first half of 2011, the balance of the current account was close to zero (0.7% of GDP in the 1st quarter and -1.1% of GDP in the 2nd quarter). In the 3rd quarter of 2011, the negative balance of the current account increased to 5.3% of GDP, mainly due to the increase in foreign trade deficit. Yet, in the 4th quarter, the foreign trade balance improved and the current account was positive again (1.2% of GDP). In total, there was a slight deficit in the balance of the current account in 2011 – 1.2% of GDP.

Similar trends were observed also in the dynamics of the current account of our neighbouring countries. Lithuania and Estonia, like Latvia, experienced a rapid correction of external imbalances due to the financial crisis.

Figure 4.22

Current Account Balance in the Baltic States

(% of GDP)



In the 1st quarter of 2012, the balance of the current account was negative in all Baltic States, in Estonia – 2.1%, in Lithuania – 9.2% and in Latvia – 2.9% of GDP.

Changes in the current account balance of Latvia in 2010 were mainly related to changes in the income balance sheet items and less to changes in the foreign trade balance sheet items. Yet, changes in the current account situation in 2011 and in the 1st quarter of 2012 are mainly related to the dynamics of exports and imports of goods.

Along with increasing economic activities, the dynamics of imports are accelerating. In 2011, imports in current prices increased by 30.5%, but exports increased by 25.7%, while foreign trade deficit reached 9.9% of GDP, which was by 3 percentage points higher than a year ago, though considerably lower than before the crisis (in 2007 – 24%). In the 1st quarter of 2012 compared to the previous quarter the deficit of the foreign trade balance increased by 2.8 percentage points as export volumes increased faster than import volumes.

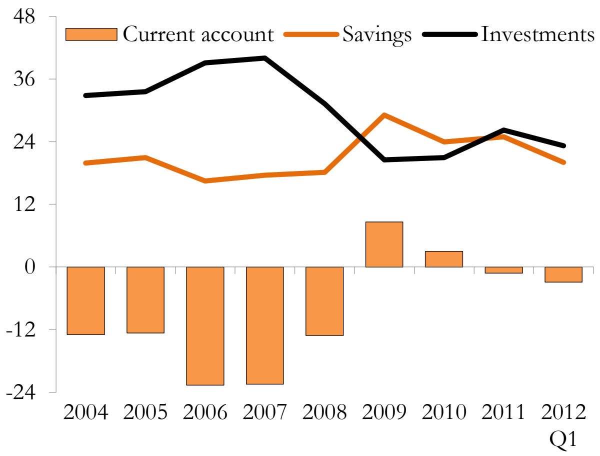
The balance of services is positive and has been growing in the past few years, covering over a half of the foreign trade deficit.

Significant changes were observed in the income balance of the current account. The balance has been positive for seven successive quarters since the 4th quarter of 2008 mainly in relation to the losses of foreign investors due to the crisis. As the economic situation improved, the surplus of income balance decreased and has become negative again since the 3rd quarter of 2010. In 2011, the income balance deficit was 0.9% of GDP. The decrease of the positive income balance in the 1st half of 2010 was due to a decrease in losses of non-resident enterprises, as well as due to a significant increase in the amount of paid dividends. The increase of income balance deficit was related to the increase of non-resident investment income including an increase in the amount of non-residents' paid dividends.

Figure 4.23

Current Account, Investments and Savings

(% of GDP)



As the capital inflow drained away due to the impact of the global financial crisis, also investments and savings went through significant adjustments.

The inflow of foreign capital until 2007 positively affected investments on the one hand, but on the other hand it became a substantial factor for decreasing the level of savings. In 2007, the investment level increased from 33% to 40.4%, but the level of savings decreased from 20.2% to 18.1% compared to 2004, ensuring less than a half of domestic investment financing.

As the conditions in the global financial markets deteriorated, the situation changed drastically. A high debt burden, decrease of economic activities and income, as well as uncertainty about the future development fostered thrift of households. Along with the increase in the level of savings, the investments are decreasing rapidly. In 2009, the share of investments in GDP was 20.4%. However, the level of national savings in 2009 was 30% of GDP. The level of savings exceeded the level of investments also in 2010, though this difference has decreased mainly due to the decreasing level of savings. Yet, the deteriorating balance of the current account in 2011 was mainly related to a more rapid increase in investments while savings remained at the level of the previous year.

Table 4.6

Balance of Payments of Latvia
(% of GDP)

	2008	2009	2010	2011	2011 Q1	2012 Q1
A. Current account	**-13.1**	**8.6**	**3.0**	**-1.2**	**0.7**	**-2.9**
Trade balance	-17.8	-7.1	-7.1	-9.9	-8.6	-11.7
Exports	*28.5*	*28.4*	*37.9*	*42.9*	*44.5*	*44.6*
Imports	*-46.3*	*-35.5*	*-45.0*	*-52.8*	*-53.1*	*-56.3*
Balance of services	4.0	6.0	6.1	6.6	6.5	7.5
Net revenues	-1.6	6.3	0.3	-0.9	-0.3	-1.7
Current transfers, net	2.2	3.4	3.6	3.1	3.2	3.0
B. Capital account	**1.5**	**2.4**	**1.9**	**2.1**	**0.1**	**0.0**
C. Financial account*	**11.5**	**-6.9**	**-1.5**	**-4.8**	**-9.8**	**14.4**
Direct investments	3.0	0.6	1.5	5.2	5.8	3.1
Abroad	*-0.7*	*0.2*	*-0.1*	*-0.3*	*-0.5*	*-0.7*
In Latvia	*3.8*	*0.4*	*1.6*	*5.5*	*6.2*	*3.8*
Portfolio investments**	0.8	2.3	-1.8	-1.8	-9.9	5.4
Assets	*1.8*	*3.2*	*0.3*	*-1.6*	*-6.7*	*-8.3*
Liabilities	*-1.0*	*-0.9*	*-2.1*	*-0.2*	*-3.2*	*13.6*
Other investments	7.6	-9.8	-1.1	-8.2	-5.6	6.0
Assets	*-1.4*	*-4.0*	*-3.7*	*-2.5*	*11.6*	*-1.8*
Liabilities	*9.0*	*-5.8*	*2.5*	*-5.7*	*-17.2*	*7.8*
D. Net errors and omissions	**-1.8**	**0.8**	**-0.5**	**-0.6**	**2.0**	**-1.6**
E. Reserve assets	**2.0**	**-5.0**	**-4.0**	**4.5**	**7.1**	**-9.9**

* excluding reserve assets
** portfolio investments and derivative financial instruments

4.3.2. Financial Flows

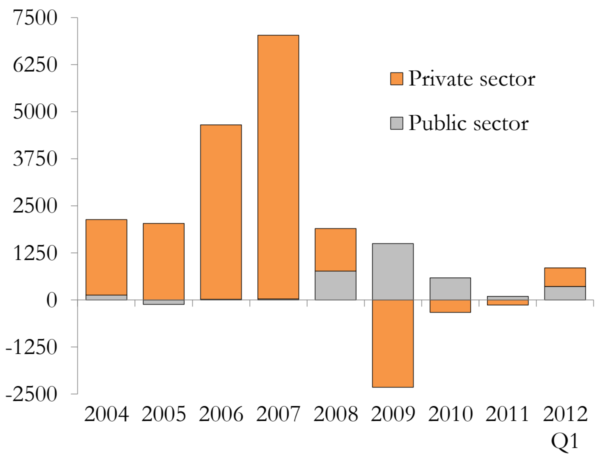
Since 2009, financial account of the balance of payments (excluding reserve assets) is negative and its fluctuations by quarters still are rather significant. The state of the financial account is mainly determined by the decreasing debt commitments of private sector (commercial banks) and long-term loans of public sector.

During the previous years, foreign investments were mainly attracted by the private sector. Since 2004, the volume of foreign investments has grown rapidly and in 2007 compared to 2004 had increased almost 3.5 times. The unfavourable conditions in global financial markets weakened the intensity of the foreign investment flow. Volumes of private capital inflow decreased rapidly in 2008 (almost 7 times lower than in 2007), but since the 4th quarter of 2008, outflow of private foreign capital was observed. Outflow of private foreign capital in 2009 intensified and was almost 2 times higher than the inflow in 2008.

In general, the decrease in liabilities of the financial account was more moderate in 2010 than it was in the two previous years, however, in the 3rd and 4th quarter of 2010, for the first time since the end of 2008, capital inflow into the private sector was observed and it was influenced by the increase of reinvested profit and extensive investments in the banking sector.

Figure 4.24

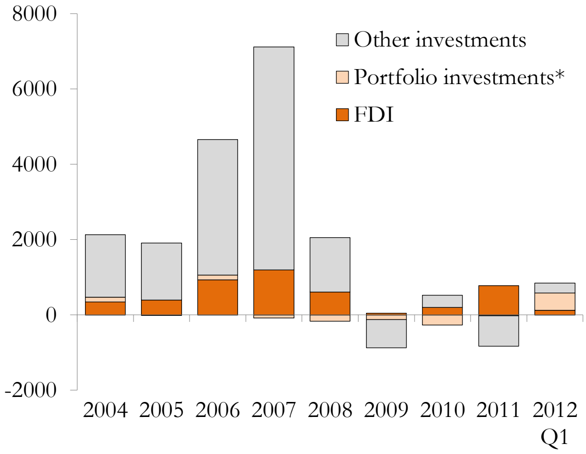
Inflow of Foreign Investments in the Economy of Latvia
(million LVL)



In the 1st quarter of 2011, the foreign private capital flows were negative due to the increase in external assets of the banking sector mainly in portfolio investments, but liabilities of the financial account increased in the 2nd and the 3rd quarter due to the impact of foreign direct investments in equity capital of enterprises, while in the 4th quarter, the private capital flows were negative due to asset increase and liabilities decrease in the banking sector. In general, the deficit of the financial account balance was 4.8% of GDP in 2011. In the 1st quarter of 2012, public debt commitments increased considerably, thus influencing the positive balance of financial account (14.4% of GDP).

Figure 4.25

Inflow of Foreign Investments in the Economy of Latvia by Types of Investments
(million LVL)



* portfolio investments and derivative financial instruments

With the change of the dynamics and direction of foreign capital flow, its structure is also changing.

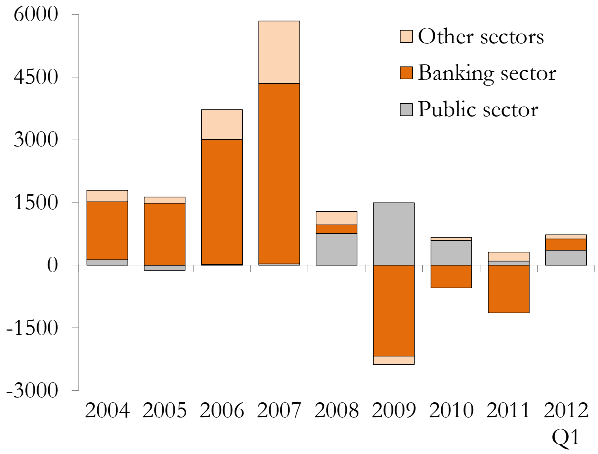
During the period of 2005-2007, the foreign direct investments (FDI) in the inflowing foreign capital structure on average constituted almost 20%. In comparison with 2004, the volume of FDI has tripled, but in 2008 compared to 2007, the FDI stock decreased by almost a half and covered 30% of the negative current account balance. In 2009, the incoming FDI flows were only 7.8% of the indicator of the previous year.

In 2010, the amount of incoming FDI flows was four times higher than in 2009 and constituted almost 1/3 of foreign investments attracted to the Latvian economy in 2010. In 2011, the volume of incoming FDI was almost four times higher than in 2010. In the 1st quarter of 2012, inflow of FDI was by 33% lower than a year ago.

The share of portfolio investments in the incoming financial flows is small and has not been exceeding 10% of these flows over the last three years. In 2010 and 2011, the balance of portfolio investments was negative, which was mainly due to the increase of foreign assets in the banking sector in the form of portfolio investments. Yet, the balance of portfolio investments was positive in the 1st quarter of 2012 mainly due to the increase in public debt commitments.

Figure 4.26

Incoming Foreign Investment Flows by Sectors*
(million LVL)



* excluding foreign direct investments

Significant fluctuations are observed regarding other investments that until 2008 formed a large part of the total foreign investments. These are trade loans, loans and borrowings, cash and deposits, etc. As a result of the global financial crisis, a decrease of short-term flows was observed in 2008, but in 2009 flows of other investments were negative (-9.8% of GDP), mainly at the expense of the rapid decrease of foreign liabilities of the banking sector.

In 2010, the negative balance of other investments decreased and was only 1.1% of GDP determined by the decrease of long-term government loans and debt commitments of banks.

In 2011, the negative balance of other investments increased reaching 8.2% of GDP. The fluctuating indicator of the balance of other investments was mainly influenced by the decreasing deposits in the banking sector. In the 1st quarter of 2012, the balance of other investments was positive.

In general, it should be noted that currently fluctuations of financial flows depend mostly on stabilization measures of the financial sector.

The data of the international investment balance of Latvia shows that the government gross external debt was LVL 5016.7 million (34.6% of GDP) at the end of March 2012. The government external debt has increased by 19.8% in comparison with the end of the 1st quarter of 2011. At the same time, it should be noted that the total Latvian gross external debt was 145.3% of GDP at the end of March 2011, which is by almost 12.6 percentage points lower than a year ago.

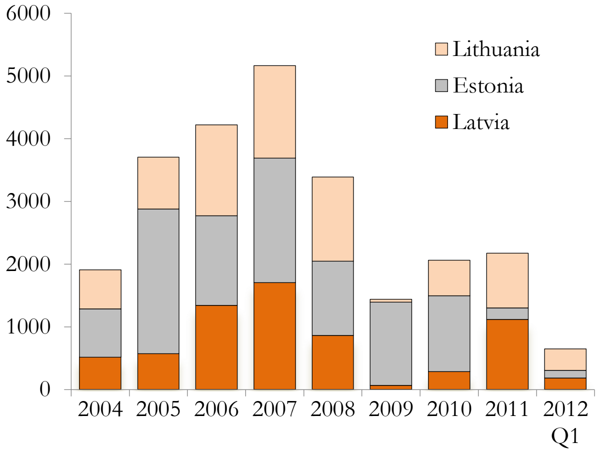
4.3.3. Foreign Direct Investment

The intensity of FDI flows had significantly decreased due to the global financial crisis, but had been growing in the past few years. At the same time, it should be noted that all in all FDI flows remained positive during the recession years, thus proving the trust of foreign investors in the implemented economic stabilization policy.

In the first years of the crisis, a decrease of FDI inflow was observed also in all Baltic States. In Estonia, the volume of incoming FDI in 2009 was only by 8.6% lower than in 2008, and it was due to the significant investments in the financial intermediation sector, while in Lithuania and Latvia they were respectively by 80% and 94% lower, than a year ago. However, flows of incoming FDI have been growing since 2010. If compared to the previous year, the volume of FDI increased by 43.3% in all Baltic States, while in 2011 it was by 5.4% higher than in 2012. It should be noted that in 2011 Latvia has attracted a half of the incoming FDI in the Baltic States.

Figure 4.27

Inflow of FDI in the Baltic States
(million EUR)



The activities of Latvian investors abroad have been increasing since 2010. Foreign direct investments of Latvian entrepreneurs have been four times higher in comparison with 2010.

The structure of the incoming FDI shows that since the 4th quarter of 2008 until the 2nd quarter of 2010, direct investment enterprises have been operating with losses. In 2009, they reached LVL 1094.5 million (EUR 1542 million). Losses of the foreign direct investment enterprises were fully compensated by investments in equity capital and other capital, therefore the incoming FDI flows were positive in 2009 (LVL 47.5 million). In the 1st half of 2010, investments in equity capital were slightly lower than the losses of the direct investments of enterprises, thus resulting in still negative incoming FDI flows.

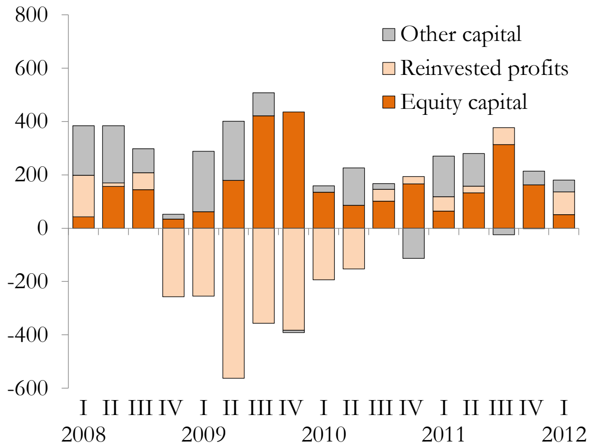
FDI flows experienced a rapid increase along with the economic recovery. The amount of incoming FDI in 2010 was fourfold the FDI in 2009, while in 2011, FDI flows exceeded the indicator of the previous year almost four times and reached 5.5% of GDP. Also in the 1st quarter of 2012, the level of incoming FDI remained rather high.

According to the international investment balance of Latvia, the FDI stock in the economy of Latvia reached LVL 6567 million (EUR 9344 million) at the end of the 1st quarter of 2012 which is by 10% more than at the end of the 1st quarter of 2011. The share of FDI in the structure of foreign capital stock constituted 25.4 percent.

The global financial crisis did not affect the geopolitical structure of foreign capital stock of Latvia. Mainly these are investments of the EU Member States. At the end of March 2012, the FDI of the EU Member States constituted 71.7% of all FDI stock, a fifth of them are investments of the new EU Member States, and almost a half of them are investments of the euro zone countries.

Figure 4.28

Foreign Direct Investments in Latvia
(received during the quarter, million EUR)

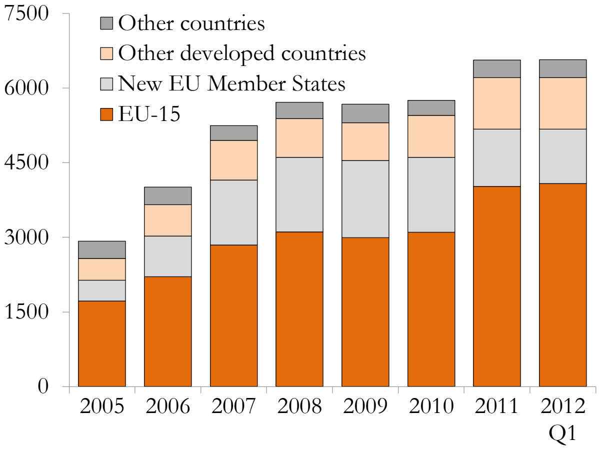


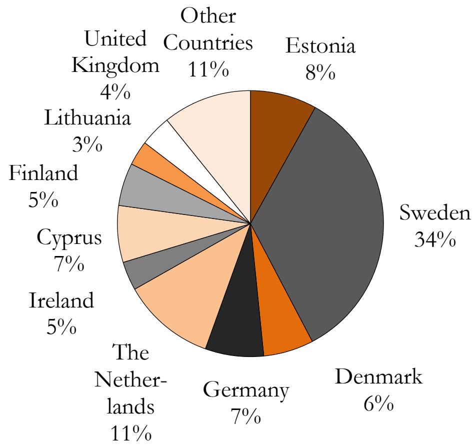
Sweden is the biggest investor country in the economy of Latvia. At the end of March 2012, investments of Sweden constituted almost 25% of the total FDI stock. Mainly they are investments in financial intermediation (85% of all FDI stock in the sector). Since the end of the 1st quarter of 2011, direct investments of Sweden have almost tripled which is mainly due to mutual transactions between Estonian and Swedish owners in the banking sector. At the same time, the direct investment stock of Estonia in Latvia decreased by 56% and constituted 5.8% of the total FDI stock at the end of March 2012 (at the end of March 2011 – 14%). Large investments have been made also by entrepreneurs from Denmark, the Netherlands, Germany, Finland, Russia and Cyprus. Investment volumes of these countries at the end of March 2012 constituted almost 60% of the total FDI stock in the economy of Latvia.

Figure 4.29

FDI Stock

By Groups of Countries (million LVL, at the end of the period)	FDI of EU Member States (percent, at the end of March 2012)





The FDI are focused mainly in services sectors.

Until 2008, the growth rates of the FDI in services sectors were almost one and a half times faster than in manufacturing sectors. However, in 2009 and 2010, the foreign direct investment increased faster in manufacturing sectors (by 6.6% and 10.6%, respectively), while the level of the FDI stock in services sectors remained unchanged in 2009, but in 2010 it decreased by 5%. At the end of March 2012, the FDI stock in services sectors constituted 68.1% of the FDI stock in the economy of Latvia.

After accession of Latvia to the EU, foreign investors have made significant investments in the financial intermediation sector, the share of which in the FDI stock increased from 16% at the end of 2004 to 29% at the end of 2008. During the crisis, it decreased and at the end of March 2012, the share of this sector in the amount of FDI stock was 22.6%, while 85% of them were Swedish investments. It should be noted that at the end of March 2012 the FDI stock in financial intermediation sector was by 10% lower than at the end of 2008. The decrease of FDI in this sector was compensated by investments in the real estate sector (by 34%), thus the total level of FDI stock in services sectors has not changed significantly since the end of 2008. Yet, the level of FDI stock in manufacturing increased by 28 percent.

From the end of 2008 until the end of March 2011, a particularly rapid increase of the FDI stock in industry was observed in the energy sector and manufacturing – by 41.1% and 29.5%, respectively. The increase of the FDI stock in manufacturing to a great extent was influenced by substantial investments in production of construction materials (increase by 40.5%) and wood processing (increase by 68.1%). The share of sectors mentioned above in the FDI stock constituted 64.4% in manufacturing at the end of the 1st quarter of 2012 (at the end of 2008 – 55.5%).

Table 4.7

FDI Stock by Sectors
(end of the period, million LVL)

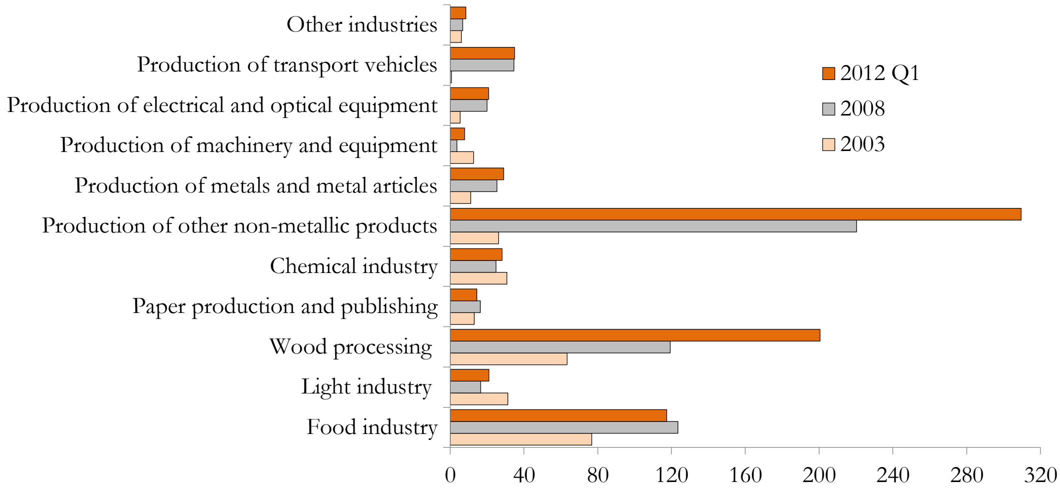
	2004	2007	2008	2009	2010	2011	2012 I
Primary sectors	49.8	113.1	145.2	167.5	207.9	217.2	229.3
Manufacturing	276.1	516.8	611.0	654.5	725.0	809.2	792.5
Energy	164.7	270.7	204.9	190.5	216.0	250.7	289.2
Construction	36.5	85.5	107.1	126.6	109.4	90.6	87.3
Trade	395.7	676.4	862.0	856.5	737.4	889.9	880.5
Transport and communications	333.3	392.5	466.3	428.1	424.7	462.8	496.5
Financial intermediation	375.9	1486.2	1647.3	1645.1	1326.8	1528.8	1483.9
Other services	439.2	1223.5	1251.3	1371.3	1492.1	1682.7	1612.9

In general, by evaluating the FDI structure in manufacturing, it can be concluded that it is constantly changing. In some sectors, like the light industry, the FDI have been decreasing already since 2005, and the main reason for that is loss of competitiveness in foreign markets. The volume of the FDI stock in the light industry in 2010 was by 4.8% lower than in 2008. Similar tendencies are observed in several EU Member States. It should be noted that the FDI in this sector has been growing since the 3rd quarter of 2010. At the end of March 2012, the FDI stock in the light industry increased by 27.3% compared to the end of 2008.

The FDI in food industry decreased during the rapid downturn that was mainly influenced by the low domestic demand. However, as the economic situation has improved in the past few years, the FDI stock has increased and constituted 14.8% of the FDI stock in manufacturing (at the end of 2010 – 13%). The FDI in production of electrical and optical equipment has been increasing since 2010 – by 52.6% at the end of March 2012 compared to the end of 2010.

Figure 4.30

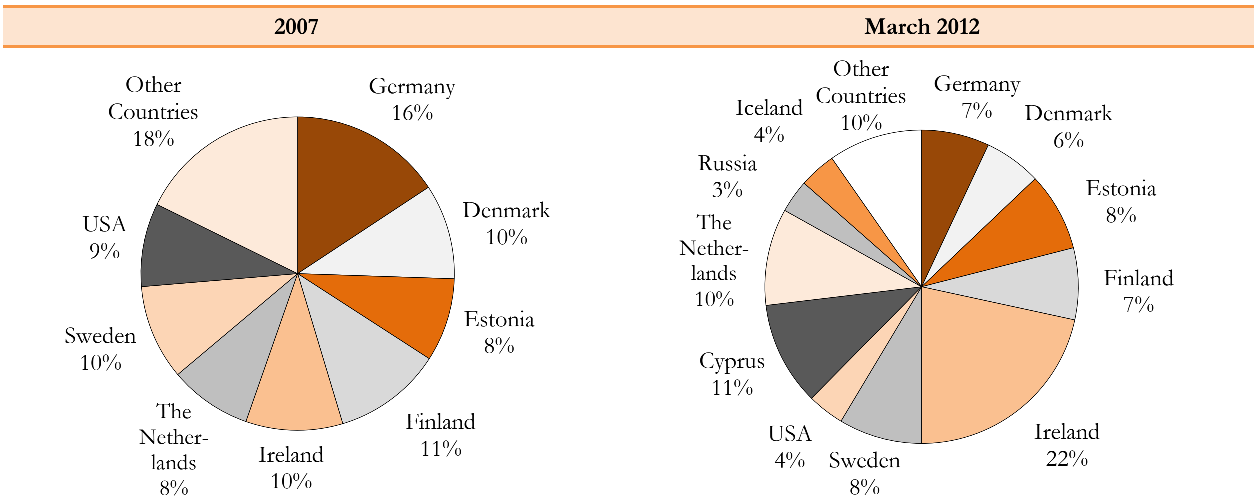
FDI Stock in Manufacturing
(end of the period, million LVL)



At the end of March 2012 compared to the end of 2010, the FDI in production of machinery and equipment decreased significantly (by 72%). The share of this sector in the structure of FDI stock constituted 1% in manufacturing at the end of March 2012 (at the end of 2010 – 3.8%). Changes of the FDI stock in other manufacturing sub-sectors are insignificant.

Figure 4.31

Structure of the FDI Stock in Manufacturing by Countries
(at the end of the period, percent)



By analysing changes of FDI stock in the structure of manufacturing, it can be concluded that the share in high and medium-high technology sectors constituted almost 10% at the end of March 2012 (at the end of 2008 – 11.3%).

Largest investments in manufacturing have been made by investors from Denmark, Finland, Germany, Sweden, Ireland, Estonia, the Netherlands and Cyprus. The investments of the abovementioned countries constituted 80% of the FDI stock in manufacturing. It should be noted that by the end of 2007, none of the countries held the leading position in the structure of the FDI stock in manufacturing. Due to the financial crisis, the situation has changed significantly. At the end of March 2012, the capital of Ireland was dominating in the structure of the FDI stock constituting more than a fifth of the FDI stock in manufacturing, which was greatly influenced by the rapid increase of investments of this country. Entrepreneurs from Cyprus and the Netherlands have also made large investments in manufacturing. Investments of these countries in manufacturing increased 3 times compared to the end of 2008. Yet, the volume of the FDI stock of other largest investor countries has decreased, for example, Germany and Denmark –by 7.4% and 8.6%, respectively, as well as Finland – by 21.6%. At the same time, at the end of March 2012, Russian businessman investment stock in manufacturing increased by 17%, when compared to the end of 2008 and was 3.4% of FDI stock in manufacturing.

The Investment and Development Agency of Latvia (IDAL) plays a significant role in attracting foreign investment. The investment attraction strategy of the IDAL is focused on qualitative maintenance of incoming investment projects and active operations related to attraction of investment projects, by addressing the potential investors.

The IDAL continues developing its range and supply of services on the basis of FDI market needs and ensuring a link between the IDAL and investors. Latvia can offer the investors a favourable geographic location, advantages of natural resources, advantages in the sphere of science, as well as assistance of the IDAL experts in the process of project implementation.

Overall, it should be noted that interest about Latvia as a possible investment destination is increasing as the world recovers from the global economic and financial crisis.

In 2011, incoming investment projects have been successfully serviced – processed 348 investment information requests, which exceed the amount of processed requests of 2010 by 120%. In 2011, the IDAL worked with 55 potential investment projects, as well as launched active post-project monitoring of investors implementing their projects in Latvia (27 projects).

As a result of the abovementioned activities, 17 projects are going to be implemented in Latvia (moreover, 2/3 of investments are focused in manufacturing), among them 10 new projects, for example, "Statoil Fuel and Retail" (Norway), SSC; the United Kingdom, data entry centre; "Baltic Crystal" (Russia), production of semiconductor materials; "SiTDeLa" (Russia), processing silicon waste for electronic industry; the Netherlands, wood processing; "Fiber Optical Solution" (Russia), production of optical equipment; "Libra group" (Greece/United Kingdom), production of energy/biogas; Luxembourg/Belgium, renewable resources, etc. Meanwhile, 7 enterprises already operating in Latvia have made decisions on expanding, among them Ferroplan (Finland, conveyor and warehouse systems), Bucher Schoerling Baltic (Switzerland, street cleaning machines), Malmar Sheet Metal (Belgium, metal parts for engineering industry), AKG Thermotechnik Lettland (Germany, production of radiators/coolers) etc. The implementation of projects is expected to bring investments in the amount of over EUR 70 million, thus creating more than 950 new jobs.

At the beginning of 2012, foreign investors are mostly interested in manufacturing, including they are particularly interested in metal processing and electronics, as well as life sciences and green technologies. While the highest number of requests and projects in the services sector is related to IT, including business services (BPO/SSC). Yet, in terms of investment projects that the IDAL is currently working on, metal processing and electronics are still the leading sectors, as well as IT, including business services (BPO/SSC), as well as green technologies and logistics. It should be noted that in the 1st quarter of 2012, a decision on implementation in Latvia has already been adopted within 3 projects (investors from Germany/Italy will invest in production of sailboats, investor from Germany will invest in production of large surfaces, as well as an investor from the US will invest in wood industry).

The IDAL is working on new investment stimuli for attracting foreign investments, for example, as of January 1, 2011, entrepreneurs are offered corporate income tax relief for large investment projects, as well as grants for creation of new jobs were approved on March 13, 2012.

In order to improve the progress of local and foreign investment projects important for Latvia, the IDAL continues implementing investment attraction methodology *POLARIS* process, which envisages unified and coordinated action of ministries, municipalities, infrastructure enterprises and public institutions in implementation of strategically important local and foreign investment projects, as well as involvement of the private sector, universities and scientific institutions in this process.

In order to ensure coordinated inter-institutional cooperation for successful implementation of investment projects in Latvia in favour of the country, the Coordination Council for Large and Strategically Important Investment Projects established on August 10, 2010 continues working based on the investment attraction strategy POLARIS process developed by the IDAL.

4.4. Financial and Capital Markets

4.4.1. Monetary Policy and Exchange Rate

Like in the case of majority of world's central banks, the main goal of monetary policy also of the Bank of Latvia is to maintain price stability in the country. The Bank of Latvia is independent in making and implementing its decisions, and it is not subordinated to the decisions or instructions of the government or governmental institutions. The Bank of Latvia is under the supervision of the Saeima.

Since February 12, 1994, the Bank of Latvia has been implementing fixed national currency exchange rate policy by pegging the exchange rate of the lats (LVL) to the SDR[1] currency basket (1 SDR = 0.7997 LVL). As of January 1, 2005, the peg of the lats to the SDR was replaced with the peg to the euro (1 EUR = 0.702804 LVL). The change of the lats peg was determined by the plans of Latvia to join the European Exchange Rate Mechanism II (ERM II) and after fulfilment of the required criteria to join the Economic and Monetary Union (EMU)[2]. Joining the EMU means that Latvia will have the same currency (euro) as in other EMU member states and common monetary policy throughout the euro zone implemented by the European Central Bank together with the euro zone central banks, as well as common economic and fiscal policy coordination between member states.

On May 2, 2005, Latvia joined the ERM II with the already existing exchange rate of the lats against euro. Within the framework of the ERM II standard fluctuations of the exchange rate in the amount of +/-15% around the central or peg rate are allowed. However, Latvia commits unilaterally to keep the exchange rate fluctuation margin within +/-1%, retaining the former range of fluctuation band of the lats, which was habitual to the financial market since 1994, when the lats was pegged to the SDR and was kept when the lats was re-pegged to the euro on January 1, 2005. Duration of participation in the ERM II will depend on the capability of Latvia to reach the economic convergence level set by the Maastricht criteria. The Bank of Latvia will continue implementing former policy of fixed exchange rate until the euro is introduced in Latvia.

According to the *Convergence Programme of Latvia for 2011–2014*, the medium-term monetary and exchange rate policy of Latvia to a great extent is related to monetary integration plans – introduction of the euro in Latvia. On March 16, 2010, the Cabinet of Ministers set January 1, 2014, as the target date for the euro introduction by approving the amendments to the *National Plan for the Introduction of the Euro*. On June 7, 2012, the meeting of State Secretaries announced the *Draft Law on the Euro Introduction* defining principles for the euro introduction. The draft law is aimed at ensuring efficient and transparent introduction of the euro in Latvia. It provides a period of simultaneous circulation of lats and euros, a period of time for free of charge change of currency, a period of time for parallel price reflecting, adapting costs of introducing the euro, accounting and credit registers to the introduction of the euro and other activities related to the introduction of the euro.

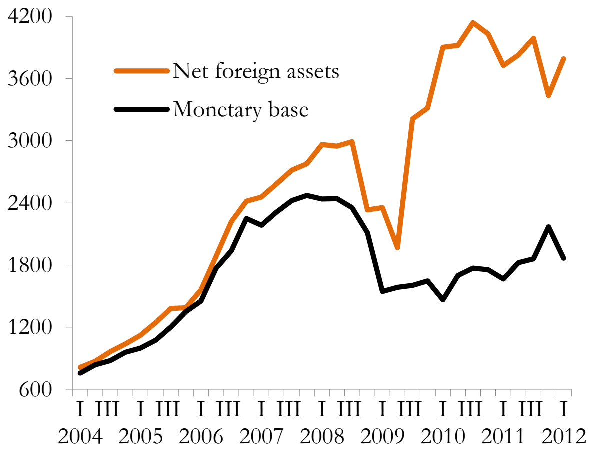
In order to efficiently implement the monetary policy, the Bank of Latvia is adapting the instruments of implementing the monetary policy to the practise of the European Central Bank. The Bank of Latvia is already using the same indirect monetary policy instruments based on free market principles as the European Central Bank, and after joining the EMU in the future, it will be necessary only to review importance of separate instruments in implementation of the monetary policy and procedural elements.

In order to keep a fixed exchange rate, it is necessary to have a sufficient amount of foreign reserves. Net foreign reserves of the Bank of Latvia continuously cover the monetary base of Latvia (see Figure 4.32). Coverage of the monetary base (cash in circulation and deposits in the Bank of Latvia) with net foreign assets was 203.1% at the end of the 1st quarter of 2012.

Figure 4.32

Net Foreign Assets of the Bank of Latvia and Monetary Base, Quarterly Profile

(million LVL, at the end of the period)



Foreign reserves of the Bank of Latvia are administered according to the guidelines developed by the Council of the Bank of Latvia, investing them in safe and liquid financial instruments, mainly in debt securities issued by the governments of the USA, euro zone countries, the United Kingdom and Japan, as

[1] Special Drawing Rights (SDR) – special currency code in accordance with the international currency classifier ISO 4217 – XDR.

[2] Participation in the EMU has been defined in the EU Accession Treaty, but Latvia is allowed to choose the most appropriate time for the euro introduction.

well as by their agencies and international organizations. Foreign reserves of the Bank of Latvia (including gold reserves, foreign convertible currency, and SDR) at the end of May 2012 have decreased in comparison with the end of May 2011 and were USD 7525 million (at the end of May 2010 – USD 6854.5 million).

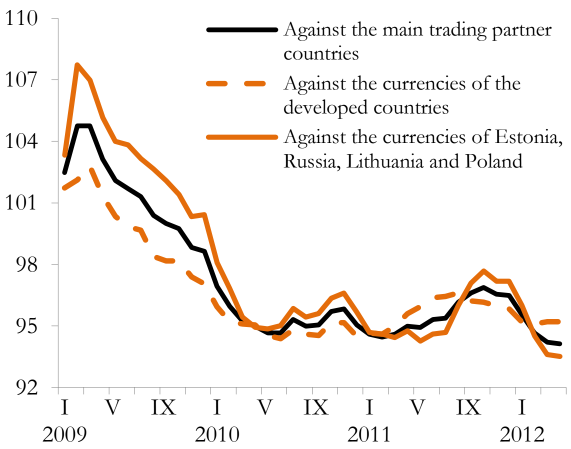
The Bank of Latvia calculates the real effective exchange rate of the lats[1] against the currencies of 13 main trading partner countries of Latvia[2]. It shows the relative export competitiveness of Latvia in the global markets.

An especially rapid increase of the real exchange rate of the lats occurred during the 2nd half of 2008 and at the beginning of 2009, which mainly was related to devaluation of national currencies of the trading partner countries of Latvia. Since March 2009, the real effective exchange rate of the lats decreased gradually due to the decrease of the price level and wages, as well as due to optimizing other production costs. However, since April 2010, the real effective exchange rate showed a moderate tendency to decrease, but since June, when inflation resumed, the real effective exchange rate of lats was increasing, and this tendency continued also in 2011. At the beginning of 2012, the real effective exchange rate was decreasing.

Figure 4.33

Index of the Real Effective Exchange Rate of the Lats*

(December 2006 = 100)



* Calculated using the consumer price index.

[1] The real exchange rate of the lats includes changes of the nominal exchange rate of the lats against the currency of the trading partner countries of Latvia, as well as consumer price changes in Latvia compared with consumer price changes in the trading partner country. The real exchange rate is calculated by dividing the nominal exchange rate index with the ratio of foreign and domestic price indices.

[2] Denmark, Finland, France, Germany, the United Kingdom, Italy, the Netherlands, Sweden and the USA are included in the group of developed countries, while Estonia, Lithuania, Poland and Russia are included in the group of developing countries.

4.4.2. Market Structure and Development

At the end of the 1st quarter of 2012, 21 **banks** operated and 9 branches of foreign banks were registered in Latvia. 12 branches of Latvian banks are operating abroad. Banking services in Latvia can also be provided by credit institutions or their branches, which are registered in the European Economic Area countries and have submitted an application to the Financial and Capital Market Commission (FCMC).

At the end of 2011 and beginning of 2012, several Latvian banks went through structural changes:

- In July 2011, the process of selling the shares of the JSC "Citadele banka" was launched, though it is suspended at the moment until the situation in the international financial markets improves. The JSC "Citadele banka" remains in possession of the current shareholders until further decisions of the shareholders. The decision on suspension of selling has no impact on the operation of the JSC "Citadele banka" and it continues implementing the restructuring plan. The restructuring plan envisages that the state will gradually return the bank to the private sector, however, the plan does not envisage compulsory sale as the state must recover the maximum of the invested financing. At the beginning of 2012, the JSC "Citadele banka" has made advance repayment of its entire term deposit EUR 203.7 million to the state of Latvia. The JSC "Citadele banka" has paid an interest in the amount of EUR 14.7 million to the state within the time period from August 2010 until February 2012. At the beginning of 2012, the Bank of Latvia included the interbank interest bid rate RIGIBID and RIGIBOR of the JSC "Citadeles banka" in the calculation;
- On December 23, 2011, the JSC "Latvijas Krājbanka" was declared insolvent, and on May 10, 2012 a decision was adopted to cancel the licence (permit) for credit institution activity issued to the JSC "Latvijas Krājbanka". The decision was adopted based on the decision of the Riga Regional Court of May 8, 2012 on initiating the insolvency procedure;
- On March 15, 2012 a decision was made to cancel the licence for credit institution activity issued to the JSC "Parex banka" and to permit to reorganize the bank by registering it as a commercial company that is in no way related to credit institution activities. Such a decision was made based on the request of the JSC "Parex banka" to cancel the licence for credit institution activity issued to the bank. On May 8, 2012 after changing the status and the name, the JSC "Parex banka" started working as a professional distressed asset management company – the JSC "Reverta". With its asset

portfolio in the amount of nearly one billion, "Reverta" is the largest manager of distressed assets in the Baltic region.

In the 1st quarter of 2012, performance indices of all Latvian banks complied with the regulatory requirements. Liquidity ratio of banks was 63.2% (minimum regulatory requirement is 30%) and in comparison with the corresponding period of 2011 it has slightly decreased. It was mainly based on the suspended activity of the JSC "Latvijas Krājbanka".

Like in 2011, also at the beginning of 2012, all 16 Latvian banks and 6 foreign bank branches operated with profit, and overall in the 1st quarter 2012 the banking sector operated with profit of LVL 38 million.

In the 1st quarter of 2012, the average banking sector capital adequacy ratio continued increasing and reached 18.1% (minimum regulatory requirement is 8%). Both the return on assets (ROA)[1] and the return on equity (ROE)[2] of banks have increased and were 1% and 10.9%, respectively (in the 1st quarter of 2011 ROA – 0.6% and ROE – 7.2%).

In 2011, 12 **insurance companies**, 3 of which offered life insurance and 9 – non-life insurance, as well as 10 branches of foreign insurance companies operated in Latvia.

In 2011 compared to 2010, the amount of gross premiums signed by insurance companies has increased by 19.3%, but the amount of paid gross compensations has increased by 12.5%. In 2011, life insurance companies operated with losses of LVL 2.6 million, while non-life insurance companies operated with profit of LVL 741 thousand.

Since 2010, the situation in the **Latvian securities market** has significantly improved, yet, at the end of the 1st quarter of 2012, the situation slightly deteriorated and the OMX Baltic Benchmark index value was 470.5 points which is by 12.6% lower than in the corresponding period of 2011. The downturn of the Baltic stock market is caused to a great extent by instabilities in the euro zone and the negative impact of the global stock market and not on companies' performance. NASDAQ OMX Riga index value also decreased and was 391.4 points which is by 4.5% lower than in the corresponding period of 2011. In some sectors it is due to the increase in production costs. NASDAQ OMX Riga experienced the smallest drop within a year among all Baltic stock exchange markets.

In the 1st quarter of 2012, the amount of central government debt securities in bank assets has increased by 4.5% compared to the corresponding period of 2011 mainly due to the increase in the amount of foreign central government securities by 26.8%, whereas the amount of Latvian central government securities has decreased by 15.7%. Out of other securities, shares and other variable-yield securities experienced the most rapid increase (by 105.9%).

On February 14, 2012, Latvia successfully emitted 5-year bonds in the amount of USD 1 billion with the fixed interest (coupon) rate set at 5.25% a year (profitability 5.37%). The emission was implemented according to the national borrowing strategy, thus fully attracting the annual planned emissions to the external financial markets to refinance the international borrowing programme. The transaction involved a wide range of investors from the USA, Europe, including London and Asia, thus achieving diversification of investors in external markets. This proves confidence of foreign investors in external markets.

4.4.3. Assets, Deposits and Loans

At the end of the 1st quarter of 2012, **bank assets** of Latvia were LVL 20.2 billion, which is by 4.9% less than in the corresponding period of the previous year. Bank loans constituted the largest part of bank assets (60.9%).

The amount of currency in circulation has considerably increased constituting LVL 1021.2 million in circulation at the end of the 1st quarter of 2012, which is by 28.4% more than in the corresponding period of 2011.

At the end of the 1st quarter of 2012, the balance of private and corporate deposits attracted by banks decreased by 2.5% in comparison with the corresponding period of the previous year.

At the beginning of 2012, changes of the deposit currency structure continued. At the end of the 1st quarter of 2012, the amount of residents' deposits in lats decreased by 2.7% compared to the corresponding period of 2011. The residents' deposits in USD have increased by 15% during this period. Unlike the end of the 1st quarter of 2011, when the majority of deposits were in euro, in the 1st quarter of 2012, the biggest part of residents' deposits was in lats (48.2%). The residents' deposits in euro decreased from 49.3% at the end of the 1st quarter of 2011 to 43.4% at the end of the 1st quarter of 2012.

Taking into account that loans are repaid faster, the balance of bank **loans** granted to residents still continues decreasing. The balance of loans granted to residents' financial institutions, non-financial corporations and households decreased by 11% at the end of the 1st quarter of 2012 in comparison with the corresponding period of the previous year.

In the 1st quarter of 2012, the banking sector has issued in total 20.5 thousand new loans in the amount of LVL 217.7 million to residents which is by 88.7% less than in the corresponding period of the previous year. Overall in 2011, about 139.8 thousand new loans in the total amount of LVL 1.1 billion have been issued to residents.

[1] ROA – ratio of profit/loss to assets.
[2] ROE – ratio of profit/loss to capital and reserves.

Table 4.8

Monetary Indicators of the Latvian Banking System

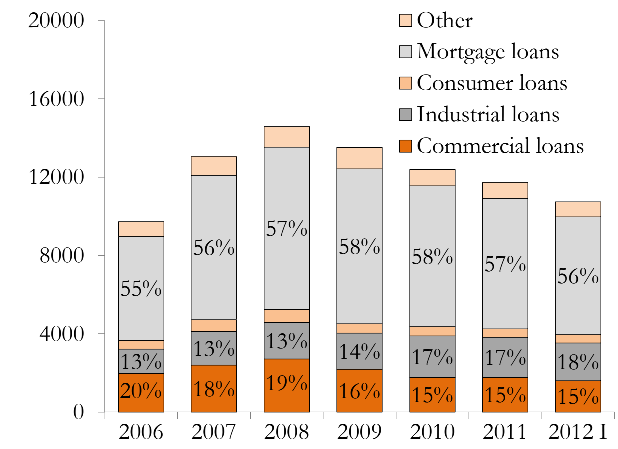
	2007	2008	2009	2010	2011	2012 I
at the end of the period, million LVL						
Net foreign assets	-4482.8	-5914.6	-3022.0	-1219.8	-224.8	-131.4
Net domestic assets	10 654.0	11 846.1	8842.3	7609.8	6710.9	6554.7
Domestic loans	13 018.2	14 279.7	12 204.3	11 215.1	11 045.4	10 072.1
to the government (net)	-87.4	-370.0	-1474.6	-1430.8	-663.8	-1021.8
to companies and individuals	13 105.6	14 649.7	13 678.9	12 645.9	11 709.2	11 093.9
Other assets (net)	-2364.2	-2433.6	-3362.0	-3605.3	-4334.5	-3517.4
Broad money M2X	6171.3	5931.4	5820.3	6390.0	6486.1	6423.4
Cash in circulation (without vault cash balance)	900.0	866.1	667.3	807.4	1040	1021.2
Deposits of individuals and companies	5271.3	5065.3	5153.0	5582.7	5446.1	5402.2
including:						
overnight deposits	2864.9	2308.0	2206.2	2782.1	3109.2	3058.9
time deposits	2406.4	2757.3	2946.8	2800.6	2336.9	2343.3
changes in comparison with the corresponding period of the previous year, %						
Domestic loans	31.8	9.7	-14.5	-8.1	-1.5	-9.0
including:						
to companies and individuals	34.0	11.8	-6.6	-7.6	-7.4	-10.0
Broad money M2X	12.6	-3.9	-1.9	9.8	1.5	1.3
Cash in circulation (without vault cash balance)	-7.1	-3.8	-23.0	21.0	28.8	28.4
Deposits of individuals and companies	16.9	-3.9	1.7	1.1	-2.5	-2.5
GDP (in current prices)	**32.3**	**9.3**	**-18.7**	**-2.5**	**11.2**	**11.1**

In the 1st quarter of 2012, a half of the loans in the economy have been granted to the transport and storage sector and 15.1% – agriculture, forestry and fishery sector, but in terms of the amount, 1/3 of all new loans (49.5 million) within the economy have been granted to the transport and storage sector and 21% – financial and insurance operations.

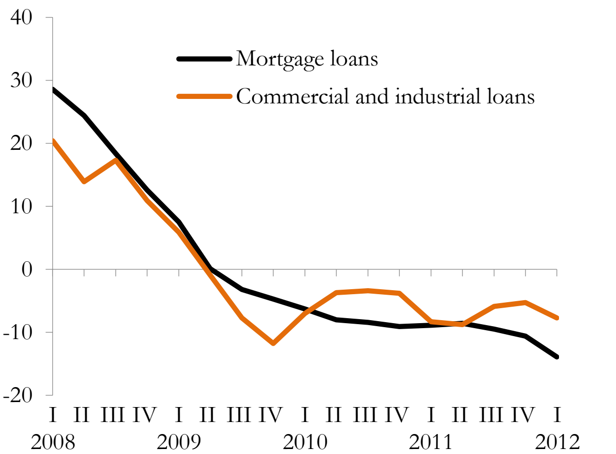
Like before, in the 1st quarter of 2012, mortgages dominate in the structure of loans granted to domestic companies and individuals. The share of mortgages in the total loan structure is 56%. The share of commercial loans and industrial loans in the total loan structure has increased to 32.9%, which is the highest indicator since 2006, when the share of commercial loans and industrial loans was 33.2 percent.

Figure 4.34

Amount and Structure of Loans Granted to Resident Financial Institutions, Non-Financial Corporations and Households
(end of the period, million LVL)



Loans Granted to Resident Financial Institutions, Non-Financial Corporations and Households
(changes in comparison with the respective quarter of the previous year, %)



The balance of granted mortgage loans still continues decreasing and in the 1st quarter of 2012 has shrunk by 13.9% in comparison with the corresponding period of the previous year.

Consumer crediting is showing positive tendencies – at the end of the 1st quarter of 2012, the balance of consumer loans decreased only by 4.8% in comparison with the corresponding period of the previous year, which is much more moderate than before.

At the beginning of 2012, the balance of industrial and commercial loans decreased by 7.7%, when compared with the according period of the previous year.

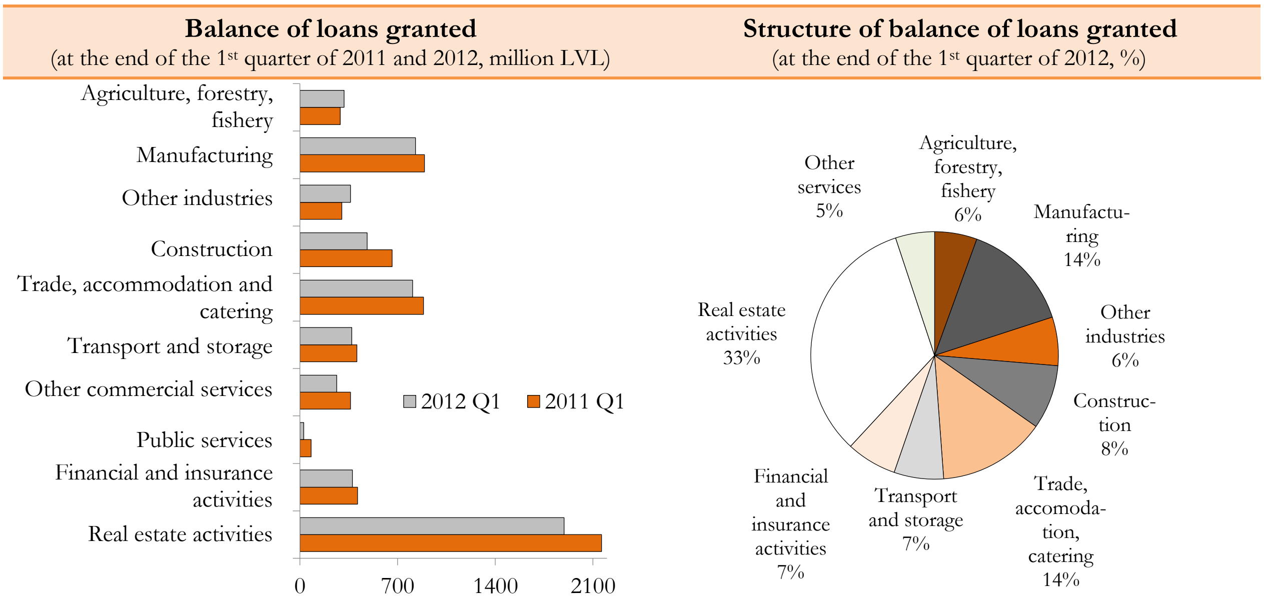
In 2012, the amount of loans granted to residents (financial institutions, private and public non-financial corporations) **in the economy** in general constituted LVL 5734.5 million which is by 11.2% less than in the corresponding period of 2011. The most rapid decrease in the balance of granted loans has been observed for public services (by 64.4%) determined by the decrease in the balance of loans in public administration and defence (by 98.6%). The balance of loans granted to construction and other commercial services decreased by almost one third. Yet, the balance of loans granted to agriculture and other industries (mainly water supply and waste management) has increased.

The largest share of loan balances is still related to real estate operations (33% of the total loans granted to the sectors of the economy). A relatively high share of granted loans is also observed in manufacturing (14%), trade, accommodation and catering sectors (14%), as well as construction sector (8%).

9.6% of all loans granted to residents are loans in lats. The majority of loans (84.7%) are granted in EUR. The amount of these loans has decreased by 15.3% in the 1st quarter of 2012 compared to the corresponding period of 2011, while the amount of loans granted in lats has increased by 22.4%, as the LVL interest rates came closer to the euro rates.

Figure 4.35

Loans to Residents by Sectors of Economy



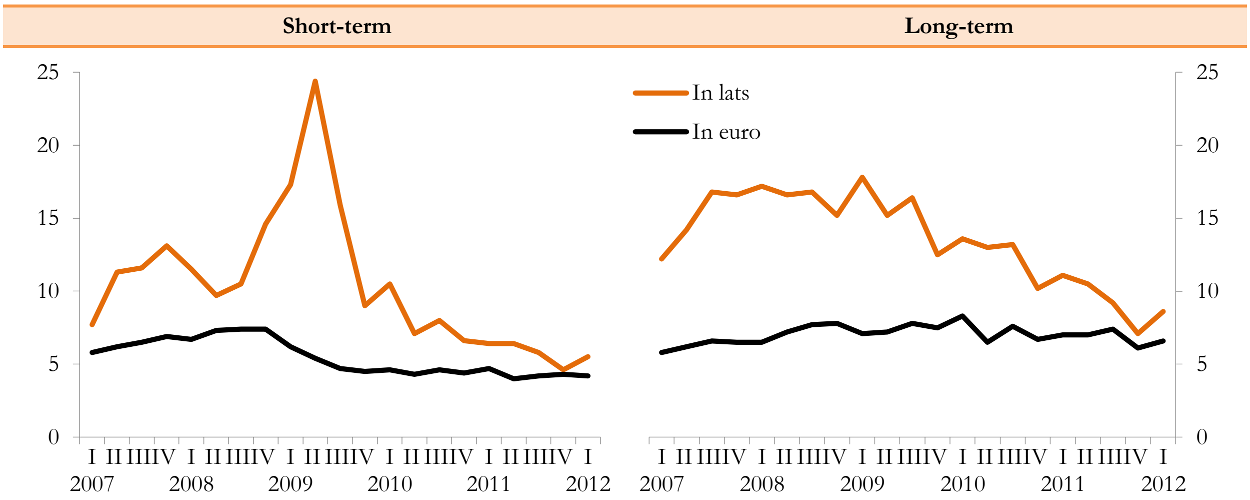
In the 1st quarter of 2012, the **amount of loans with overdue payments** shrank by 26.5% in comparison with the corresponding period of 2011. It was mainly determined by the decrease in the amount of loans with overdue payments of more than 180 days by 39.1%, which is a positive trend considering that these loans constitute the highest share (11.9%) of all loans with overdue payments. Yet, the amount of loans with overdue payments from 91 to 180 days increased by 13.4%. In the 1st quarter of 2012, the amount of loans with overdue payments in the total loan portfolio was 22.2%, which is the lowest indicator since the beginning of 2009.

27.9% of loans granted to households are loans with overdue payments, indicating to the slow improvement of the loan quality of individuals. However, the number of loans with overdue payments is still high. The quality of corporate loans has improved significantly along with recovering growth of the economy. At the end of March 2012, 19.5% of loans granted to sectors of the economy were loans with overdue payments (at the end of the 1st quarter of 2011 – 25%). The majority of loans with overdue payments is in sectors like accommodation and catering (31.6%) and administrative and support service activities (35.4%), while the lowest number – in public administration and defence (2%) and electricity, gas and heat supply sector (2.8%).

Figure 4.36

Weighted Average Interest Rates for Loans Granted in Credit Institutions, Quarterly Profile

(percent)

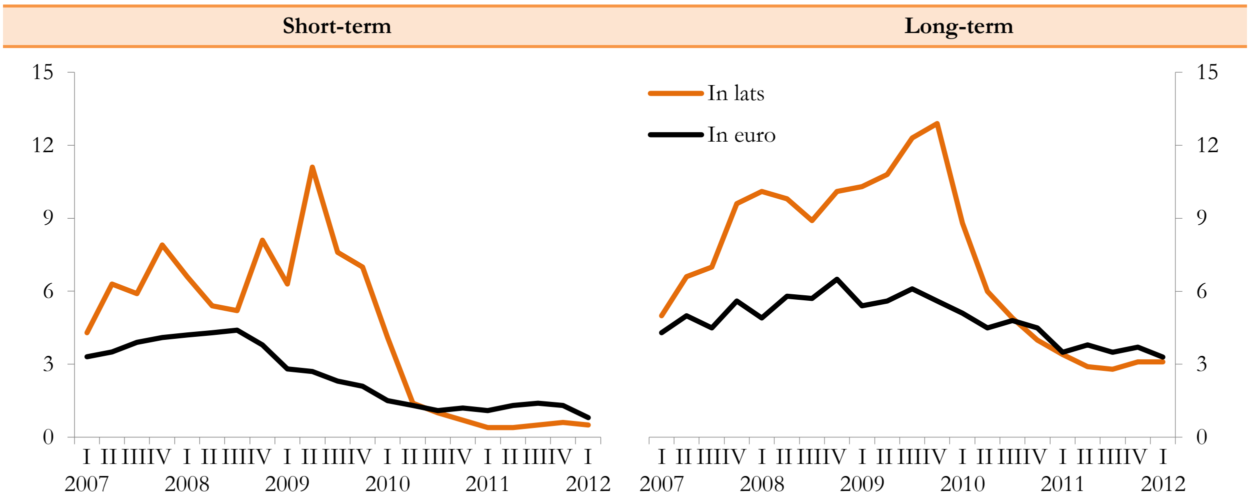


At the beginning of 2012, the banks continued to cooperate with the clients facing difficulties to repay the loans. At the end of the 1st quarter of 2012, restructured loans and loans currently being recovered constituted 28.6% of the total loan portfolio, though the amount of these loans is decreasing. The share of restructured loans in the total banks' loan portfolio decreased to 16.2%, while the share of loans currently being recovered was 12.5% of the total banks' loan portfolio in the 1st quarter of 2012.

Figure 4.37

Weighted Average Interest Rates for Deposits Attracted by Credit Institutions, Quarterly Profile

(percent)



In the 1st quarter of 2012, the weighted average **interest rates** on short-term and long-term loans granted to companies and individuals were 5.5% and 8.6%, respectively, which means that they have come closer to the euro rates compared to the previous quarter, an increase in the weighted average interest rates on short-term and long-term loans is observed.

Fluctuations of the interest rates on loans granted in EUR were less explicit. At the end of the 1st quarter of 2012, the weighted average interest rate on short-term loans granted in EUR was 4.2%, but on long-term loans – 6.6 percent.

In 2011 and in the 1st quarter of 2012, the interest rates on short-term and long-term deposits attracted in LVL by credit institutions reached the lowest indicators over a decade and were even lower than those of EUR, 0.5% and 3.1%, respectively. The interest rates on short-term and long-term deposits attracted in EUR by credit institutions reached the lowest indicators over a decade, 0.8% and 3.3%, respectively.

5. LABOUR MARKET

5.1. Employment and Unemployment

The gradual increase of economic activities has a positive impact on the labour market – the employment rate is growing and the high unemployment caused by the crisis is decreasing. At the same time, certain population groups, especially people with poor education and qualification, older people, as well as the youth barely feel the improvement.

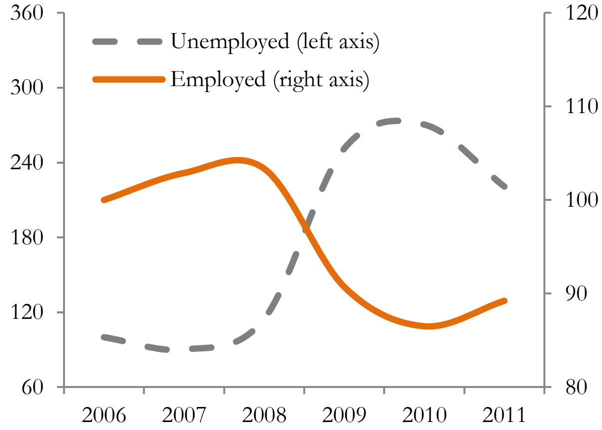
Overall, in 2011, the number of employed has increased by 2.5% compared to 2010. Within a year, the unemployment rate has decreased significantly – in 2011 it was on average 16.2%, which is by 3 percentage points lower than in 2010. The number of economically active population in 2011 has increased by 0.6%. A more rapid increase was hindered by negative demographic tendencies – a decreasing number of working-age population.

Although labour market indicators dropped slightly at the beginning of 2012 due to seasonal factors, the positive tendencies, however, have remained. In the 1st quarter of 2012, the number of the working age population aged 15-74 years increased by 2.6% or 21.7 thousand and reached 857.6 thousand in comparison with the corresponding period of the previous year. The employment rate in the 1st quarter of 2012 increased to 54.5% (in the 1st quarter of 2011 it was 52.4%). The unemployment rate in the 1st quarter of 2012 dropped to 16.3%, which is by 1.3 percentage points lower than a year ago. It was one of the fastest unemployment declines among the EU Member States. Despite the quite rapid decline in unemployment, Latvia had still the third highest unemployment rate in the EU in May 2012.

Figure 5.1

Changes in the number of employed and unemployed

2006 = 100



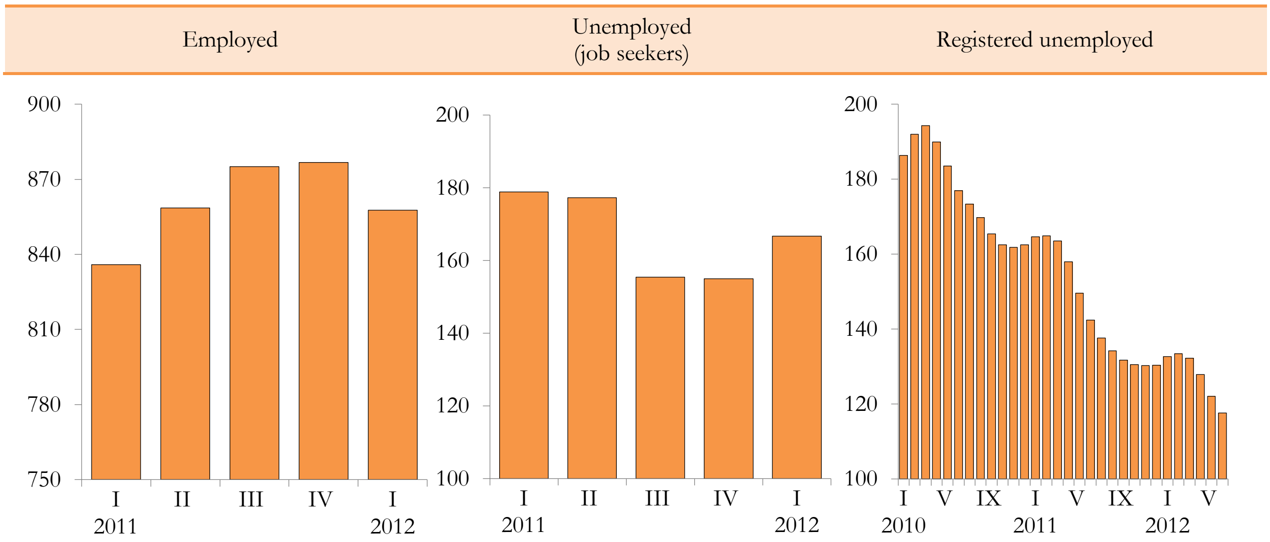
Source: CSB, estimation of the Ministry of Economics

The registered unemployment rate was 11.9% or 117.6 thousand unemployed at the end of June 2012, which is by approximately 25 thousand less than in June 2011. The highest registered unemployment rate remains in the Latgale region (22.9%), while the lowest – in Riga (8.1%).

Figure 5.2

Employment and Unemployment in Latvia

(thousands)



The current unemployment rate exceeds the pre-crisis level by about 10 percentage points, and it is mainly related to the cyclical unemployment, i.e. the significant decrease in production volumes and provided services during the crisis. Therefore, all measures related to the promotion of economic activities and entrepreneurship foster an increase in the labour demand and employment growth. At the same time there is a risk that some of the currently unemployed will not be able to find a job for a longer period resulting in structural unemployment, as sectors that recover faster from the crisis are neither the ones offering vacancies before the crisis nor those where people lost their jobs during the crisis. The economy is experiencing structural changes and mismatch may occur between the labour supply and demand – skills of job seekers fail to meet employer requirements.

The number of long-term unemployed or jobless unemployed for longer than a year increased along with the total unemployment rate during the crisis. Currently, the number of long-term unemployed is tended to decrease. Yet, according to the CSB data, in the 1st quarter of 2012, more than a half (54.1%) of the total number of unemployed (job seekers) or 90.2 thousand people were looking for a job for 1 or more years. In the 1st quarter of 2011, the number was 58.3% of the total number of unemployed (job seekers) or 104.4 thousand persons.

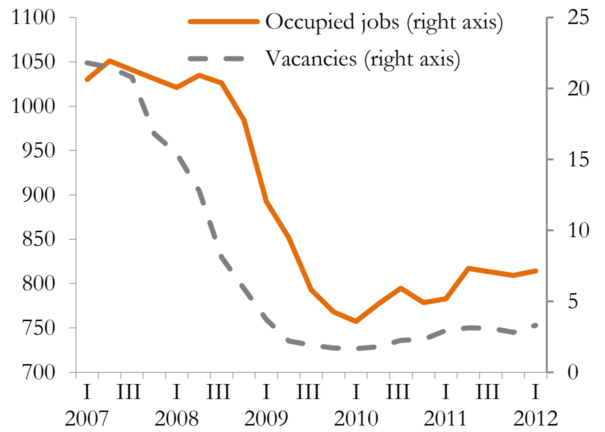
High long-term unemployment may cause an increase in the structural unemployment, as the longer such people are jobless, the higher is the risk of losing working skills and competences.

The number of vacancies is one of the indicators reflecting changes in the labour demand. Since the 2nd quarter of 2010, the number of vacancies started growing along with the gradually improving economic situation. According to the CSB data, the total number of jobs at the end of the 1st quarter of 2012 has increased by 31.7 thousand or 4% compared to the corresponding period of 2011. Most of them are filled and the number of vacancies increased just by 0.4 thousand in the same period. It should be taken into account that the balance between the labour demand and supply is influenced not only by labour education and skills but also by wages, therefore vacancies stay open even under high unemployment conditions.

Figure 5.3

Free and Filled Positions

(at the end of period, thousands)



In 2011, the number of filled positions has increased in all sectors, though it still lags behind the pre-crisis level. The highest increase in the number of filled positions in 2011 compared to 2010, was in construction (by almost 11%), agriculture (by 8.5%) and manufacturing (by 7.1%), while the lowest increase – in public services sector (by 0.4%) and trade (by almost 2%).

Table 5.1

Filled positions by sectors on average per year

	Number (thousand)			Changes (%)	
	2009	**2010**	**2011**	**2011/2008**	**2011/2010**
Total	**826.1**	**776.7**	**805.5**	**-20.8**	**3.7**
including:					
Agriculture	17.9	17.5	19.0	-8.7	8.5
Primary sectors	104.1	101.8	109.1	-21.5	7.1
Other industries	23.7	22.4	22.9	-14.0	2.3
Construction	54.6	46.0	50.9	-43.0	10.7
Trade, accommodation	173.3	159.7	162.8	-26.6	1.9
Transport and storage	67.6	66.8	68.8	-11.6	3.1
Other commercial services	162.8	148.4	157.0	-20.0	5.8
Public Services	222.1	214.2	215.0	-12.3	0.4

The Population Census took place from May until June 2011. According to the provisional results, the data on 2011 have been recalculated (see Table 5.2) – the biggest number of the employed in 2011 were in public services sector – almost ¼ of all employed, trade and commercial services – each almost 20% and manufacturing – 13% of all employed.

Table 5.2

Key Indicators of Employment and Unemployment

Indicators	2011 (without correction)	2011* (recalculated according to the results of the Population Census 2011)
Population, thousand	2229.6	2074.6
Economically active population (aged 15-74 years, thousand)	1147.0	1028.2
Number of employed (aged 15-74, thousand)	970.5	861.6
Employment rate (aged 15–74, %)	55.3	53.4
Participation rate (aged 15-74 years, %)	65.4	63.7
Unemployment rate (share of job-seekers aged 15-74, %)	15.4	16.2
Number of job-seekers (unemployed) (aged 15-74, thousand)	176.4	166.6

* Data on 2011 according to the Population Census data. Previous years have not been recalculated and are not comparable.

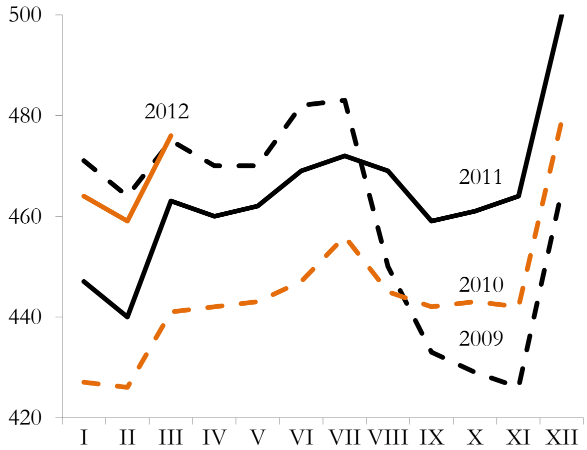
5.2. Labour Costs and Productivity

During the economic recession, significant adjustments took place in the labour market resulting in a decreased number of the employed and wages. As the economic situation has stabilized, wages have started growing since the end of 2010, while the unemployment rate remains quite high.

The average gross wage in 2010 was LVL 445, i.e. by 3.5% lower than in 2009 and by 7.3% lower than in 2008. As regards assessment of wage dynamics during the crisis, it should be noted that, taking into account the severity of the economic recession in Latvia, overall, wage adjustments were relatively moderate and the labour market was balanced mainly on the account of the decrease in the number of the employed.

Figure 5.4

Average Gross Monthly Wage of the Employed
(in lats)

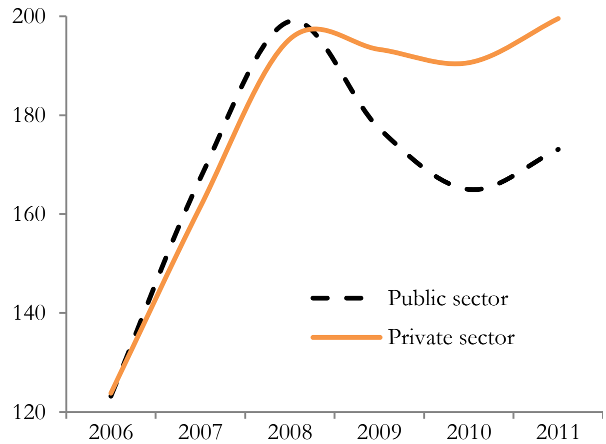


The average gross wage in 2011 was LVL 464, i.e. by 4.4% higher than in the previous year, yet by 3.2% lower than in 2008. The wages continue growing along with the increase of economic activities. In the 1st quarter of 2012, the average gross wage of the employed was already by 3% higher than before the crisis.

It should be noted that the adjustment of wages in the public sector was considerably bigger than in the private sector, mainly due to the necessity to limit state budget expenditures. Thus, in 2011, the average gross wage in the public sector was by almost 13.1% lower than in 2008. While the average gross wage in the private sector in 2011 exceeded the level of 2008 by 2.2 percent.

Figure 5.5

Average Gross Monthly Wage of Employed in Public and Private Sectors
(2005 = 100)



In 2011 compared to the previous year, the average gross monthly wage of the employed in public and private sectors increased almost evenly, by 4.7% and 4.6%, respectively. Uneven adjustments in the last two years resulted in balancing the average gross monthly wage of the employed in the public and private sectors.

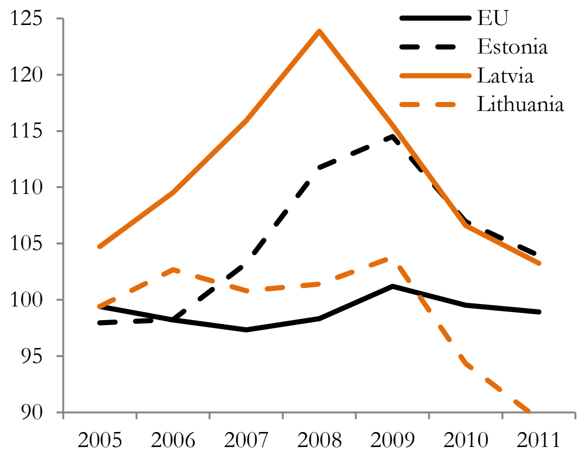
Wages are increasing in almost all sectors of the economy. In 2011, the average gross monthly wage of the employed in manufacturing compared to the previous year increased by 5% and was by 3.1% higher than in 2008.

The adjustments in product and labour markets caused by the crisis eliminated the gap between productivity and labour costs resulting in gradual improvement of Latvia's competiveness in external markets as proved by the dynamics of the production unit labour costs (ULC) [1].

Figure 5.6

Changes of Real ULC in the EU and Baltic States

(2004 =100)



Compared to the years of rapid growth, when changes (growth) in the ULC were mainly determined by structural factors, the ULC dynamics since 2008 to a great extent are related to the cyclical factors or crisis consequences.

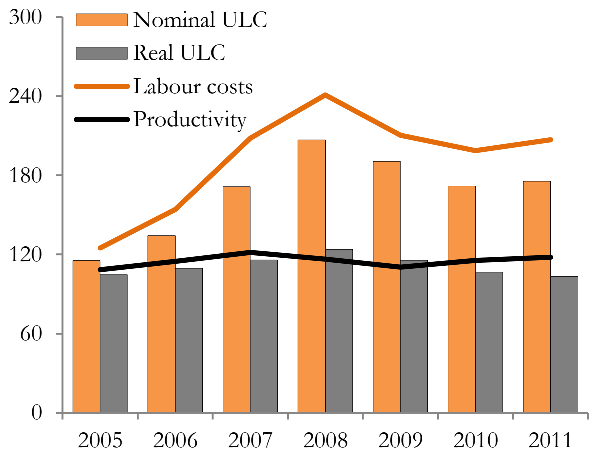
The significant adjustments in the labour market in 2009 affected the dynamics of both productivity and labour costs. If compared to 2008, productivity has decreased by 5.3%, as GDP decreased faster than the number of employed. However, labour costs in 2009 compared to 2008 decreased by 12.7% as the number of employed decreased faster than the payroll. In the result, the real ULC decreased by 6.2 percent.

Dynamics of the ULC in 2010 were mainly determined by relative changes in the wages and the number of employed. The high unemployment rate and budget consolidation measures still put pressure on wages. However, taking into account the low competition of Latvia in the single EU labour market, the changes already were rather moderate. Therefore, the decrease in the ULC, as well as the increase in productivity was to a great extent based on changes in the number of employed. The real ULC in 2010 were by 7.7% lower than in the previous year.

Figure 5.7

Changes of Labour Costs in Latvia

(2004 =100)



In 2011, both the number of employed and the payroll increased along with the resuming economic growth. As the payroll increased faster than the number of employed, the labour costs increased by 4.2%, while productivity increased by 2% in 2011, i.e. slower than the labour costs. Yet, since real wages increased slower than productivity, the real ULC in 2011 has decreased by 3.1%, thus proving that the increase in labour costs did not have a negative impact on competiveness of Latvia. Also in the 1st quarter of 2012, productivity increased faster than real wages and the real ULC decreased by 5.3% in comparison with the 1st quarter of 2011.

At the same time, it should be noted that the dynamics of unit labour costs and productivity over the last two years show that labour costs will continue growing along with increase of economic activities. Therefore, further competiveness relies on the ability to increase productivity.

[1] ULC is defined as a relation between labour costs and labour productivity. If the productivity is growing faster than wages, the ULC decreases, which means that competitiveness of the state costs increases and vice versa.

5.3. Labour Market Forecasts

Labour market forecasts for the period until 2016 have been developed in compliance with the economic development scenarios (see Chapter 3.3). The forecasts have been prepared taking into account the results of the Population Census 2011.

According to the forecasts of the Ministry of Economics, the situation in the labour market will be improving also in 2012. As compared to 2011, the population will feel the improving situation both in terms of wages and vacancies. At the same time, employment and unemployment indicators may not show explicitly positive tendencies.

According to the estimates of the Ministry of Economics, the number of employed will increase by approximately 13 thousand or 1.5% in 2012 compared to 2011. The employment rate will increase respectively by 1.6 percentage points to 55.6%. In total, the number of employed will increase to 875 thousand in 2012.

The number of job seekers is expected to decrease by approximately 16% (27 thousand) to 140 thousand in 2012, while the average annual unemployment rate will be 13.8 percent.

Positive tendencies in the labour market will remain also in the upcoming years. Employment is likely to grow also in the medium-term, however, the increase in employment will be more moderate than the growth, as the output will be based mainly on the increase of productivity.

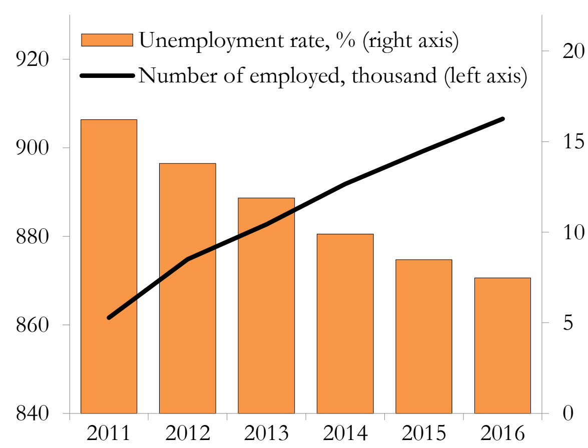
The number of employed is expected to increase on average by 1% per year until 2016. In 2016, the number of employed population might reach 907 thousand and its share in the total population (aged 15-74 years) will be close to 61 percent.

The unemployment will also continue declining, though remaining high until 2014 – above 10%. The situation might considerably change in 2014-2015 – the unemployment rate will be about 8% and the shortage of labour will become a topical issue. In total, the unemployment rate might drop to 7.5% in 2016.

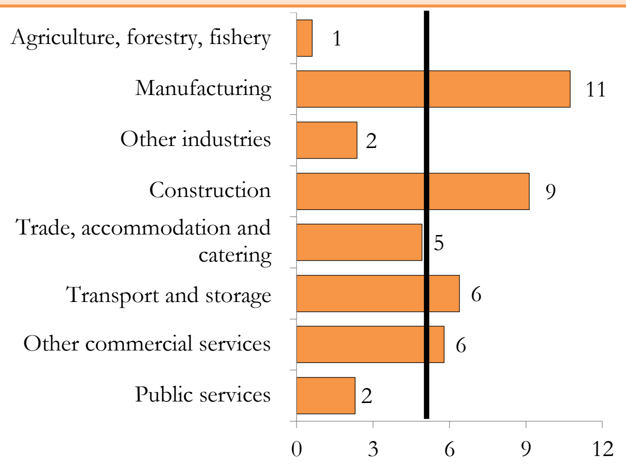
Figure 5.8

Medium-Term Labour Market Development Trends*

Forecasts of labour demand and supply*
(aged 15–74 years)



Changes in the number of employed in 2016 compared to 2011 by sectors
(percent)



* The actual data reflected for 2011 (the CSB recalculation of the Labour survey data according to the results of the Population Census 2011).

In 2012, majority of economy sectors will experience fast growth that will be reflected in the increase of employment. At the same time, increase of employment in most of the sectors will be slower than growth mainly due to a faster increase in productivity. It particularly applies to tradable sectors operating in open product and services markets, where the maintenance of competiveness has a big role.

The most rapid increase in the number of employed in 2012 is expected in manufacturing and construction – by 3.9% and 2.9%, respectively. At the same time, a significant increase is expected also in a range of services sectors – information and communication sector (2.2%), transport and communication sector (2.1%), professional scientific services sector (1.8%), as well as trade (1.6%). The exacerbating situation in external markets might lead to increased importance of the domestic demand-oriented sectors in the labour market.

In general, similar tendencies are likely to be observed until 2016. The most rapid increase in employment will remain in manufacturing and construction, followed by transport and commercial services sectors. The increase in employment will remain steady though small in most of the sectors until 2016. Agriculture is the only sector that expects a decrease in employment after 2014. It is mainly related to improvement of the sector – formation of agricultural cooperatives and large farms, introduction of systemised production organisation, introduction of complex technological solutions in the production process.

Overall, the medium-term and long-term situation in the labour market will be determined by several important factors.

The biggest uncertainty and major risks in the medium-term are related to further development of the European debt crisis. The deteriorating situation in Europe might significantly influence the key export markets of Latvia that would later affect the growth of Latvia and also the situation in the labour market.

Long-term challenges, however, are mainly related to a gradual decrease in the number of population (particularly, working-age population), as well as general labour ageing tendencies.

According to the estimates of the Ministry of Economics, the number of the working-age population (aged 15-74 years) will drop by about 8% until 2030 in comparison with 2011. At the same time, the demographic burden will increase by about 17%. Significant changes are expected also in the structure of population age – the share of older people in the total number of population will increase in the future.

In general, these tendencies will escalate the problem of labour shortage until 2030 that might cause different disproportions in the labour market.

5.4. Employment Policy

The quantitative target set by Latvia in the context of the implementation of the *Europe 2020 Strategy* is to reach an employment rate of 73% (see Chapter 6.1) by 2020 in the age group of 20–64. For reaching this target, policy directions are planned on both, labour supply and labour demand side.

The key elements of employment policy of Latvia:

– fostering labour demand – stimulating economic activities and entrepreneurship, including labour tax reduction, combating undeclared employment, state provided indirect and direct support measures for entrepreneurs, measures to eliminate administrative barriers, implementing support measures for micro-enterprises, business incubators, etc. (see Chapters 6.7 and 6.8);
– strengthening labour supply – improving competiveness of the unemployed and persons at risk of unemployment in the labour market, including improving skills;
– fostering labour demand and labour supply matching, including improving the educational system, involving employers' organisations in improving education quality, forecasting conformity of labour demand and supply, educating the labour market participants, including pupils and students about the labour market and career issues.

In order to solve current issues of the employment policy, the Action Plan for Implementation of Cross-Industry Employment Policy will be developed by the end of 2012 in cooperation with all interested ministries and involving employers in the process.

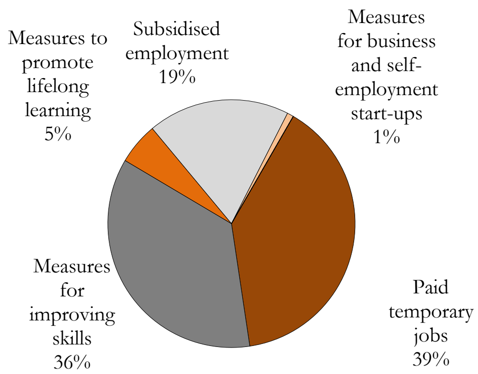
The State Employment Agency (SEA) is the implementation institution of the state policy in the field of unemployment reduction and support to the unemployed and job seekers. In performance of its functions, the SEA influences the labour market by both active employment measures and preventive unemployment reduction measures. The changing labour market needs determine the necessity for a regular revision and improvement of these measures.

Overall in 2011, the funding used for labour market policy activities was LVL 48.2 million. Most of the financing is granted for paid temporary work or the measure *Work Practice with a Grant* and the measures for improving skills, which involve professional training, retraining and promotion of qualification, measures to promote competitiveness and career consultations. Funding granted for these measures amount to ¾ of all funding allocated for these activities.

The rest of the funding is allocated for subsidised employment and measure *Training Programmes for Involvement of Adults in Lifelong Learning* to promote lifelong learning, as well as for the measures for business or self-employment start-ups.

Figure 5.9

Distribution of the SEA labour market policy measures' funding in 2011



Currently, the SEA is implementing the following **active employment measures**:

– professional training, retraining, and promotion of qualification;
– measures for specific groups of persons;
– measures to improve competitiveness;

- paid Temporary Work (in 2010 and 2011 this measure completely replaces the measure *Work practice with a grant*);
- measures for business or self-employment start-ups;
- complex support measures.

During the years of economic growth, the demand for active employment measures decreased, however, in 2009 due to the significant rise in unemployment, it increased considerably. The demand remained at a high level also in 2010 and 2011. In 2007, a total of 64.6 thousand unemployed were involved in the active employment measures, in 2008 – 84.8 thousand, in 2009 – 237.9 thousand, but in 2010 – 269.2 thousand, while in 2011 – 287.5 thousand unemployed, in the 1st quarter of 2012 – 57.6 thousand unemployed (one unemployed person may participate in several activities).

The majority of the unemployed are involved in the measures to improve competitiveness (including information days). In 2011, the number of such unemployed was 124.3 thousand (excluding informal education). The rest of the measures in this period were implemented to the following extent: 8.6 thousand unemployed participated in professional training, retraining and improvement of qualification; 1 thousand unemployed have started training with an employer; 1.5 thousand were involved in measures for specific person groups; 50.6 thousand unemployed – in the measure *Work Practice with a Grant*, 11.6 thousand – in complex support measures, 26.1 thousand – in informal education, and 272 unemployed – in measures for business or self-employment start-ups.

In 2011, improvement of the active labour market policy measures was continued:

- the principle "money follows the unemployed" in the training coupon system was improved – an unemployed person selects an educational institution and the SEA pays a certain amount for the education;
- new unemployed youth-oriented measures were developed and implemented – *Job for Youth* and *Support for Youth Volunteers* aimed at developing practical working skills of young people, thus strengthening their competiveness in the labour market;
- implementation of the measure *Work Practice with a Grant*, which was introduced during the crisis period, was completed; since January 1, 2012 this measure is replaced by paid temporary public work.

The SEA implements **preventive unemployment reduction measures:**

- career consultations;
- training programmes for involvement of adults in lifelong learning.

The career consultations help clients to increase awareness about their professional disposition. In terms of the number of clients serviced, this is the most important preventive unemployment reduction measure. In 2010, career consultation services were provided to 78.4 thousand people, 61.5 thousand of them were unemployed and job seekers, in 2011, 47.7 thousand were serviced, 39.9 thousand of them unemployed and job seekers, in the 1st quarter of 2012 – 15.3 thousand, 12.9 thousand of them unemployed and job seekers.

In 2010, in order to gradually shift the focus from operative short-term measures reducing the social impact of the crisis to traditional employment policy measures, the implementation of the following measures has been launched:

- education programmes for involvement of adults in lifelong learning;
- mastering the first and second level professional higher education programmes.

A training coupon system is used in the measure *Training Programmes for Involvement of Adults in Lifelong Learning* aimed at promoting availability of lifelong learning. The target group includes employed and self-employed persons (except employees of the public civil service) who have reached the age of 25, but have not reached the age for granting the state old age pension. In 2010, 5155 unemployed persons started the training using LVL 0.9 million of the funding, while in 2011 – 15 418 persons, funding – LVL 2.6 million.

The measure *Mastering the First and Second Level Professional Higher Education Programmes,* however, no longer was continued in 2010 due to administration issues and high expenses.

Due to the increasing economic globalization, rapid development of technology, and negative demographic processes, increasingly more attention in the European employment strategy is being paid to the issues of **labour market flexibility and employment security or flexicurity**.

Flexicurity comprises 4 fields of activity, which must promote labour market flexibility and employment security by mutual cooperation. It is necessary to achieve that labour legislation and agreements are sufficiently flexible and correspond to the interests of both the employer and the employee. If necessary, active labour market policies must efficiently facilitate the transfer from one workplace to another or from the status of an unemployed to the employed. The lifelong learning systems should be improved enabling an employee to be employed during the entire period of the ability to work. At the same time, a modern social security system must be established, which would provide adequate assistance to residents in case of unemployment, as well as would facilitate mobility and faster return to the labour market.

The social dialogue is important in the implementation of flexicurity principles. The institutions participating in the employment partnership – Employers' Confederation of Latvia, Free Trade Union Confederation of Latvia, local governments of Latvia, and Latvian Association of Local and Regional Governments – are involved in improving the social dialogue at both national and regional level.

An important aspect is **safety at work** ensuring conditions for safe and healthy work environment. The goal in the field of labour protection is by 2013 to improve the working conditions in enterprises and reduce the number of fatalities at work by 30% (per 100 thousand employed) compared to 2007.

In order to ensure gradual reduction in the number of fatal accidents at work, thus promoting safe and healthy working environment in enterprises, prolongation of working life and improvement of the entire public welfare level, the Cabinet of Ministers on April 20, 2011, approved the *Plan of Labour Protection Development for 2011–2013*. It sets several objectives: improving the labour protection policy planning, increasing capacity and efficiency of the national control and supervision mechanism, introducing the "preventive culture" into the society and enterprises, ensuring economic impetus and state support to the employers.

Latvia has a relatively high rate of **undeclared employment** in certain sectors, and these issues have become more aggravated due to the economic recession, thus increasing unfair competition and reducing the social security of employees.

In order to use the available resources effectively and in a coordinated manner, while bearing in mind the limited budget conditions, an *Action Plan for Reducing Unemployment for 2010-2013* has been developed. In April 2010, the Cabinet of Ministers approved the action plan prepared by the Ministry of Welfare. The measures are implemented in the following key directions: effectivization of the control mechanism for the undeclared employment; reduction of unfair competition; revision of the penalties policy with regard to undeclared employment; informing and educating the society about the negative consequences of undeclared employment.

In August 2010, the Cabinet of Ministers approved the *Action Plan for Combating the Shadow Economy and Ensuring Fair Competition for 2010–2013* prepared by the Ministry of Finance. The aim set in this plan is to reduce the shadow economy and ensure fair competition. The key directions of activity are tax policy, reduction of administrative burden, support to the honest entrepreneurs, and promotion of transition to legal economy, improving capacity of controlling institutions, elaboration of laws and regulations, penalties policy, work with society and elimination of shadow economy in risk sectors. Implementation of the measures included in the plan will also promote reduction of the undeclared employment.

The education system plays an important role in the context of labour market development, particularly emphasizing the significance of **lifelong learning**. Introduction of the lifelong learning principle is emphasized also in the *National Reform Programme of Latvia for the Implementation of the Europe 2020 Strategy*.

Latvia has decided to foster continuous improvement and development of public knowledge, skills and competences providing the lifelong learning available so that 15% of the population (aged 25–64 years) would be continuously involved in educational process by 2020. In 2011, the share of these persons was 5.1%, whereas 12.5% is expected to be reached by 2013.

The lifelong learning principle is going to be implemented in several directions:

- developing the national qualification framework structure, and adjusting its levels to the European qualification structure, thus fostering transition to outcome-based education offer;
- ensuring evaluation of knowledge, skills and professional competence acquired outside the formal education;
- offering the second chance education as a compensating mechanism to reduce the number of early school leavers;
- supporting qualification improvement of the employees according to the employers' requirements that are necessary for the employed training within the framework of the sectors.

6. Economic Policy and Priorities of Structural Policy

6.1. *Europe 2020* Strategy and the *National Reform Programme of Latvia*

6.1.1. *Europe 2020* Strategy and its Progress

On March 3, 2010, the European Commission published a communication *Europe 2020: A Strategy for Smart, Sustainable and Inclusive Growth,* which outlines the European Commission's vision on the *Europe 2020* strategy.

On June 17, 2010, the European Council formally approved the *Europe 2020* strategy and its key elements: EU-level headline targets for 2020, the *Integrated Guidelines* (developed according to Articles 121 and 148 of the Treaty on the Functioning of the European Union, which set the main directions of economic and employment policies, as well as serve as a base for development of national reform programmes of the EU Member States) and agreed that the EU Member States in cooperation with the European Commission must develop national reform programmes and submit them to the European Commission by the end of April 2011 together with the *Stability* or *Convergence Programmes* (developed and implemented for fulfilling requirements of the Stability and Growth Pact).

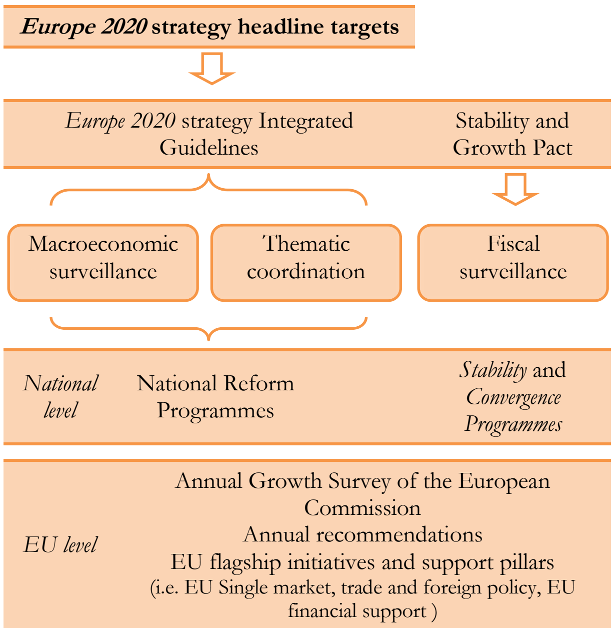
The surveillance of the *Europe 2020* strategy's implementation consists of two pillars (see Figure 6.1) – macroeconomic and thematic surveillance (National Reform Programmes of the EU Member States for the implementation of the *Europe 2020* strategy and their conformity with the *Integrated Guidelines* are being assessed), as well as fiscal surveillance (the *Stability* and *Convergence Programmes* of the EU Member States and their conformity with the *Stability and Growth Pact* are being assessed).

Since January 1, 2011, **the European semester** is held every year to evaluate the overall economic situation in the EU and Member States, as well as to provide recommendations to the EU Member States for the implementation and strengthening of their economic policy.

The *Europe 2020* strategy, national reform programmes, *Stability* and *Convergence programmes* of the EU Member States are the core elements of the coordination and surveillance of the EU Member State economic policy at the EU level within the European semester (see Figure 6.2). Multilateral surveillance of both programmes is carried out at the EU level, based on which the European Commission is entitled to give a policy warning, if the economic policy of any particular EU Member State is not in line with the EU *Integrated Guidelines* and targets set at the EU level. The National Reform Programmes are linked also to the EU budget as part of the measures is co-financed from the EU budget.

Figure 6.1

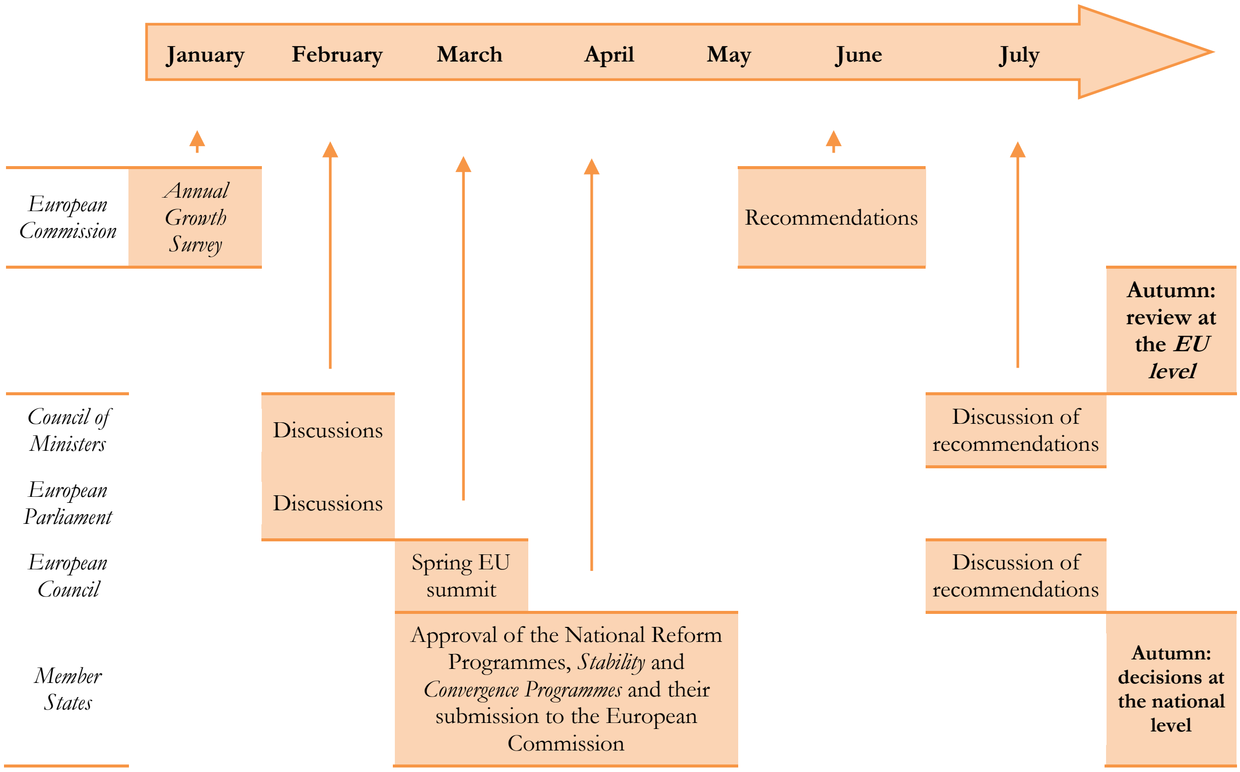
Surveillance mechanism of the National Reform Programmes, *Stability* and *Convergence Programmes* of the EU Member States



By approving the *Euro Plus Pact*, the European Council on March 24–25, 2011 strengthened the coordination of the EU economic policy. The primary focus of the *Euro Plus Pact* (see Box 6.1) is on areas of the euro zone countries, however, non-euro zone countries may also join the pact. Currently, apart from the euro zone countries, several other EU Member States have joined the *Euro Plus Pact*, among them Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania. Those EU Member States that have joined the *Euro Plus Pact* have to reflect definite measures oriented towards implementation of this pact for the next 12 months in their National Reform Programmes, *Stability* and *Convergence programmes*. Moreover, the EU Member States have to prepare and submit the annual *Progress Reports on the Implementation of the National Reform Programme* to the European Commission reflecting the progress on implemented measures.

Figure 6.2

The European Semester and surveillance of national programmes of the EU Member States



Box 6.1

Euro Plus Pact

The *Euro Plus Pact* is aimed at strengthening the pillar of the Economic and Monetary Union and at improving the quality of economic policy coordination, thus increasing competitiveness and achieving better convergence. The primary focus of the *Euro Plus Pact* is on those policy areas that fall under the national competence of the EU Member States and by the help of which competitiveness can be increased and macroeconomic imbalances eliminated.

The *Euro Plus Pact* has four key priorities:

– *Fostering competitiveness* by ensuring wage dynamic conformity to productivity, fostering competitiveness and liberalization of "protected" sectors, eliminating unreasonable restrictions in the sector of professional services and retail trade, improving education system, promoting research and development (R&D) and innovation, developing infrastructure and improving business environment;
– *Fostering employment* by implementing labour market reforms aimed at ensuring flexicurity, reducing undeclared employment and increasing participation in the labour market, fostering lifelong learning, implementing tax reforms aimed at eliminating tax burden imposed on the employed, however, taking into consideration the aim to preserve tax revenues;
– *Ensuring sustainability of public finances* by adapting the pension systems to demographic development, limiting early retirement schemes and fostering employment of older workers, as well as by introducing the EU fiscal rules based on the Stability and Growth Pact into the national legislation;
– *Reinforcing financial sector stability* by adapting the national legislation on surveillance of the banking sector in compliance with the EU requirements.

New economic and fiscal policy surveillance rules (so-called "six-pack") consisting of five regulations and a directive came into force on December 13, 2011. By adopting these new rules in the EU, in addition to the excessive deficit procedure, a macroeconomic imbalances procedure is established to identify timely (using scoreboard of the alert mechanism) and to correct macroeconomic imbalances (for example, huge current account deficit, etc.) – see Box 6.2. Since the national reform programmes of the EU member states are oriented towards implementation of key structural reforms, they help to eliminate timely excessive budget deficit and macroeconomic imbalance.

Box 6.2

Alert mechanism and scoreboard

The European Commission publishes the annual *Alert Mechanism Report*, which analyses the EU Member states according to certain indicators and thresholds:

- 3 year backward moving average of the current account balance as percent of GDP, with a threshold of +6% of GDP and -4% of GDP;
- net international investment position as percent of GDP, with a threshold of -35% of GDP;
- 5 years percentage change of export market shares measured in values, with a threshold of -6%;
- 3 years percentage change in nominal unit labour cost, with thresholds of +9% for euro-area countries and +12% for non-euro-area countries;
- 3 years percentage change of the real effective exchange rates based on HICP/CPI deflators, relative to 35 other industrial countries, with thresholds of -/+5% for euro-area countries and -/+11% for non-euro-area countries;
- private sector debt in % of GDP with a threshold of 160%;
- private sector credit flow in % of GDP with a threshold of 15%;
- year-on-year changes in house prices relative to a Eurostat consumption deflator, with a threshold of 6%;
- general government sector debt in % of GDP with a threshold of 60%;
- 3-year backward moving average of unemployment rate, with a threshold of 10 percent.

Currently, the possibility to add an additional financial sector indicator to the list is being discussed. In case, if any of the EU Member States violates the threshold of any of the indicators, the European Commission carries out in-depth analysis and publishes it in the *In-depth review*.

In the first *Alert Mechanism Report* (published on February 14, 2012) the analysis of the indicator list led the European Commission to a conclusion that considers that the risks of imbalances in the following countries warrant further investigation: Belgium, Bulgaria, Cyprus, Denmark, Finland, France, Italy, Hungary, Slovenia, Spain, Sweden and the United Kingdom.

The *Alert Mechanism Report* concluded that the following countries did not require a further in-depth review at this point in time: Austria, Czech Republic, Estonia, Germany, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland and Slovakia.

A conclusion on the need for in-depth analysis was not addressed to Greece, Ireland, Portugal and Romania as these countries coordinate their policy within the international loan programme with the European Commission and the International Monetary Fund.

According to the *In-depth reviews* for 12 EU Member states published on May 30, 2012 the European Commission concluded that there are some macroeconomic imbalances though not excessive in these member states, therefore, there is no need to initiate the macroeconomic imbalance procedure. These 12 EU Member States received specific recommendations from the European Commission to tackle existing macroeconomic imbalances.

6.1.2. *National Reform Programme of Latvia for the Implementation of the Europe 2020 Strategy*

The ***National Reform Programme of Latvia for the Implementation of the Europe 2020 strategy*** (the NRP of Latvia) was approved in the Cabinet of Ministers on April 26, 2011 along with the *Convergence Programme of Latvia for 2011–2014*.

The NRP of Latvia describes the medium-term macroeconomic scenario, reflects key macro-structural bottlenecks of the economy of Latvia and main measures for 2011–2013 to tackle them, as well as the targets of Latvia for 2020 in the context of the *Europe 2020* strategy and main measures for 2011–2013 to achieve them.

The aim of Latvia is to foster growth and employment, thus ensuring medium-term growth rate of GDP in the amount of 4-5% and a high employment rate in the amount of 73% by 2020.

The NRP of Latvia is mainly focused on eliminating the macro-structural bottlenecks, thus creating also preconditions for successful achievement of targets of Latvia for 2020 in the context of the *Europe 2020* strategy.

The NRP of Latvia identifies the following macro-structural bottlenecks:

- reducing the high general government structural deficit;
- ensuring a well-functioning and stable financial sector in the light of the ongoing deleveraging of the private sector;
- promoting rebalancing the economy towards the tradable sectors and raising productivity levels;
- avoiding high unemployment from becoming structural and ensuring better matching in the labour market;
- addressing the weaknesses in the business environment, ensuring efficient use of EU structural funds and adequate access to finance for companies with a view of favouring productive investment.

According to the European semester process, on April 27, 2012, the Cabinet of Ministers approved the ***Progress Report on the Implementation of the National Reform Programme of Latvia within the Europe 2020 Strategy*** (*Progress Report on the Implementation of the NRP of Latvia*) and the updated *Convergence Programme of Latvia for 2012–2015*. Both abovementioned documents have been submitted to the European Commission on April 29, 2012.

Box 6.3.

Progress of the implementation of the National Reform Programme of Latvia

Since the approval of the *NRP of Latvia* in spring 2011, the growth rates of the economy have been faster than expected. Thus, GDP increased by 5.5% in 2011 (the macroeconomic scenario forecasted 3.3%), the number of employed – by 3.1% (forecasted – 1.5%) and the unemployment rate dropped from 18.7% in 2010 to 15.4% in 2011 (forecasted – 16.4%). Moreover, not only the economy has grown significantly, but also the government has been able to implement structural changes in the economy and turn public finances in a more sustainable direction.

A year after approving the national quantitative targets and taking into account the fact that not all statistical data is available for 2011, rather general conclusions on their achievement can be drawn. Due to the economic recovery, the employment rate has increased from 65% in 2010 to 67.1% in 2011.

Within a year, since the approval of the NRP of Latvia, a good progress has been achieved in eliminating some of the macro-structural bottlenecks mentioned above.

The general government budget deficit in 2011 was 3.5% of GDP according to the ESA'95 methodology and that is considerably below the set budget deficit target – the budget deficit target for 2011 was 6% of GDP, however, budget amendments for 2011 made in April 2011 determined budget deficit in the amount of 4.5% of GDP.

Although the debt level of the private sector in Latvia still remains high, overall, loans with overdue payments above 90 days are shrinking (by 16% in 2011 compared to 2010). Banks have been able to raise the capital adequacy ratio.

Positive tendencies have been observed in developing a more balanced economy. A gradual transition to sustainable economic model is taking place in the economy of Latvia – exports being the key growth driver, as well as the ability to compete in domestic and external product markets, as well as ability to be competitive in attracting capital to increase productive potential of Latvia. It is proved also by the increase in the share of manufacturing in the total value added from 13.4% in 2010 to 14.1% in 2011.

Although a high structural unemployment risk still persists, positive tendencies have been observed also in this regard. The number of long-term unemployed decreased by 20% in the 4th quarter of 2011 compared to the 4th quarter of 2010. Also the youth unemployment has decreased by 4.4 percentage points during this period.

Latvia has achieved substantial progress in improving the business environment – the evaluation of Latvia in the World Bank's *Doing Business 2012* has improved by 10 places: Latvia has moved from the 31st place (*Doing Business 2011*) up to the 21st place among 183 countries in the world. As regards the assessment of the business-friendly environment, Latvia is ranked 7th among the EU member states.

The Progress Report on the Implementation of the NRP of Latvia contains updated medium-term macroeconomic scenario described in the *NRP of Latvia* and evaluates the implementation progress of the *NRP of Latvia* (see Box 6.3), particularly emphasizing fulfilment of the *Euro Plus Pact* commitments and the Council recommendations, as well as it provides a detailed description of the *NRP of Latvia* policy directions, including the key measures and priority directions of the *NRP of Latvia* for 2012–2013:

– developing sustainable budget (budget deficit targets: in 2013 – 1.4% of GDP, in 2014 – 0.8% of GDP, in 2015 – 0.3% of GDP according to the ESA'95 methodology);
– promoting competiveness (developing and implementing industrial policy, etc.);
– improving business environment, including reduction of labour taxes, combating the grey economy;
– reforms in education (developing a new financing model of education, reforms in vocational education, etc.);
– reducing the risk of structural unemployment (active labour market policy, lifelong learning).

On May 30, 2012, the European Commission presented **recommendations for Latvia** and other EU Member States. The European Commission recommends Latvia to:

– Ensure planned progress towards the timely correction of the excessive deficit. To this end, implement the budget for the year 2012 as envisaged and achieve the fiscal effort specified in the Council recommendation under the Excessive Deficit Procedure. Thereafter, implement a budgetary strategy, supported by sufficiently specified structural measures, for the year 2013 and beyond, to make sufficient progress towards the medium-term budgetary objective (MTO), and to respect the expenditure benchmark. Use better than expected cyclical revenue to reduce government debt;
– Implement measures to shift taxation away from labour to consumption, property, and use of natural and other resources while improving the structural balance; ensure adoption of the *Fiscal Discipline Law* and develop a medium term budgetary framework law to support the long-term sustainability of public finances; restore contributions to the mandatory funded private pension scheme at 6% of gross wages from 2013;
– Take measures to reduce long-term and youth unemployment by fighting early school leaving, promoting more efficient vocational education and training and its apprenticeship component, enhancing the quality, coverage and effectiveness of active labour market policy and its training component and through an effective wage subsidy scheme;
– Tackle high rates of poverty and social exclusion by reforming the social assistance system to make it more efficient, while better protecting the poor. Ensure better targeting and increase incentives to work;
– Further encourage energy efficiency by implementing measures and providing

incentives for reducing energy costs and shifting consumption towards energy-efficient products, including vehicles, buildings and heating systems. Promote competition in major energy networks and improve connectivity with EU energy networks;
- Take measures to improve management and efficiency of the judiciary, in particular to reduce the backlog and length of procedures. Take steps to improve the insolvency regime and the mediation laws;
- Continue reforms in higher education, inter alia, by implementing a new financing model that rewards quality, strengthens links with market needs and research institutions, and avoids fragmentation of budget resources. Design and implement an effective research and innovation policy encouraging companies to innovate, including via tax incentives, upgrading infrastructure and rationalising research institutions.

These recommendations for Latvia are a core element in identifying national priorities, developing and implementing the necessary reforms and policy measures, as well as in successful implementation of the *National Reform Programme of Latvia* and *Convergence Programme of Latvia.*

6.2. Integration of Latvia in the Economic Policy and Structural Policy of EU

6.2.1. Utilisation of the European Union Structural Funds and Cohesion Fund

As an EU Member State, Latvia has access to the financial support from the EU Structural Funds (SF) and Cohesion Fund (CF), which are instruments for implementation of the EU regional cohesion policy.

Programming period 2004-2006

In the period of 2004-2006, the total available financing for Latvia in the framework of the SF programmes was EUR 625 million or LVL 439.3 million.

Latvia was one of the first EU Member States to submit all closing documents for the EU Structural Funds programming period 2004-2006 to the EC by June 30, 2010 (three months ahead of the term), to receive the final payment of the programme. The amount of the final payment is potentially up to 5% of the Structural Funds allocation, which in the case of Latvia is LVL 22 million. Considering the former practice of the EC with respect to making final payments, the final payment may be expected not sooner than in 2012 when the EC will have examined the closing documentation of the programme and verified eligibility of the declared costs.

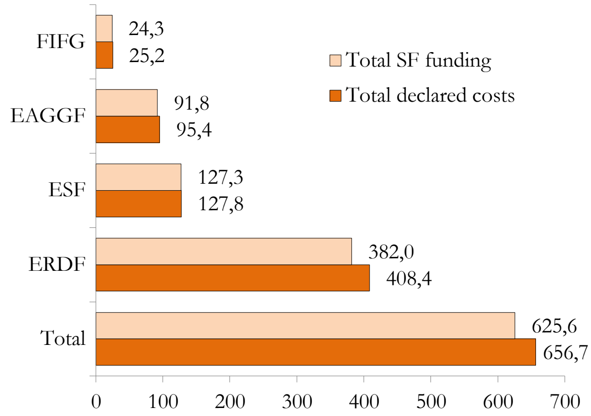
Overall projects for EUR 673.3 million or 107.6% of total SF funding available for Latvia have been approved and completed in the programming period 2004-2006. The sum of approved projects exceeds the available SF funding due to the undertaken overcommitments under decrees of the Cabinet of Ministers providing for a possibility to undertake overcommitments in the SF projects exceeding the available funding in the ERDF, the EAGGF and the FIFG activities by 12%, as well as exceeding the available funding in the ESF activities by 5%. At the same time, state budget funding was allocated for the ERDF projects for the purpose of covering the cost increase.

Figure 6.3 reflects the total declared costs of the EU Structural Funds for the programming period 2004-2006.

Figure 6.3

Total declared costs of the EU Structural Funds for the programming period 2004-2006

(million EUR, till June 30, 2012)

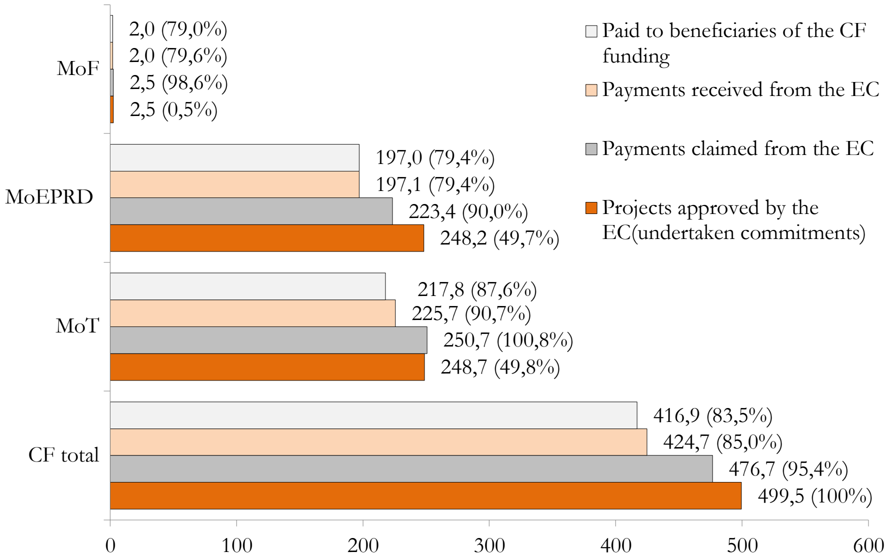


In the period of 2004–2006, the total available funding for Latvia for implementation of the Cohesion Fund projects was LVL 499.5 million.

Implementation of the CF projects for the programming period 2004–2006 was carried out until December 31, 2010. Altogether, 46 large-scale projects for the total funding of the CF in the amount of LVL 499.5 million were approved. Furthermore, 34 out of 46 approved projects were implemented in the environment sector, 24 – in the transport sector, and 2 projects were implemented as technical support projects by the Ministry of Finance for administrative capacity-building of the implementation system. Works of 45 projects were completed and one project was terminated.

Figure 6.4

EU Cohesion Fund absorption in the programming period 2004–2006 (full financial flow) by the end of June 30, 2012
(million LVL, % of undertaken commitments)



By October 31, 2011, the CF funding beneficiaries had received LVL 416.9 million or 83.5% of the CF funding. LVL 476.7 million or 95.4% of the CF funding has been claimed from the European Commission. LVL 424.7 million or 85% of the CF funding have been received from the European Commission.

Programming period 2007–2013

In the programming period of 2007–2013, the SF support is mainly directed towards education of inhabitants, technological excellence and flexibility of enterprises, as well as towards development of science and research in order to promote knowledge-based economy and strengthen other prerequisites for sustainable economic development and general living conditions for people in Latvia.

Programming of the SF and the CF resources is implemented on 3 levels: the EU level strategy or Community Strategic Guidelines, strategy of the Member States or the National Strategic Framework Document (NSFD), and Operational programmes (OP) of the Member States.

NSFD, which is the basis for allocation of the SF and CF funding in the amount of EUR 4.53 billion available for Latvia within the planning period of 2007–2013, was approved by the Cabinet of Ministers on June 19, 2007. However, on September 20 of the same year, it was also approved by the EC.

According to the Decision of the EU Council of Ministers on the EU Multi-Annual Financial Framework for the programming period of 2007–2013 Latvia has received EUR 4.53 billion or LVL 3.18 billion for implementing cohesion policy objectives through the EU funds (the European Regional Development Fund – hereinafter the ERDF; the European Social Fund – hereinafter the ESF) and the CF.

Breakdown of the funding among OPs from the total EU funding of EUR 4.53 billion in the programming period of 2007–2013:

- 1. OP *Human Resources and Employment* (ESF) – EUR 583 million or LVL 409 million;
- 2. OP *Entrepreneurship and Innovations* (ERDF) – EUR 736 million or LVL 517 million;
- 3. OP *Infrastructure and Services* (ERDF+CF) – EUR 3.2 billion or LVL 2.25 billion.

Figure 6.5

Breakdown of funding among OP's in the programming period 2007-2013
(percentage)

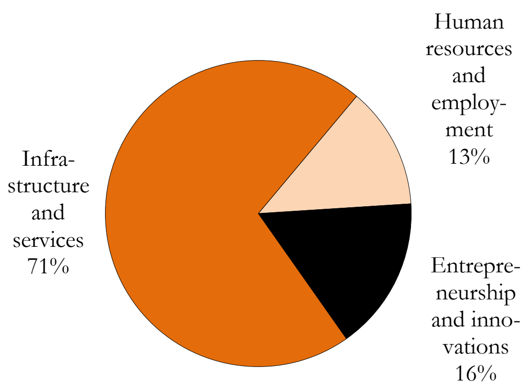


Table 6.2

EU fund financial progress in the programming period 2007-2013 till April 30, 2012

Fund	Funding of the EU funds	Concluded contracts		Paid to the funding beneficiaries		Received EC's repayments (incl. advances)	
	million LVL	million LVL	%	million LVL		million LVL	million LVL
ESF	409.8	401.5	98.0	266.1	65.0	246.0	60.0
ERDF	1 692.0	1 418.0	83.8	767.3	45.4	566.2	33.4
CF	1 082.1	957.8	88.5	465.8	43.0	347.7	32.1
Total	**3 184.0**	**2 777.4**	**87.2**	**1 365.8**	**47.1**	**1 160.0**	**35.3**

As of April 30, 2012, projects for the amount of more than a half (or 87.2%) of all financing of the EU funds available for Latvia within the given programming period have been approved, and contracts for a total of LVL 2 777.4 million had been concluded. As of April 30, 2012, the funding beneficiaries have received LVL 1 365.8 million.

Box 6.4

Activities under the responsibility of the Ministry of Economics

A total of LVL 524.8 million of the European Union resources are available for the activities of the Ministry of Economics in the programming period 2007–2013, and this amount is distributed as follows:

1. OP *Human Resources and Employment* – LVL 35.7 million;
2. OP *Entrepreneurship and Innovations* – LVL 347.6 million;
3. OP *Infrastructures and Services* –LVL 141.4 million.

Contracts concluded until May 31, 2012 within the framework of activities under the responsibility of the Ministry of Economics:

- Within activity *Support to Training of the Employed for Promotion of Competitiveness of Entrepreneurs – Support to Training Organized in Partnerships*, 30 contracts have been concluded for the total contractual sum of LVL 17.9 million.
- Within activity *Support to Individually Organised Trainings for Entrepreneurs*, 85 contracts have been concluded for the total contractual sum of LVL 2.2 million.
- Within activity *Attraction of Highly Qualified Employees*, 3 contracts have been concluded for the total contractual sum of LVL 100.9 thousand.
- Within activity *Competence Centres* 6 contracts have been concluded for the total contractual sum of LVL 37.3 million.
- Within activity *Technology Transfer Contact Points*, 7 contracts have been concluded for the total contractual sum of LVL 1.6 million.
- Within activity *Development of New Products and Technologies*, 86 contracts have been concluded for the total contractual sum of LVL 6.5 million.
- Within activity *Introduction of New Products and Technologies into Production*, 138 contracts have been concluded for the total contractual sum of LVL 39.2 million.
- Within activity *Development of New Products and Technologies – Support to Strengthening Industrial Property*, 6 contracts have been concluded for the total contractual sum of LVL 73.1 thousand.
- Within activity *High Value Added Investments*, 22 contracts have been concluded for the total contractual sum of LVL 48.9 million.
- Within activity *Access to International Trade Markets – External Marketing*, 881 contracts have been concluded for the total contractual sum of LVL 5.8 million.
- Within activity *Development of External Markets – Strengthening International Competitiveness of Industry Sectors,* 2 contracts have been concluded for the total contractual sum of LVL 4.9 million.
- Within activity *Support for Self-employment and Business Start-ups* until April 30, 2012, 657 loan contracts have been concluded for over LVL 7.8 million, as well as grants have been issued in the amount of LVL 2.65 million.
- The following results have been achieved within the financial instruments of the activity *Holding Fund*:
  (1) venture capital – on January 22, 2012, a contract on establishment of venture capital fund was concluded with *BaltCap Management Latvia*. In addition to the 20 million euro invested by the Holding Fund, *BaltCap Management Latvia* invested another 10 million euro of private investor co-funding. By April 30, 2012 *BaltCap Management Latvia* has made 7 venture capital investments in the amount of EUR 6.6 million;
  (2) seed and start-up capital – on June 16, 2010, a contract on establishment of seed and start-up capital fund was concluded with *Imprimatur Capital Baltics*. The total available financing for seed and start-up capital investments is expected to amount to EUR 6.4 million By April 30, 2012 *Imprimatur Capital Baltics* has made 7 seed capital investments in the amount of EUR 700 thousand and 2 start-up capital investments in the amount of EUR 800 thousand;
  (3) high risk loans – on March 26, 2010 contracts with *AS Swedbank* and *AS SEB Banka* were concluded. The total financing available to SME's is LVL 61.8 million. By April 30, 2012, 29 loan agreements have been concluded for the total funding in the amount of EUR 13.44 million.

Box 6.4 continued

- Within activity *Guarantees for Improvement of Enterprise Competitiveness* until April 30, 2012, 243 guarantee contracts have been concluded for the total amount of LVL 65.47 million, and until April 30, 2012, 83 export guarantee contracts have been concluded for the total amount of LVL 5.2 million.
- Within activity *Loans for Improving Enterprise Competiveness* until April 30, 2012, 362 loan agreements have been concluded for the total amount of LVL 136.4 million, including 52 loan agreements have been concluded for the amount of LVL 47.8 million in the ERDF part of the programme.
- Within the activity *Measures to Encourage Innovations and Business Start-ups* 1 contract has been concluded for the total contractual amount of LVL 2 million. Measures, seminars and competitions organized within the activity have involved 14 701 persons.
- Within activity *Business Incubators,* 9 contracts on providing business incubation services in Latvian regions and 1 contract on providing business incubation services to creative industry enterprises in Riga have been concluded. 509 enterprises are supported within the activity.
- Within activity *Co-financing to the Investments in Micro, Small and Medium-sized Enterprises Operating in the Specially Assisted Areas*, 177 contracts have been concluded for the total contractual sum of LVL 7.3 million.
- Within sub-activity *Maintenance and Renewal of Town Planning Monuments of National Importance and Infrastructure Adjustment to Develop a Tourism Product*, 21 contracts have been concluded for the total contractual sum of LVL 7.6 million (ERDF).
- Within sub-activity *Development of Cycling Tourism Product of National Importance*, 7 contracts have been concluded for the total contractual sum of LVL 4.3 million (ERDF).
- Within activity *Improvement of Heat Insulation of Multi-apartment Residential Buildings*, 466 contracts have been concluded for the total contractual sum of LVL 27.4 million (ERDF).
- Within activity *Improvement of Heat Insulation of Social Residential Buildings*, 59 contracts have been concluded for the total contractual sum of LVL 4.6 million (ERDF).
- Within activity *Measures for Raising Efficiency of Central Heat Supply Systems,* 40 contracts have been concluded for the total contractual sum of LVL 28 million (CF).
- Within activity *Development of Cogeneration Power Plants Using Renewable Energy Resources,* 10 contracts have been concluded for the total contractual sum of LVL 21.3 million (CF).

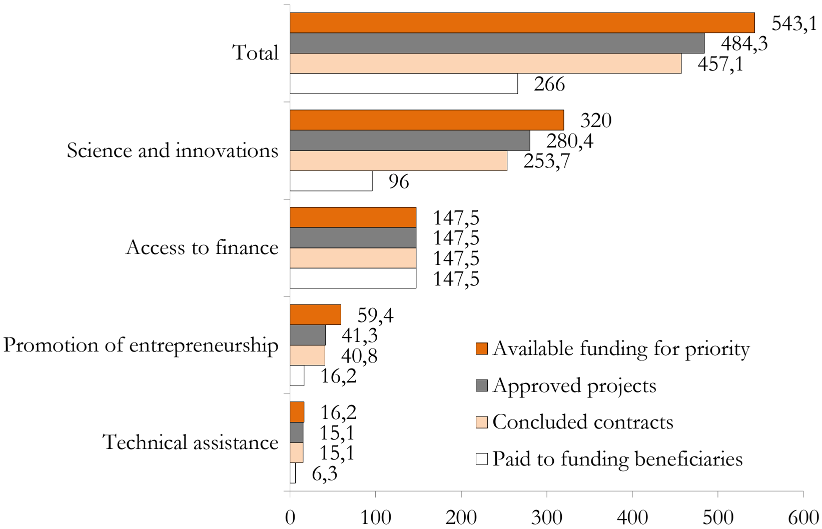
Absorption of the EU funds in operational programmes *Human Resources and Employment, Entrepreneurship and Innovations,* and *Infrastructure and Services*

In the framework of the OP *Human Resources and Employment*, the most rapid progress of implementation has occurred in social inclusion activities, promoting employment and health care activities, as well as higher education and science support activities with an increased number of both concluded agreements and bigger payments to beneficiaries.

Figure 6.6

Absorption of EU funds in the operational programme *Entrepreneurship and Innovations* till December 31, 2011

(million LVL)



The most significant progress in percentage in the field of approved projects and concluded agreements funded from public financing available to priorities has been observed in the field of employment *Human Resources and Employment,* where contracts have been concluded for LVL 451 million (98.8%), within the priority *Promotion of Employment and Health at Work*, where contracts have been concluded for LVL 201.9 million (101.5%), within the priority *Education and Skills,* where contracts have been concluded for the amount of LVL 99.6 million (97%), within the priority *Higher Education and Science*, where contracts have been concluded for LVL 85.7 million (93.6%) of the public financing available to priorities. Contracts on financing from the EU funds in the amount of LVL 35.2 million (97.1%) have been concluded within the priority *Promotion of Social Inclusion*, and within the priority *Administrative Capacity Building*, contracts on financing from the EU funds in the amount of LVL 15.8 (93.4%) million have been concluded. Payments made within programme *Human Resources and Employment* constitute LVL 300 million (65.3%), but in the priorities *Promotion of Employment and Health at Work* – LVL 143 million (71.9%), *Higher Education and Science* – LVL 61.9 million (67.6%), *Education and Skills* – LVL 59.4 million (57.9%), *Promotion of Social Inclusion* – LVL 20.4 million (56.1%), and *Administrative Capacity Building* – LVL 8.5 million (50.5%).

Overall, implementation of activities in the OP *Entrepreneurship and Innovations* exceeds the expected. Within the OP until March 31, 2012, payments in the amount of LVL 22.3 million have been made to funding beneficiaries thus significantly exceeding the expected (by 88%), as well as 28.7% of the funding absorption objective for 2012 have already been achieved. By March 31, 2012, the number of approved projects has decreased in entrepreneurship and scientific activities. Project dropout relies on the failure to meet the conditions, loss of interest of entrepreneurs in implementation of the projects and intensified inspections that allow avoiding nonconformities and termination of contracts in a timely manner.

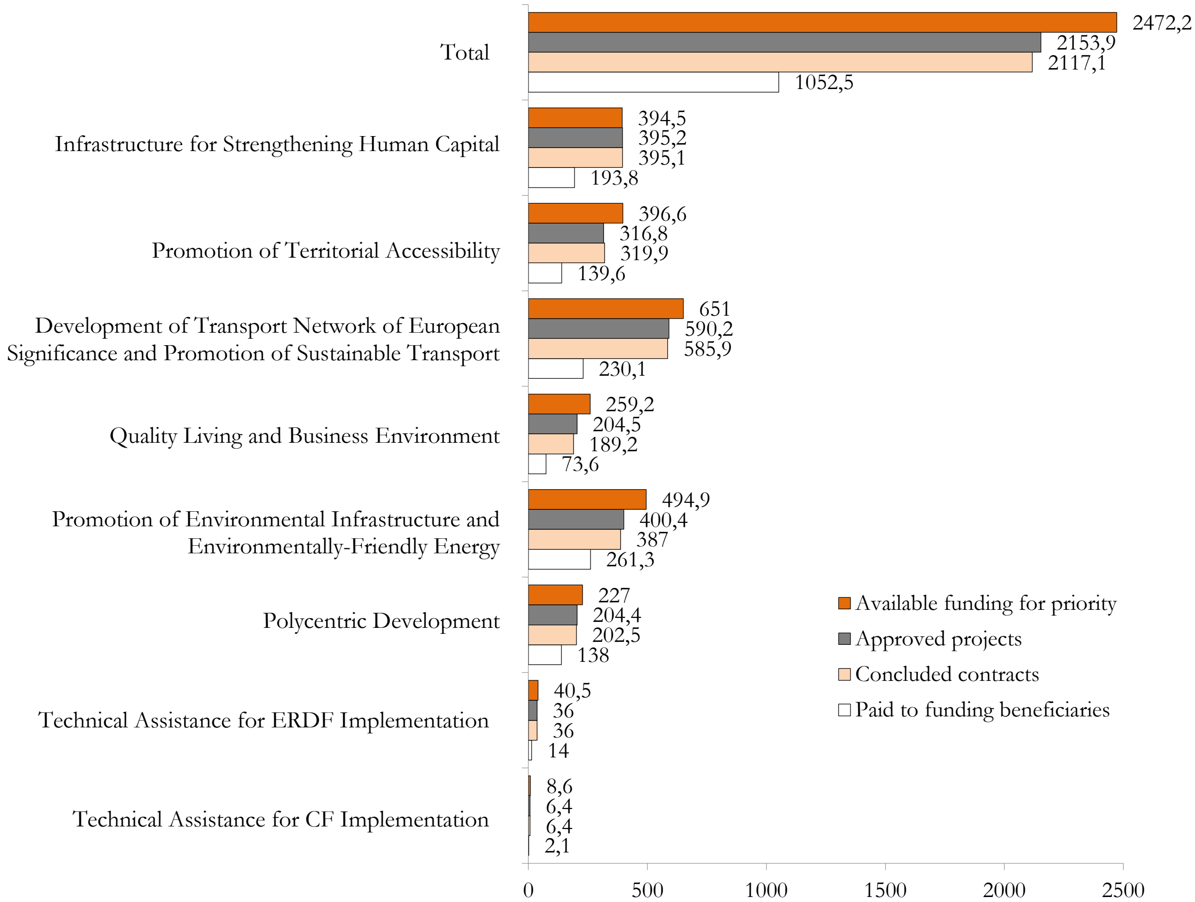
In order to improve absorption of the EU funds available within the OP *Entrepreneurship and Innovations*, until June 30, 2012 evaluation of project applications was carried out in the activity 2.1.2.4 *High Added Value Investments* and the activity 2.3.2.3 *Cluster Programme*.

Information regarding fund absorption in the operational programme *Entrepreneurship and Innovations* is reflected in Figure 6.6.

Figure 6.7

Absorption of EU fund financing in the operational programme *Infrastructure and Services* until December 31, 2011

(million LVL)



Within the OP *Infrastructure and Services* the most of programme projects are being implemented at the moment. Payments are made by over 20% more than expected, mainly to projects in the field of road, transport, ports, ICT, health, energy efficiency and culture. The most significant progress has been achieved in the priority of improving accessibility and availability of territories within road and ICT projects, more than three times exceeding the average payment progress in the OP.

The main factors delaying project implementation are procurement issues (complaints, procurements completed without any results, problems occurred within procurement procedure), identified nonconformities within the framework of the projects related to the regulations of the Cabinet of Ministers regarding excess of expenditures defined for implementation of activities and increasing prices in road construction and water management projects.

Information regarding fund absorption in the operational programme *Infrastructure and Services* is reflected in Figure 6.7.

6.2.2. Foreign Trade Policy

In the first half of 2012, there was a range of topical issues within the EU Common Trade policy, among them development of common framework for the EU investment policy, restricting protective measures in export markets, the EU bilateral trade agreement negotiations with certain third countries, developing conditions for third countries' access to the EU public procurements market, as well as promotion of intellectual property rights in international trade, etc.

Multilateral relations

In mid-2012, the World Trade Organization (WTO) had 155 members.[1] Accession of Russia and Vanuatu to the WTO was supported at the WTO's 8th Ministerial Conference in Geneva (Switzerland) held on December 15–17, 2011, therefore these countries are becoming members of the organization in the upcoming months.

After over a decade since the launch of the (WTO) Doha Round (DDA) negotiations (November 2001), the member countries continue their efforts to reduce the global trade barriers. Over the past months informal consultations of the WTO member states have been held in all central DDA areas, including non-agricultural market access, agriculture, as well as service trade. Yet, no significant progress has been achieved. Although the actual situation in negotiation prevents the WTO from successful completion of the DDA in short-term, it is planned in near future to focus mainly on such issues as promoting trade that has sufficient convergence of opinions among the member countries needed to achieve the progress. Also, in terms of service negotiations among some of the member countries[2], the possibility to liberalized multilateral service trade conditions is being considered that over time might serve as a base for simplifying multilateral conditions among all WTO's member countries.

The Ministerial Declaration on *Trade in Information Technology Products* (ITA) was concluded by 29 participants at the Singapore Ministerial Conference in December 1996 is considered a successful example of progressive reduction of trade barriers; the ITA provides for contracting parties (currently, 74 countries, including the EU member states) to completely eliminate duties on IT products covered by the Agreement. Considering the ITA preferential impact on development of information technology products and distribution worldwide, at the ITA Committee meeting on May 15, 2012 some of its contracting parties, including USA, Japan, and Korea asked the rest of contracting parties to launch informal consultation on expanding the range of products covered by the Agreement, as well as inclusion of new products. The EU supports the idea of expanding the ITA product coverage, at the same time asking to particularly focus also on eliminating non-tariff barriers that presently impose the main barriers to information technology products in the global trade.

In order to develop multilateral trade system conditions, the WTO members in different formats (bilaterally, regionally, multilaterally, etc.) are working on improving specific trade conditions. One of such initiatives involves an idea of several countries[3] to develop global framework for efficient restriction of counterfeit and pirated goods and services related to distribution thereof according to the WTO standards. In order to implement it, the parties held negotiations on the *Anti-Counterfeiting Trade Agreement* (ACTA) from 2008 to 2010. All of the parties involved in the ACTA negotiations, except the EU, Mexico and Switzerland, signed the agreement on October 1, 2011 in Tokyo (Japan). Yet, based on the decision on signing ACTA adopted by the EU Council on December 16, 2011, the EU and majority of its member states, except Estonia, Cyprus, the Netherlands, Slovakia and Germany, signed the agreement on January 26, 2012 in Tokyo after completing all the necessary internal procedures. That gave rise to wide discussions in a number of the EU member states, including Latvia, on possible threat to human rights arising out of ACTA. In order to allay the concerns of the Latvian society, the Ministry of Economics in cooperation with responsible institutions has implemented a range of informative measures, among them the online seminar on ACTA held on February 10 and the public discussion about the copyright and related rights aspects of the agreement held on May 14, emphasizing that the regulations under ACTA comply with the effective legislation and no changes in the legislation are expected in relation to the agreement.

At the same time the EC has referred ACTA to the Court of Justice of the EU for ruling on its conformity to the EU fundamental rights and freedoms, including the freedom of expression, as well as information and

[1] At the moment, 26 candidate countries are continuing negotiations on accessing the WTO, including Azerbaijan, Belarus, Kazakhstan, and Serbia are the most important for Latvia.

[2] Australia, Canada, Chile, China Taipei, Columbia, EU, Hong Kong, Japan, Mexico, New Zealand, Norway, Pakistan, Singapore, South Korea, Switzerland, and USA.

[3] Australia, Canada, EU, Japan, Morocco, Mexico, New Zealand, Singapore, South Korea, Switzerland, and USA.

personal data security. The ruling of the Court of Justice of the EU regarding ACTA is expected within 1–2 years. Besides, it should be taken into account that according to the procedure for adopting the EU decisions along with the decision of the EU Council and national parliaments of the member states, the European Parliament has to adopt a decision on ACTA. The European Parliament vote on this agreement is expected in June/July 2012 and depending on its result, as well as the ruling of the Court of Justice of the EU, the progress of this question will be implemented in a range of the EU member states, including Latvia.

Bilateral relationships within the framework of the EU Common Trade Policy

At the same time, the EU has concluded a number of **preferential agreements** prescribing mutually favourable trade conditions with such partners as Andorra, the Balkan countries[1], European Economic Area countries[2], San Marino, Switzerland, Chile, South Africa, South Korea[3], Mexico, and Turkey.

In the first half of 2012, the topical issues of the EU bilateral relationships with third countries include the work in the EU-USA High-Level Working Group on Jobs and Growth on identifying cooperation scenarios for improving trade and investment flow between both parties to promote mutually preferential jobs, economic growth and global competitiveness. The possible scenarios cover improved cooperation in certain issues, including reducing tariffs and simplifying technical regulation, as well as improving service trade and investment conditions and singing of comprehensive free trade agreement (FTA). According to the plan, proposals of the working group for further development of the EU–USA trade are expected to be submitted to the policy leaders of both parties over the coming months. The EU has already acknowledged its interest in signing a comprehensive and balanced FTA with the USA.

At the moment the assessment of the EU and Japan framework for deepening the bilateral trade relationships is being completed. The framework identifies the main fields of cooperation and steps to be taken to solve priority trade issues, particularly the non-tariff barriers in Japan. After completing the assessment, the parties are expected to start working on the EU-Japan FTA negotiations.

Negotiations on singing the EU free trade agreements with Armenia, Georgia, and Moldova have been launched, as well as reached political agreement between the EU and Vietnam on launching the FTA process in the near future. The *EU–Central American*[4] *Association Agreement* and the free trade agreement therein initialled in the spring of 2011, as well as submission of the EU-Columbian and Peru FTA to the parties for signing, including the EU member states in May/June 2012 should also be noted. At the same time, legal verification and harmonization of the FTA text contained in the EU-Ukraine Association Agreement initialled in April 2012 in Brussels is being continued. The verification will continue until fall of 2012 and will be initialled right after the verification. Considering the internal political situation in Ukraine, the question about practical application of the EU-Ukraine FTA in near future is open at the moment.

As regards active preferential agreement processes, the negotiations on the EU–Canada Comprehensive Economic and Trade Agreement to be completed in late 2012 are the closest to completion. Also, the FTA negotiations with Singapore and India are expected to be completed after solving the most sensitive issues. Yet, contrary to the expected, the results of negotiations with the Southern Common Market countries[5] (*Mercosur*) are far from positive due to the different positions of the *Mercosur* countries.

At the same time, the EU is holding the FTA negotiations also with Malaysia, the Gulf Cooperation Council countries[6] (GCC) and Mediterranean countries[7], as well as the negotiations on economic partnership agreements with the majority of African, Caribbean and Pacific Group of States (ACP).

Promotion of accessibility to the third country markets

In order to ensure efficient access of exporters from the EU, including Latvia, to the third country markets, in the first half of 2012, measures for identifying, eliminating, and preventing barriers were implemented according to the updated *EU Market Access Strategy* approved in April 2007. Within the strategy, 12 Working groups and 33 Market Access Teams were established to deal with issues specific for the EU enterprises in relation to situations of trade limits in the third countries, as well as matters of various sectors and regions. The groups and teams include also economic representatives from Latvia in USA, Israel, Kazakhstan, Russia, Turkey, and Ukraine.

Since launching the supervision of world country trade policy instruments in 2009, the most trade restrictions have been imposed not only in such markets important to the Latvian export as Russia, Ukraine, Belarus, and Kazakhstan, but also in the markets of the strategically important trade partner countries of the EU-USA, Argentina, Brazil, China, India, and Japan.

It should be noted that the European Council of March 1-2, 2012 approved the second annual *Trade and Investment Barriers Report*, covering the trade restrictions important for the EU enterprises, including the

[1] Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro, and Serbia

[2] Iceland, Liechtenstein, and Norway

[3] Temporarily in force as of July 1, 2011 (until ratification is completed by all parties; Latvia has completed the ratification on August 4, 2011)

[4] Costa Rica, Guatemala, Honduras, Nicaragua, Salvador, and Panama after its involvement in the Central American economic integration process

[5] Argentina, Brazil, Paraguay, Uruguay, and Venezuela

[6] Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates

[7] Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestinian Authority, Syria, and Tunisia

prohibition of Russia to import live pigs form the EU member states that is important to Latvia as well.

Economic cooperation agreements of Latvia and third countries and regions of third countries

In order to activate the bilateral economic cooperation after the accession to the EU, Latvia has concluded bilateral economic cooperation agreements with Russia, China, Belarus, Ukraine, Kazakhstan, Azerbaijan, Georgia, Moldova, Uzbekistan, Kyrgyzstan, Turkmenistan, Tajikistan, and Armenia. Within the framework thereof, Intergovernmental Commissions (IGC) have been established, ensuring supervision of validity of agreements and analysis opportunities for further cooperation improvement.

An IGC meeting has been held with Belarus in the second half of 2011, and in the first half of 2012 – with China and Uzbekistan and business forums of Latvian-Chinese, Latvian–United Arabian Emirates and Latvian-Qatar entrepreneurs and have been organized as well.

The IGC meeting is planned to be held with Kazakhstan (June 27–28, Astana), Ukraine (July 4–5, Riga), Belarus (Riga), Georgia (Tbilisi) and Turkmenistan (Riga) in the second half of 2012.

Although Latvia and Russia have concluded an agreement on economic cooperation, active cooperation is carried out also with the regions of the Russian Federation. At the moment, agreements on economic cooperation with the Republic of Karelia, the Republic of Bashkortostan, the Chuvash Republic, Vologda Oblast, the Pskov Oblast and Kirov Oblast are in force. Negotiations are currently held with the governments of Kirov, Ivanovo, Yaroslavl, and Kaluga Oblasts on the conclusion of an agreement in the field of economic cooperation. To ensure implementation thereof, the parties prepare and sign measure plans as soon as the agreement enters into force. A plan for implementation measures of the agreement is being developed with Vologda and Kirov Oblasts. Yet, the agreement between the Ministry of Economics and the government of the Pskov Oblast on the action plan for implementation of economic cooperation for 2012-2014 was signed on May 2, 2012 during the business visit of the governor of the Pskov Oblast in Riga (the agreement came into force on the date of signing).

On November 13-15, 2011 the Minister for Economics was on a business visit to Azerbaijan within the framework of which he met high level officials of the Republic of Azerbaijan, including the president of Azerbaijan. The event Latvian Days *Taste Latvia* was open during the visit. In order to promote export of Latvian-produced goods to Azerbaijan, the Latvian Days in Baku were organized in November–December, 2011.

On March 10-15, 2012 the Minister for Economics together with Latvian entrepreneurs were on a business visit to the United Arab Emirates and Qatar within the framework of visit of the Prime Minister V. Dombrovskis. This visit was initiated by Latvia to look for new export markets for Latvian producers and attract new investments to Latvia. During the visit, Latvian delegation met a range of high-level officials and participated in business forums. 42 entrepreneurs representing 32 enterprises participated in the visit. Potential cooperation areas are agriculture, wood and wood products, food production, and new technologies.

On April 22-24, 2012, the Minister for Economics went on a business visit to Hannover and visited the international engineering fair *Hannover Messe 2012*, in which 9 representatives of Latvian enterprises participated representing the field of metal processing, alternative energy and rubber production. Within the fair, the Minister met the German Minister for Economics and Technologies, as well as the State Secretary of the Ministry for Economics of the state of Lower Saxony to discuss cooperation possibilities with the state of Lower Saxony, especially in the field of clusters. On May 7-14, 2012, the Minister for Economics was on a business visit to USA. During the visit, he met US officials and representatives of entrepreneurs and discussed possibilities to further develop mutually preferential economic dialogue between Latvia and USA, including attracting new USA investments to Latvia and promoting more active bilateral trade. The Minister also met representatives of the World Bank to discuss possible support for development of national industrial policy. During the visit, the Minister for Economics was accompanied by representatives from Riga Technical University, RIX Technologies and the Latvian Information and Communications Technology Association (LIKTA) who had an opportunity to directly develop contacts with potential USA partners for implementation of new cooperation projects.

Sectoral issues of the EU foreign trade

Steel

Flexibility and multiple processing potential of steel make it one of the most widely used industrial raw materials in the world. The metal industry forms a part of the general European competitiveness in all links of the value chain, besides, the EU is the second largest steel producer in the world after China.

The sector all over the world has recovered more rapidly than expected. Although the demand for steel is slowly increasing in the EU internal market, high energy process, fiscal consolidation and difficult access to financial resources have diminished this increase.

The EU currently applies quantitative restrictions on import of certain steel products from Russia and Kazakhstan. In October 2007, the EU and Russia concluded an agreement on steel trade for 2007 and 2008, as well as agreed on annual extension thereof for the years 2009 and 2010, envisaging an annual increase of 2.5% in quotas. Thus, in 2011, the quotas for Russia were defined in the amount of 3.27 million tons. Yet, after accession of Russia to the WTO, the agreement will become invalid and the quota system cancelled As regards Kazakhstan, the EU currently applies autonomous measures defining the import quota in the amount of 0.1 million tons.

Additionally, for the purpose of steel flow monitoring system, the EU applies the prior surveillance system for the import of particular steel products from all third countries.

Textiles

Products of the textile industry are among the most marketed goods in the global economy. The EU is the second largest exporter of textile goods in the world after China, dominating in the world in markets of high income and high quality textile goods and clothing. The main EU trade policy activities also in 2012 regarding textiles and clothing are related to development of proper regulations regarding development of intellectual property protection provisions and breaking down trade barriers to the European textile goods export in markets of rapidly developing third countries.

The textile and clothing sector was an exception for the progressive trade liberalization of industrial goods in the multilateral negotiations of the WTO for a long time until 1995, when the developing countries made the WTO member states to pledge on gradual implementation of a complete trade liberalization of textile goods. Thus, the restrictions of the EU textile goods import imposed on China were cancelled as of January 1, 2009, and since May 5, 2010, the double-control monitoring system (licensing) without quantitative restrictions applied to the import of certain textile goods originating from Uzbekistan has been cancelled, as well. Thereby the EU is currently applying quantitative restrictions only to the import of textile goods from Belarus and North Korea, which are not WTO member states.

Trade Defence Instruments

The EU uses trade defence instruments (TDI) to prevent sale of import goods in the EU market for dumping prices, to protect EU enterprises against unfair state subsidies used by producers in third countries, as well as to ensure fair competition in case of sudden changes in a flow of goods trade by domestic market defence measures. The European Commission initiates an inspection based on claims of enterprises representing industry indicating significant damage caused to the EU industry by third countries import dumping prices or applied subsidies. The EU applies the TDI system provided within the WTO for preventing unfair trade and emphasizing its efficient application and evaluating interests of all involved parties, i.e. producers, importers, and users.

In the 1st quarter of 2012 the EU inspections have resulted in applying 115 anti-dumping measures and 10 anti-subsidy measures to various products of other countries. For comparison – there were 253 anti-dumping measures and 51 anti-subsidy measures in force in the USA, 109 anti-dumping and 4 anti-subsidy measures in China, and 71 anti-dumping and 1 anti-subsidy measures in Argentina at the end of 2011. Over the last few years, most of the cases in the EU have been initiated against China, India, USA, Thailand, Taiwan, Malaysia, Russia, Ukraine, and Indonesia. In the 1st quarter of 2012, 8 new antidumping and anti-subsidy cases and 8 expiry and 2 interim reviews have been initiated.

In anti-dumping inspections Latvia supports open trade, access for producers and users to the necessary raw materials and intermediate consumer goods, as well as differentiation of supply chains thereof. From the perspective of interests of Latvian producers, the most significant TDI are the following:

– anti-dumping duties on the import of continuous filament glass fibre products and glass fibre mesh fabric from the People's Republic of China introduced by the EU in February 2012, as well as subsequent application of the abovementioned to Malaysia after initiating inspection with respect to avoiding payment of anti-dumping duty and detecting that since application of the measures in the EU, the import of glass fibre mesh fabric of China origin from Malaysia has been increased;
– anti-dumping measures introduced by the USA in 2001 with respect to import of steel bars from seven countries, including Latvia. Considering the fact that the WTO Disputes Settlement Institution has recognized the anti-dumping margin calculation method *(Zeroing)* used by the USA as unjustified and non-compliant with the WTO's norms, in May 2012 the USA recalculated the duty thus reducing the amount of duty applicable to Latvian enterprises. Nevertheless, the sunset review is going to be initiated on July 2, 2012 which might result in complete cancelation of the duty.

In order to encourage small and medium-sized enterprises to get involved in TDI inspections, in 2012, the European Commission in cooperation with the responsible institutions of the member states established the SME Helpdesk, and developed guides on initiating anti-dumping and anti-subsidy inspections, as well as a guide on TDI. It is aimed at improving the understanding of the EU entrepreneurs about their rights and obligations in inspections carried out in third countries. As part of the launched measure, an initiative on improving the TDI has been made available for public discussion as of May 2012 aimed at making the EC TDI inspections more transparent and simplifying participation of interested parties in the TDI inspection procedures.

6.2.3. Internal Market of the European Union

The EU internal market currently comprises 30 countries (including European Economic Area countries – Norway, Iceland, and Liechtenstein) with approximately 500 million consumers. The EU internal market encompasses a territory without internal borders where free movement of goods, persons, services, and capital is ensured. After continued and serious work within the framework of the EU, a uniform formation of set of rules has been achieved for operators of economic activity, border control has been cancelled, more competitive business environment is established, a wider choice of goods and services is provided for consumers, new jobs are created, an opportunity to live, work, study, and retire in another country is provided for residents, an opportunity to introduce single currency has been established, as well as many other benefits have been provided. However, the potential of the internal market still has not been fully employed, and its improvement is continuing by promoting sustainable and stable development of the EU economy and prosperity of the EU residents.

In Latvia, implementation of internal market directives is taking place successfully, and sufficiently high results regarding the transposition efficiency of the directives have been achieved. Latvia has repeated the best result so far with a deficit of directive transposition of 0.4% and has been ranked the 3rd among 27 Member States, after Malta (0.1%) and Ireland (0.3%), thus achieving the Lisbon objective of 2009 to transpose 99% of directive requirements or allow a transposition deficit of 1 percent.

In Latvia, the process of implementing the principles of free movement of goods and services and the rights to do business established in articles 34-36 and 49-62 of the *Treaty on the Functioning of the European Union (TFEU)* is supervised and coordinated by the Ministry of Economics, constantly identifying legal regulations that may potentially or actually hinder implementation of the freedoms in the EU internal market, *inter alia*, by assessing the current draft laws and regulations.

The procedure for submitting technical regulations (*Directives 98/34/EC* and *98/48/EC*), which prescribes the obligation of the EU Member States to submit draft technical regulations to the European Commission and to other EU Member States, as well as to the European Economic Area countries for further assessment, serves as a preventive, single, and transparent monitoring instrument with the aim of evaluating and preventing the setting of such requirements of the laws and regulations that may create obstacles for free movement of goods and social services. Any business, not only the responsible institutions of the Member States, may take part in the harmonization process of technical regulations in order to provide its comments and objections concerning the projects prepared by other EU Member States, which may potentially influence export of production or the cross-border provision of information society services of the merchant. Information on draft technical regulations announced by the Member States is freely accessible on the *Technical Regulations Information System* (TRIS) database: *http://ec.europa.eu/enterprise/tris/default.htm*. *TRIS* database is a free service, and the majority of the notified draft technical regulations are available in Latvian. In case an enterprise has any objection to draft technical regulations of other countries that might or do affect sale of its products in the market of a particular EU Member State, the enterprise is entitled to submit its objections to the responsible ministry the competence of which includes coordination of specific policy in Latvia. List of contact persons in responsible ministries is available on the website of the Ministry of Economics: *http://www.em.gov.lv/em/2nd/?cat=30412*.

The principle of mutual recognition is the sole legal instrument in the non-harmonised sphere of application of national technical regulations and standards for harmonisation of draft technical regulations pursuant to the procedures set by the *Directives 98/34/EC* and *98/48/EC* in order to ensure free movement of goods.

In order to improve application of the principle of mutual recognition within the administrative practice of the national competent authorities, after a suggestion of the European Commission and with the support of the EU Member States, the *Regulation (EC) No 764/2008* of the European Parliament and of the Council laying down procedures relating to the application of certain national technical rules to products lawfully marketed in another Member State and repealing *Decision No 3052/95/EC* was adopted and enforced on September 2, 2008. Thereby, a substantial step was taken towards introduction of a new legal instrument at the EU level. Application of the requirements of the Regulation in Latvia and other Member States is ensured as from May 13, 2009.

The aim of the Regulation is to envisage the procedures, whereby the principle of mutual recognition must be observed in the work of public authorities by applying the national technical regulations to the goods manufactured or lawfully released into free movement in the European Economic Area countries, distribution of rights and obligations among the national competent authorities and economic operators within the framework of the mutual recognition procedure, as well as for the purposes of simplification of applicable administrative procedures, the Regulation stipulates an obligation for the state to establish one or more product information points for the informative support of performers of economic activity. Currently, the functions of the product information contact point in Latvia are performed by the Ministry of Economics *(e-mail: pcp@em.gov.lv)*. Since the inception of the activity, the

Product Information Contact Point has replied to requests for information on national requirements regarding various products received from merchants of 29 other European Union Member States.

In order to promote business activity and innovations in the service sector, as well as gradual modernisation and simplification of state administration, one of the priorities set for Latvia within the EU is promotion of free movement of services. In the field of services, in cooperation with non-governmental organizations and public institutions, requirements of the laws and regulations are regularly analysed, and proposals on necessary amendments are prepared in order to eliminate current administrative burden for enterprises. Current administrative barriers and procedures are under revision, respectively cancelling or simplifying requirements for issuing permits (licences, certificates, confirmations, and other documents), as well as making it possible to handle all the necessary procedures electronically.

Procedures of extending the validity term of permits are also simplified, and the list and the number of documents to be submitted for receiving the permit is revised, requests for permits are replaced with requests for registration, procedures for re-certification of persons, as well as other administrative processes are simplified. Additionally, implementation of the one-stop shop principle still continues, thus improving access to services rendered by public administration in one place – in the single state and municipal service portal *www.latvija.lv*.

The principle of silence means consent is one of tools that fosters modernization of public administration to reduce delay of public institutions in decision-making, costs and adverse effect incurred to small and medium-sized enterprises by, for example, overlapping procedures or excessive bureaucracy in relation to submission of documents. The principle defines that in case a responsible institution fails to make a timely decision on application for a permit, it shall be considered that the service provider has received the permit and is entitled to start service rendering. Many EU countries have already adopted the silence-means-consent mechanism thus trying to simplify public administration for the benefit of enterprises and population. Currently, the responsible institution of Latvia plans to make the necessary amendments to laws and regulation to apply the silence-means-consent principle to the issue of certain permits.

In order to ensure administrative cooperation among public administration authorities of the European Union, the European Commission has introduced the ***Internal Market Information (IMI)*** system. The *IMI system* allows fast and easy communication between the responsible institutions of EU Member States (also Norway, Iceland, and Lichtenstein) both at national, regional, and local level. The *IMI system* provides an option to search the responsible institutions of other Member States for cooperation purposes and a set of prepared questions and answers to make the daily use of the *IMI system* easier for users. At the same time, the *IMI system* provides clear information exchange to its users, thus allowing efficient keeping up with information exchange in the system. Through the *IMI system,* the Member States can verify authenticity of documents issued in other Member States and submitted by legal entities and individuals and contact the issuing institution in case of any questions. Thus, the person submitting the documents is released from additional bureaucratic barriers to solve different issues in the Internal Market of the European Union. Currently, the *IMI system* is available in the field of the *Service Directive (2006/123/EC)*, the *Professional Qualification Directive (2005/36/EC)* and the *Posting of Workers Directive (96/71/EC)* (still a pilot project). Taking into account the obligation under the *Service Directive* – the Member States have to notify each another about services that might be harmful to human health, life and environment, the *IMI system* includes a *Warning mechanism* that ensures successful cross-border cooperation among supervisory institutions in risk elimination. In the IMI system, 52 responsible institutions of Latvia accounting for information exchange of one or several fields are registered: 7 – in the sphere of professional qualification, 36 – in the sphere of services, 3 – in the sphere of professional qualification and services, 3 – in the sphere of employee secondment, 2 – in the sphere of employee secondment and services. At the moment, the *Warning mechanism* has involved 3 supervisory institutions – the Consumer Rights Protection Centre, the *State Environmental Service*, the Health Inspectorate and 2 ministries – the Ministry of Health and the Ministry of Economics, as well as the *Warning message* coordinators. The Ministry of Economics is the national *IMI system* coordinator in Latvia.

Since October, 2011 the *IMI system* in Latvia has registered 40 requests for information: 2 – in the field of services, 6 – in the field of employee secondment, 32 – in the field of professional qualification.

Since 2004, the alternative *On-line problem solving network of the European Union Internal market* established by the European Commission and the Member States – **SOLVIT coordination centre network** – is available in Latvia. The task of the *SOLVIT coordination centre network* is to find a quick and practical solution to problems in the EU internal market occurring as a result of misapplication of European Union laws and regulations by public institutions. The *SOLVIT coordination centre network* serves as a free of charge problem solving instrument before bringing a court action in situations when a citizen or enterprise has suffered from unlawful decisions made by responsible institutions of other Member States. *SOLVIT coordination centres* are located in every Member State of the European Union (also in Iceland, Norway, and Lichtenstein).

In 2011, the SOLVIT coordination centre in Latvia has received 31 cases, out of which 20 cases comply with the *SOLVIT* criteria for case solving – a decision has been made by a public institution, the public institution is located in another Member State of the European Union (cross-border element), and the European Union law has been violated (regulations, directives, etc.). Most often the SOLVIT coordination centre in Latvia has solved cases of individuals regarding issue of residence permits, and of entrepreneurs – restrictions to free movement of services.

6.3. Industrial Policy

The economy of Latvia has gone through important macroeconomic adjustments. The economic model, which fostered an increase in domestic demand due to the inflow of foreign capital, thus being the main driver of growth, no longer exists. It was not a sustainable model and consequently led to a deep economic crisis due to substantial macroeconomic imbalances (high inflation, high current account deficit of the balance of payments, etc.).

Currently, a transition to sustainable economic model is taking place in the economy of Latvia, in which exports are the key driver of growth along with the ability to compete in domestic and external product markets and the ability to be competitive in attracting capital to increase the productive potential of Latvia. Along with the change of the common economic paradigm, the sectoral policies also need to be changed in the broadest meaning of the word to ensure that they correspond to the modern, updated and latest scientific methods developed and practically approbated by economic theorists on multiple occasions. The academic literature in the field of economics refers to it as the modern industrial policy (also called "industrial policy 2.0", "industrial policy for the 21st century", etc.), competitiveness of nations and strategy of regional innovations.

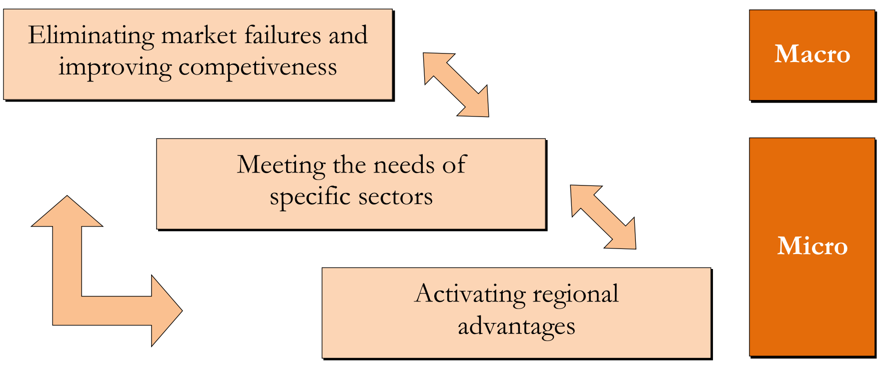
The Ministry of Economics is currently developing the *National Industrial Policy of Latvia* based on the latest world practices and approaches and aimed at changing the economic structure in favour of production of sophisticated goods and services with higher value added.

Theories of modern industrial policy developed by Mr D.Rodrik, Mr M.Porter, Mr R.Hausmann and other theoreticians of economics, as well as the framework of national competitiveness and regional innovation model are adapted within the framework of the *National Industrial Policy of Latvia*. Moreover, the EU priorities (the EU industrial and competitiveness policy) and *acquis communautaire* will be taken into account when developing industrial policy.

The *National Industrial Policy of Latvia* is based on activity directed towards eliminating market failures and improving competitiveness (macro-level economy analysis), meeting specific needs of separate sectors (micro-level economy analysis) and activating regional advantages (micro-level economy analysis).

Figure 6.8

Elements of Modern Industrial Policy



At the same time the development of basic industrial policy (related to the development of basic infrastructure, improvement of tax and educational system and many other factors that Mr. M. Porter described as "factor conditions") will be ensured, as well as development of advanced industrial policy (target oriented on the development of innovations, R&D, clusters and other factors that Mr M. Porter described as "related and supporting industries" and "firm strategy, structure and rivalry").

Modern industrial policy will be targeted both on sectors (industries) historically developed in Latvia and having already achieved comparative advantage (traditional industries), as well as on future industries currently developing with a high export potential.

The long-term planning documents approved in Latvia are taken into account within the elaboration of industrial policy – long-term conceptual document *Latvia's Development Model: People First*, *Sustainable Development Strategy of Latvia until 2030 (Latvia 2030) and National Reform Programme of Latvia for the Implementation of the "Europe 2020" Strategy*. The industrial policy is expected to become an integral part of the *National Development Plan*.

The aim of the *National Industrial Policy of Latvia* is to promote structural changes in the economy in favour of production of goods and services with higher value added, namely by increasing the role of industry, modernizing industry and services and export sophistication.

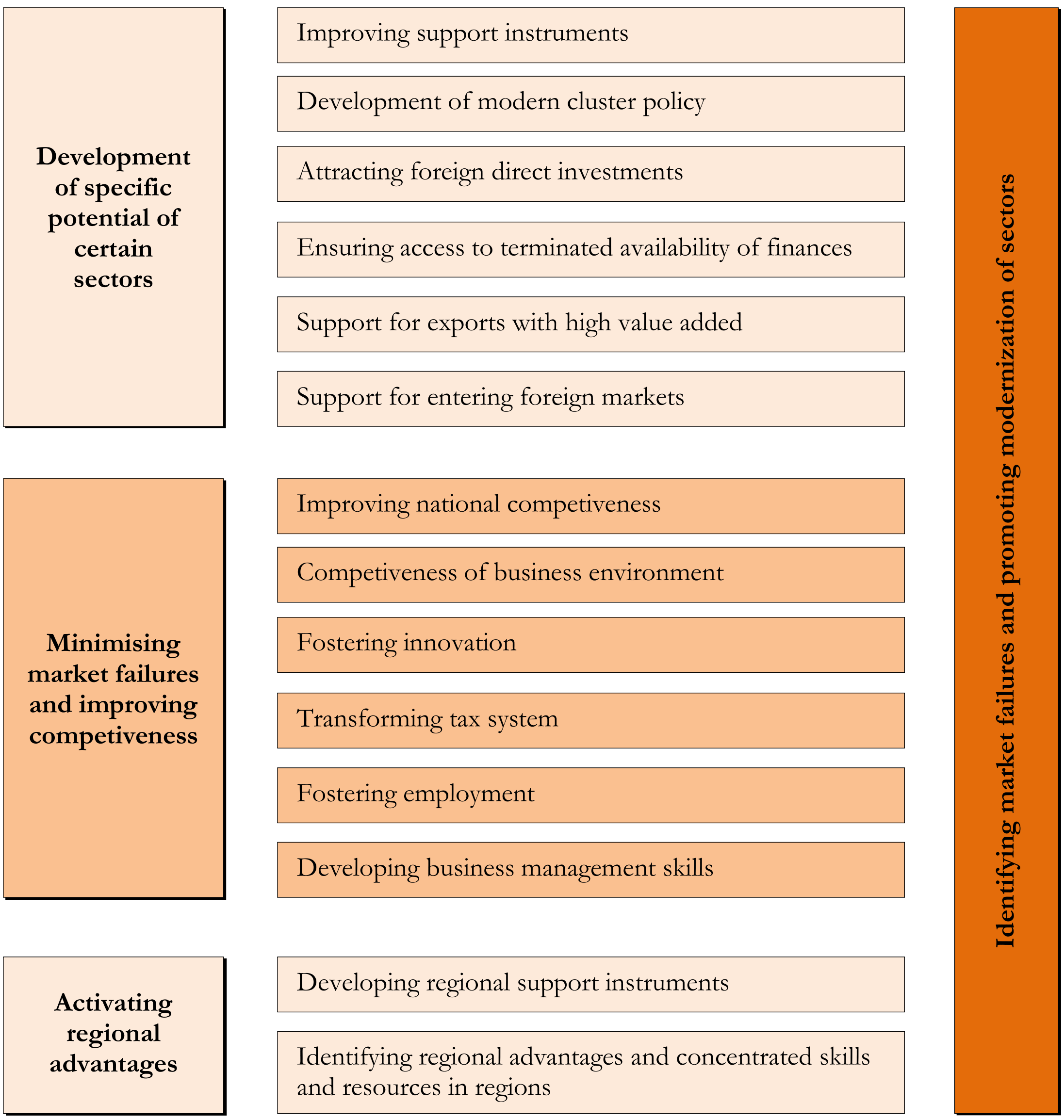
In order to reach the defined aim set within the framework of the modern industrial policy the following expected results are determined:

- the share of manufacturing shall reach 20% of the gross domestic product by 2020;
- the increase in the productivity of manufacturing shall reach 40% by 2020 compared to 2011;
- the increase of manufacturing shall reach 60% by 2020 compared to 2011;
- investments in research and development shall reach 1.5% of GDP.

The main activity directions of the *National Industrial Policy of Latvia* are presented in Figure 6.9.

Figure 6.9

Framework of Activity of Modern Industrial Policy



Eliminating market failures and improving competitiveness is an essential industrial policy direction. The analysis of indices affecting competitiveness and evaluation of strengths and weaknesses of competitiveness in Latvia was performed along with the elaboration of the first *Latvian Competitiveness Report 2011 (LCR)*[1]. The development of the *LCR* involved internationally recognized researchers and competent consultants of Latvian economy sectors. The main aim of the *LCR* was to provide general assessment of competiveness of Latvian economy thus laying a fact-based foundation for the policy orientation.

The selected concept of the *LCR* is based on productivity and focused on factors that directly or indirectly affect it. Based on the analysis of statistical data and conclusions of a number of theoretical and empiric research, the *LCR* analysed medium-term development trends of Latvian economy (on supply side), as well as short-term conditions (on demand side). Two in-depth researches were carried out within the framework of the draft *LCR*, providing the analysis of the export's goods space, as well as the analysis of innovation and small enterprise exports and financing.

Based on the assessment of competition provided in the *LCR*, the authors of the report have identified the following areas of concern for competiveness of Latvia:

– inequality – Latvia is one of the least equal societies in Europe;
– innovations – Latvia's innovation performance persists as one of the poorest in the EU;
– industry – the Latvian share of manufacturing to GDP and manufacturing productivity are the lowest in the EU;
– education – the evidence points to quality problems in parts of Latvia's education system;
– financial markets – Latvian financial market development has persistently lagged behind that of other new market economies in Europe;
– grey economy – the informal economy in Latvia persists as one of the largest in the EU.

It is important to eliminate the identified problem areas of competiveness as soon as possible, by preserving the medium-term vision.

The most substantial element of the industrial policy is the **promotion of the modernization of sectors**, in the result of which the activities mentioned in this chapter occur – in cooperation with the organisations represented in the National Economy Council a wide analysis of the abilities and skills of the sectors has been carried out within the framework of a new, improved dialogue (Dialogue 2.0), including an analysis of government failures, for example, an analysis of national priority sectors at the level of enterprises (micro) and the economy (macro), as well as an examination of the existing support instruments towards the identified market failures in order to promote the support for the increased sophistication of export products. Within the framework of the dialogue an agreement on supervision mechanism shall be reached to analyse the efficiency of the existing industrial support policy by evaluating advantages, disadvantages and mistakes on a regular basis.

One of the most important elements of the modern industrial policy in Latvia is the necessity to **develop a state intervention policy**. On the basis of international analytical research the Ministry of Economics plans to carry out the analysis of the most export-oriented niches and products of these niches. It is planned to perform an analytical evaluation within 2012 based on economic theories and global practice, for example, particularly on products space analysis method developed by Mr. Hausmann and his colleagues. This evaluation will include the identification of the most export-oriented niches of the economy, the evaluation of export ability of niche products and the investigation of opinions of enterprises with an aim to identify current shortages and future vision promoting or delaying development of the corresponding enterprise or product and transition to production of products with higher value added.

Base on the analysis and conclusions the Ministry of Economics will develop state intervention instruments that will be financed by the EU Financial Perspective for 2014–2020.

The Ministry of Economics in cooperation with other sectoral ministries will prepare a detailed description of activity directions under the *National Industrial Policy of Latvia* and planned measures according to the task assigned under the *Government Declaration* and the draft *Government Action Plan* and submit it to the Cabinet of Ministers for consideration by the end of 2012. Yet, **the key aspects for the implementation of a modern industrial policy** have already been outlined – **a six-step strategy**:

1. **Evaluating the base of resources** – envisages the analysis of Latvia's national resources (human resources, production capacity, etc.) by determining the base level for these resources in the territory of Latvia. The evaluation of resources allows identifying not only the state support policies necessary on regional aspect, but also those policies that are oriented towards the reallocation and development of resources, for example, investment attraction policy, infrastructure development policy, etc.;

2. Determining **the most export-oriented niches and corresponding niche products** with high value added potential based on the analysis performed by the Bank of Latvia according to the methodology of Mr. Hausmann, Mr. Klinger, Mr. Rodrik and Mr. Hwang. In order to promote competitiveness of products, the complexity level of currently produced

[1] *http://www.mk.gov.lv/files/latvijas_konkuretspejas_izvertejums2011_final.pdf*

products and the possibility to develop production must be analysed to produce products with higher value added. Therefore, it is planned to analyse the product space in order to identify niches and niche products that are the closest to products of the next development stage by analysing such factors as export-ability, productivity, employment and innovation, as well as future development tendencies of these factors;

3. **In-depth analysis of manufacturers** – considering the abovementioned analysis of niches and products, an analysis of enterprises, which produce goods, will be performed with an aim to identify abilities, skills, capacity, possible strategies and shortages by taking into account analysis of niche and products mentioned above. The analysis is expected to identify shortages (bottlenecks) of abilities and skills hindering the development of enterprises producing products with a higher value added. This analysis will be used as a base for further dialogues on the steps of state intervention;

4. **Dialogue 2.0** – includes a change of paradigm in the discussion between the government and society. Within the framework of the new dialogue it is planned to discuss on previously mentioned export-oriented niches, their products, results of analysis of manufacturers, as well as on identified management failures will be carried out. Dialogue 2.0 stipulates that not only the government must provide a vision and an analysis regarding the aspects of the abovementioned analysis, but also the society and non-governmental organizations representing entrepreneurs. Thereby, the result of a modern dialogue is an acquisition of complete information by analysing the results of the dialogue of both parties, as well as an agreement on innovative state intervention mechanisms;

5. **Assessing current state support instruments** – to continue the work on the development of a new EU financial framework and implementation of a modern industrial policy, it is necessary to assess the state support instruments developed so far in order to identify instruments that comply with the guidelines on modern industrial policy, as well as to identify those instruments that have promoted rent-seeking or have not been implemented in full, for example, performing an analysis of causes and reasons of the failure;

6. **Development of terminated support instruments** is performed in compliance with the EU *acquis communautaire* and aims set by the EU institutions. It is planned to develop terminated support instruments by using an instrument of the previously mentioned dialogue in order to ensure increasing export product sophistication and volume.

During the development of the *National Industrial Policy of Latvia,* six steps have been identified. Although they are not closely interrelated, they depend on the achieved results within each of the steps.

6.4. Energy Policy

The main approaches to the energy policy are directed at increasing security of energy supply of the country by encouraging diversification of supplies of the primary energy resources and by creating conditions for increasing subsistence of electric energy generation, as well as by preventing isolation of the regional electric energy market through new interconnections. Creation of competition conditions for promoting the use of renewable and local energy resources and environmental protection also plays a substantial role.

On June 27, 2006, the Cabinet of Ministers approved the *Energy Development Guidelines for 2007–2016*. The Guidelines contain the government policy, development objectives and priorities in the energy field both in the medium-term and long-term period. Taking into consideration policy priorities and significant changes in the Latvian economy, a long-term planning document for the energy sector's development – *Energy Strategy 2030* – is being prepared and it is based on four cornerstones: safety of energy supply, competitiveness of energy, efficient use of renewable resources and improvement of energy efficiency.

Box 6.5

Energy Sector in Latvia

Both the imported (natural gas, electricity, petroleum products, coal, coke, etc.) and local (hydropower, firewood, charcoal, straw, biogas, bioethanol, biodiesel, peat, used tyres, municipal waste for heating, wind energy) energy resources are used in Latvia to supply fuel, electric energy and heat to sectors of economy, commercial consumers and residents.

A part of electricity is generated by Latvian HPPs, CHPs, biogas and wind power plants, whereas the other part is imported. Mainly the imported fuels – natural gas and heavy fuel oil and local fuels – firewood – are used in heating energy generation.

In 2011, energy resource generation and recycled products in Latvia reached 86.7 PJ, but import of energy resources was 165.8 PJ, out of which 59.1 PJ was the import of natural gas.

In 2011, the total consumption of primary energy resources in Latvia amounted to 188.7 PJ, and self-security in the total consumption of primary energy resources was 33.1%. In the total consumption of primary energy sources, firewood with its total consumption forming 46.9 PJ was the most widely used local energy resource, electricity generated in hydropower stations and wind power stations constituted 10.6 PJ.

The draft *Energy Strategy 2030* sets the following objectives of the energy policy:

– Competitive economy – balanced, efficient, economically, socially and ecologically justified energy policy based on market principles ensuring further development of the economy, its competitiveness in the region and world;
– Sustainable energy – reduced dependency from imports of energy resources, new and efficient technologies for the use of renewable resources are encouraged, measures to improve energy efficiency are implemented;
– Safe supply – stable energy supply and developed infrastructure provided to energy users.

Electric energy market

More than 90% of electric energy generated in Latvia is generated by the JSC "Latvenergo", which also ensures electric energy imports and supply to the consumers. Currently, 34 traders have received licences for electric energy trade. However, only 2 traders are operating actively in the electric energy market – JSC "Latvenergo" and LLC "Enefit". Since September 1, 2005, the operator's functions for the electric energy transmission system are performed by the JSC "Augstsprieguma tīkls", which has become an independent transmission system operator as of January 1, 2012. Since July 1, 2007, the operator's functions of electric energy distribution system are performed by the JSC "Sadales tīkls".

A well-operating domestic electric energy market has to provide the producers with proper stimuli to invest in new types of energy production, among all electricity production from renewable energy sources. According to the provisions set in the EU Third Energy Package, without separating network services from production and trading activities (efficient separation), there is not only the risk to face discrimination in network management, but also the risk that vertically integrated enterprises lose motivation to make proper investments in networks. Separation of ownership at the transmission level is considered as the most efficient way to foster non-discriminating investments in infrastructure, fair access to the network for new participants and transparency in the market.

Table 6.2

Consumption of Primary Energy Resources in Latvia, PJ

	2005	2006	2007	2008	2009	2010	2011
Total consumption*	**191.9**	**199.0**	**204.6**	**196.5**	**189.0**	**200.5**	**188.7**
including:							
coal and coke	3.3	3.6	4.4	4.4	3.5	4.5	5.0
peat	0.1	0.1	0.1	0.1	0.0	0.1	0.0
petroleum products	61.9	67.5	73.3	69.3	62.4	64.6	62.9
natural gas	56.9	58.9	56.9	55.8	51.4	61.3	54.0
firewood	49.4	49.8	48.7	46.0	52.6	51.4	46.9
electricity**	19.9	18.9	20.8	20.5	18.6	16.0	15.1
other energy resources***	0.5	0.4	0.4	0.5	0.5	2.7	4.8

* All energy resources have been calculated based on the lowest calorific value
** Hydropower, wind energy and electric energy net imports
*** Used tyres, municipal waste for heating, charcoal, straw, biogas, bioethanol, biodiesel

By implementing separation of ownership of the transmission system operator, the transmission system (networks) remains a part of the vertically integrated company JSC "Latvenergo", but activities related to performing the functions of a transmission system operator (transmission service rendering, operative management of transmission system and its connected generating units, balancing, dispatching electric energy flows, management of cross-border electric energy trade, sustainable transmission system planning, participation in the European Network of Transmission System Operators ENTSO-E, etc.) are going to be separated from the JSC "Latvenergo". As a result, on April 1, 2011, the owner of the JSC "Latvenergo" subsidiary company's transmission system assets the JSC "Latvijas elektriskie tīkli" started operating, but the JSC "Augstsprieguma tīkls" began its operations on January 1, 2012 as an independent company outside the JSC "Latvenergo" concern.

Electricity market of Latvia, just like the whole Baltic energy market, is currently connected to the European energy market only through the underwater cable Estlink between Estonia and Finland, though its transmission capacity is insufficient. Since such a situation considerably reduces safety of energy supply, the EU has identified eliminating isolation of the Baltic energy as one of the priorities.

On July 17, 2009, the protocol of intent ***Baltic Energy Market Interconnection Plan*** (BEMIP) was concluded between the European Commission and a range of Member States including the Republic of Latvia.

The BEMIP identifies measures to be implemented for development of efficient joint Baltic electric energy market and its integration into the electric energy market of the Nordic states. Development of operating regional market is considered as a prerequisite for further integration of the Baltic region into the Nordic electric energy exchange Nord Pool region by taking over also Nord Pool operating principles at the same time. The main measures planned within the BEMIP are related to the internal electricity market (developed cross-border trade, separation of transmission system operators, competitive prices), electricity interconnections and generating powers, and internal gas market and infrastructure.

Box 6.6

Electricity and centralized heat supply in Latvia

The volume of **electricity** generation depends on the flow rate in the Daugava River. After closing the Ignalina NPP at the end of 2009, the situation in the electric energy market in the Baltic States has changed. Latvia is no longer the only state in this region with insufficient amount of electric energy generated in its power plants. At the moment, Lithuania is also importing electric energy. Therefore, basically the suppliers from Estonia and Russia compete for supplying electric energy to Latvia.

In 2011, the JSC "Latvenergo" generated 72% of the total electricity supply, it purchased 11% from small electricity energy producers and 17% constituted net imports of electric energy. Compared to the previous year, the total electric energy supply has decreased by 2.1 percent.

In 2011, 2888 GWh (10.40 PJ) of electricity was produced by **high efficiency cogeneration** which is 92% of the total electricity produced by cogeneration. This high indicator was fostered by mandatory electricity procurement. The existing heat energy production plants are gradually replaced with efficient cogeneration plants using local energy resources. Their replacement and efficient use of energy resources greatly contribute to the reduction of greenhouse gas emissions.

The consumption structure of **centralized heat supply** has remained the same over the past years, with central heating comprising 65-70% and hot water supply – 30-35%. Since 2011, 1.3% of the total generated heat energy has been supplied to the industrial sector, 70.4% – to households, 28.3% – to other consumers. However, the breakdown of heat energy distributed by regions is the following: Riga region – 56.3%, Pieriga region – 9.9%, Vidzeme – 5.6%, Kurzeme – 9.7%, Zemgale – 7.2% and Latgale – 11.3 percent.

In 2011, heat energy for sale was produced in 663 boiler houses and 83 cogeneration plants having generated 6.94 TWh heat energy for sale.

In 2011, natural gas was the main resource for generating heat energy and electric energy. The share of heat energy produced using natural gas as fuel was 80.2%, woodchips – 11.4%, firewood – 3.2%, heavy fuel oil – 1.3% and other types of fuel – 3.9 percent.

In order to develop cross-border trade and achieve competitive electricity prices, the BEMIP action plan envisages that the necessary measures are carried out by the countries to ensure that electricity exchange could start operating in the Baltics, including Latvia. The common Baltic day-ahead electricity trade within the trading platform *JSC Nord Pool Spot*, electric energy trade within the framework of current day, as well as market principle-based management of network jams and overload organized by the *JSC Nord Pool Spot* and organization of indirect auctions have to be implemented within time period from 2011 until 2013. On August 11, 2011, amendments to the *Electricity Market Law* came into force defining the key elements for electricity exchange status and operation in Latvia.

Table 6.3

Electricity Supply in Latvia, TWh

	2005	2006	2007	2008	2009	2010	2011
Total electricity supply	**7.1**	**7.4**	**7.8**	**7.8**	**7.2**	**7.5**	**7.3**
Gross electricity generation including:	**4.9**	**4.9**	**4.8**	**5.3**	**5.6**	**6.6**	**6.1**
from renewable energy resources:	3.4	2.8	2.8	3.2	3.6	3.6	3.1
large HPPs*	3.3	2.7	2.7	3.1	3.4	3.5	2.8
small HPPs	0.1	0.0	0.1	0.1	0.1	0.1	0.1
Biomass and biogas power stations	0.0	0.0	0.0	0.0	0.1	0.1	0.1
Wind power stations	0.1	0.1	0.1	0.1	0.1	0.1	0.1
from fossil energy resources:	1.5	2.1	1.9	2.1	2.0	3.0	3.0
large CHPs**	1.3	1.7	1.5	1.5	1.5	2.4	2.4
Other CHPs	0.2	0.4	0.5	0.5	0.5	0.6	0.6
Net electricity imports	**2.2**	**2.5**	**3.0**	**2.5**	**1.7**	**0.9**	**1.3**

* Daugava cascade – Riga HPP, Ķeguma HPP and Pļaviņu HPP
** Riga CHP-1 and Riga CHP-2

On January 1, 2012, the Regulations of the Cabinet of Ministers of October 4, 2011 No. 759 *Regulations on the Requirements for Public Electricity Network Voltage* came into force stipulating that the overtaken EU standard

LVS EN 50160:2010 *Voltage Characteristics of Electricity Supplied by Public Electricity Networks* is mandatorily applicable in Latvia.

Natural gas market

Currently, the JSC "Latvijas Gāze", which according to the Privatisation Agreement signed in 1997 has the exclusive rights to carry out transmission, distribution, storage and trade of natural gas, is the only enterprise operating in the Latvian natural gas market.

The biggest consumers of natural gas in 2011 were CHP and heat supply enterprises of the JSC "Latvenergo" – 66.5%, manufacturing – 13.5%, other consumers – 17.3%. Riga region consumes about 70% of natural gas utilised in Latvia.

The Latvian gas supply system is not connected to the EU common gas supply system. Latvia receives natural gas only from Russia, as most of gas is supplied to Latvia by the Russian enterprise JSC "Gazprom" and a small amount by the LLC "Itera Latvija" which is controlled by the JSC "Gazprom". The gas supply business environment in the region and the effective gas supply agreements practically exclude third parties except a regional transmission system operator and access to Inčukalns underground gas storage. The capacity of the gas pipeline Valday–Pskov is not sufficient to ensure gas supply to the Baltic States and to the Northwest region of Russia during winter. Consequently, at the moment, the gas market in Latvia may only be open formally.

Natural gas market at the EU level is regulated by the *Directive 2003/55/EC* of the European Parliament and of the Council of June 26, 2003 concerning common rules for the internal market in natural gas and repealing *Directive 98/30/EC*, requirements of which are being transposed into the *Energy Law*. Considering the situation in Latvian natural gas market with only one supplier of natural gas and no competition at all, moreover, according to the privatisation agreement of the JSC "Latvijas Gāze" no access to natural gas supply infrastructure can be granted to any third party until 2017, as well as considering that under the abovementioned directive, the Latvian natural gas market falls into the category "new market", which has performed its first gas supply under the long-term contract less than 10 years ago, Latvia is a subject to the derogation from several requirements of the directive.

Therefore, the *Law on Procedure for Entering into Force of Some Sections of the Energy Law* stipulates that those requirements that Latvia has derogated from – unbundling of distribution system operators, separate accounts for natural gas transmission, distribution and storage in internal accounts, as well as third person access to transmission and distribution system and liquefied natural gas objects – shall be transposed by April 4, 2014.

In order to diversify the natural gas market in Latvia and in the entire Baltic region, it is necessary to ensure an alternative supplier of natural gas in the market. It is possible by constructing an interconnection with any of the EU Member States, except those of the isolated region – Estonia, Lithuania and Finland, as well as by developing a regional liquefied natural gas (LNG) terminal. The LNG terminal has been discussed for several years, yet the Baltic region countries have not been able to agree on the best location of the terminal, therefore in March 2012, the European Commission launched an independent research, by involving Italian advisors Booz&Co, who are planning to publish the results regarding the best location for the LNG terminal at the end of 2012.

Renewable energy resources

Latvia, similarly as other EU Member States, has committed to achieve the quantitative target set in the *Directive 2009/28/EC* and the *National Reform Programme of Latvia for the Implementation of the Europe 2020 Strategy* – to achieve a 40% share of renewable energy in the gross final energy consumption, as well as a 10% share of renewable energy in the gross final energy consumption in the transport sector. Cost-efficient use of local energy resources and safe energy supply is one of the main conditions of national economic independence and energy supply safety. Therefore, it is even more important to improve efficiency of the existing heat supply systems and use energy resources more efficiently, thus greatly contributing to the reduction of greenhouse gas emissions.

Not only contribution of existing tools but also the chosen support measures for energy produced from renewable energy resources in the coming years will be crucial until 2020, so that Latvia could contribute to preventing climate change and reduce imports of fossil energy resources particularly focusing on the heat supply sector. Therefore, development of economically unfavourable projects should be limited when implementing new support measures for renewable energy, and it can be ensured, for example, by applying a technologically neutral additional payment thus reducing consumer expenses.

In order to achieve the set target for the share of renewable energy generated from renewable energy resources in the gross final energy consumption in the transport sector, the consumption of biofuel should be promoted in different sectors, as well as the use of environmentally-friendly private and public transport and implement additional measures oriented towards development of public and private electric transport infrastructure, for example, electrification and private electric vehicle charging.

The criteria for sustainable biofuel and biological liquid fuel, implementation mechanism and supervision and its monitoring procedure in Latvia are regulated by the Cabinet of Ministers Regulation of July 5, 2011 *Regulations Regarding the Sustainability Criteria for Biofuels and Bioliquids, the Mechanism for their Introduction and the Procedure by which they Shall Be Supervised and Monitored.*

In 2011, elaboration of common criteria for **development of wind parks** has been launched to avoid uncontrolled establishment of offshore wind parks, thus significantly affecting the end tariff of electricity for consumers. Construction of offshore wind parks should be carried out in a planned and determined manner and in compliance with requirements of environmental protection, fishery, navigation and national defence, as well as interests of the population of Latvia.

Box 6.7

Renewable energy in Latvia

In 2010, the total share of renewable energy decreased by 1.8 percentage points in comparison with 2009 and constituted 32.5%, although the share of renewable energy in producing electric energy increased by 0.1 percentage points reaching 42.1%, but the share of renewable energy in transport tripled reaching 3.3%. The decrease of the total share of renewable energy during this period is based on the decrease of the share of renewable energy in heating and cooling. Moreover, heat energy consumption constitutes the largest part of final consumption.

In 2011, the electricity production volume reached 6095 GWh, which is by 8% less than in 2010. 50.5% (3078 GWh) of total produced electricity volume was generated from renewable energy (HPPs, wind, biogas, biomass, etc.). While total installed capacity for electricity production from renewable energy in 2011 increased by 20 MW, constituting 1642 MW in comparison with 2010.

The share of renewable energy in transport increased in 2011 mainly due to the introduction of the mandatory 5% biofuel addition to fossil fuel reaching the share of 4.8%. Contribution of renewable energy to transport was small in 2011: a total of 1.2 million tons of fuel have been sold and used for own consumption in Latvia in 2011, including pure biofuel or mixture of fossil fuel and biofuel – 50.4 thousand tons. In 2010, the final energy consumption consisted of bioethanol – 350 TJ and biodiesel fuel – 787 TJ, experiencing an increase in 2011 (bioethanol – 318 TJ and biodiesel fuel – 1432 TJ).

In 2001, the share of biofuels in the final energy consumption in the transport sector was 4%. It has increased by 1.4 percentage points in comparison with 2010.

According to the Regulations of the Cabinet of Ministers of March 16, 2010 *Regulations Regarding the Production of Electricity Using Renewable Energy Resources and the Procedures for the Determination of the Price*, no tender for the right to sell electricity produced from renewable energy resources within public procurement was organized in 2012, however, 4 decisions were issued on biogas power plants determining the annual procurement volume of electric energy up to 28 800 MWh, as there were conditions in favour of these entrepreneurs within evaluation of applications and scoring within the tender in 2012, as well as 10 decision on hydroelectric power plants with the capacity of up to 5 MW, determining the annual procurement volume of electric energy up to 8192 MWh.

Overall, in 2011, decisions on granting the rights to sell electricity produced from renewable energy resources in a form of mandatory procurement volume of electric energy were issued to 14 power plants with the total installed energy production capacity of 5.79 MW, determining the annual procurement volume of electric energy up to 36 992 MWh.

According to the Regulations of the Cabinet of Ministers of March 10, 2009 *Regulations Regarding Electricity Production and Price Determination Upon Production of Electricity in Cogeneration,* 112 decisions on granting the right to sell electricity produced in a cogeneration power plant within the mandatory procurement for power plants with the total installed electric capacity of 120.437 MW and the total volume of electricity of 937776.68 MW were issued in 2011 including:

– on the use of natural gas as fuel – 2 decisions (0.95 MW/ 7673.46 MWh);
– biogas – 42 decisions (38.397 MW/ 308 245,17 MWh);
– biomass – 66 decisions (79.13 MW/ 606 200,05 MWh);
– hydrogen – 2 decisions (1.96 MW/ 156 58 MWh).

Energy efficiency

The *Second Energy Efficiency Action Plan of the Republic of Latvia for 2011–2012* (2nd EEAP) has been developed according to requirements of Section 17 and Section 4 of the transitional provision of the *Energy End-Use Efficiency Law* and approved by the Cabinet of Ministers on September 16, 2011, aimed at increasing energy efficiency in energy end consumption sectors and energy conversion. The Plan includes energy efficiency measures oriented towards rational use of energy and preservation of environment.

According to the *First Energy Efficiency Action Plan of the Republic of Latvia for 2008–2010,* the indicative target of energy savings for 2016 in Latvia is 3483 GWh and this target for 2016 has not been changed in the *2nd EEAP*.

The expected targets of energy savings for 2016 have not been changed and remain effective until 2014 when energy savings calculated according to the bottom-up method will be available for certain measures to improve energy efficiency within development of the *Third Energy Efficiency Action Plan of the Republic of Latvia for 2014–2016*.

Since household and transport sectors are the key sectors in final energy consumption, 33.1% and 29.5%, respectively, of the total final energy consumption in 2011, these sectors are identified as a priority in the *2nd EEAP*. In order to achieve these targets, housing insulation measures, improvement of energy efficiency in public and industrial buildings, implementation of efficient light infrastructure in public territories of local governments and increase of energy efficiency in heat energy production, and transport sector are planned.

Energy efficiency of energy-consuming products

The European Commission continues working on improving energy efficiency (eco-design) of energy-consuming products to reduce the negative impact of such products on the environment and achieve higher energy savings during their lifetime. Over 20 European Commission regulations on eco-design and energy labelling have been adopted since 2008, setting stricter requirements for energy-consuming products, which are binding also for Latvian producers, importers and distributors. Eco-design and energy labelling regulations apply to such product groups as electric products, lighting, household appliances, heating and cooling equipment, industrial and commercial equipment, etc. (a full list of adopted eco-design regulations is available on the website of the Ministry of Economics[1]). New eco-design regulations are expected to be adopted for another 27 product groups within the upcoming two years.

Investments in the energy sector

Currently, several infrastructure development projects included in the BEMIP are being implemented which will ensure successful integration of the Nordic and Baltic electricity markets.

Within the framework of *Trans-European Energy Network (TEN-E) programme,* the project *Environmental Impact Assessment and Route Investigation of Kurzeme Circle* is being implemented. The total expenses of the project amount to EUR 0.65 million, deadline – June 2012. The work is carried out in 3 stages: Grobiņa-Ventspils, Ventspils-Tume and Tume-Riga.

On August 6, 2010, the European Commission adopted a decision to financially support construction of electric power transmission infrastructure in Latvia by granting co-financing for the project *Kurzeme Circle* within the framework of a single *NordBalt* project. The European Commission is planning to invest EUR 131 million in the construction of the Lithuania–Sweden interconnection, furthermore EUR 44 million are granted for improving the network infrastructure in Latvia within the framework of the project *Kurzeme Circle*. The total expenses of the first and second stage of the project *Kurzeme Circle* amount to EUR 88 million, and deadline is 2014. At the moment, the third stage of the projects is planned to be constructed – 330 kV transmission line Ventspils–Dundaga–Tume–Imanta, deadline is 2018.

At the moment, the largest project for the development of natural gas infrastructure and improvement of regional supply safety is the *Increase of Two-Way Gas Flow between Latvia and Lithuania*, within the framework of which a new gas transmission line under the Daugava River is being constructed, 15 drill holes in Inčukalns underground gas storage are being reconstructed, and a new treatment and intellectual piston chamber for pipeline diagnostics is created. By implementing the project, gas supply safety will be improved in both directions and a possibility will be created to supply natural gas from Lithuania to Latvian consumers. The option to supply natural gas from Lithuania will be available in case of insufficient natural gas supply through gas pipeline from Riga to Bauska during the winter season. The project had been completed in 2011, however, its deadline had been extended to 2012 for additional works, because the whole granted financing had not been used for the main activities.

After closing the Ignalina nuclear power plant at the end of 2009, the new Visagina nuclear power plant project is one of the most topical issues in the context of the Baltic energy policy, because there is an apparent need to replace the generating capacities that were lost due to Ignalina NPP closing. Latvia supports the Visagina NPP project based on the regional solidarity principle, as well as on the economic benefits of the project. However, until some material questions are not answered, it is too soon to decide on involvement of the Latvian energy company “Latvenergo”. It should also be kept in mind that future decisions on the reconstruction of the Narva oil shale thermal power plant blocks in Estonia will have a significant impact on the entire Baltic energy market and the overall energy supply safety in Latvia.

In order to improve heat energy production efficiency, reduce heat energy losses in the transmission and distribution system and to foster replacement of fossil fuel types with renewable fuel, several projects are being implemented within the Cohesion Fund. A total of 32 project applications for the Cohesion Fund’s financing in the amount of LVL 25.9 million have been approved within the first and the second selection stage of project applications of the activity 3.5.2.1 *Measures Regarding the Increase of Efficiency of Centralised Heat Supply Systems* of the supplement to the Operational Programme *Infrastructure and Services*, and among them 5 projects for the Cohesion Fund’s financing in the amount of LVL 1.3 million have been finished.

From September 19, 2011 until November 21, 2011, heat supply enterprises could apply for the third selection stage of the project application within this activity for the Cohesion Fund’s financing of LVL 16.4 million.

Selection of project application within the activity *Measures to Improve Energy Efficiency of Heat Supply Systems in Enterprises* (the Cohesion Fund’s financing – LVL 13 million) was open from December 1, 2011 until February 1, 2012.

In order to increase significantly the production of electricity and heat energy from renewable resources, diversify primary energy resource supply and increase coverage of electricity, the activity 3.5.2.2 *Development of Cogeneration Power Plants Utilising Renewable Energy Resources* of the supplement to the Operational Programme *Infrastructure and Services* is being implemented. Contracts on implementation of 10 projects have been concluded within the selection of project applications for the Cohesion Fund’s financing in the amount of LVL 21.4 million.

[1] http://www.em.gov.lv/em/2nd/?cat=30641

6.5. Construction and Housing Policy

The policy for development of a sustainable and competitive **construction sector** is established taking into account principles that influence favourable and competitive business environment by reducing administrative barriers, ensuring operative exchange of construction-related information and increasing productivity of construction service providers. Regulatory framework for building contractors is just as important as access to adequate infrastructure and support.

The new draft ***Construction Law*** has been submitted to the Saeima. The law envisages simplified construction administrative process by giving up multiple interim decisions. Currently, the proposals submitted for the second reading of the *Draft Construction Law* are being considered and evaluated.

Box 6.8

Data characterising the construction sector

Data of the Central Statistical Bureau shows that in the 1st quarter of 2012 the construction production volumes (in current prices) were LVL 123.6 million.

In the 1st quarter of 2012, the construction production volumes according to the seasonally adjusted data in constant prices have decreased by 0.4% compared to the 4th quarter of 2011. Out of this, the construction of buildings has shrunk by 2.8%, while construction of civil engineering structures has increased by 0.2 percent.

In the 1st quarter of 2012, the construction production volumes according to the calendar adjusted data in constant prices have increased by 28.5% compared to the 1st quarter of 2011. Out of this, the construction of buildings has increased by 26.2%, construction of civil engineering structures – by 30.6 percent.

The most considerable increase in construction and repair works has been in construction of administrative buildings, as well as street and road construction – by 194.6% and 109.4%, respectively, if compared to the same period of the previous year. Construction volumes have shrunk in construction of bridges and tunnels and construction of residential buildings – by 60.8% and 18.5%, respectively.

In the 1st quarter of 2012, 304 construction permits have been issued for commencing construction, major repair, reconstruction and renovation of single-apartment buildings of the total area of 66.7 thousand m^2 (in the 1st quarter of 2011 – 279 and 64 thousand m^2, respectively). 80 construction permits have been issued for construction of production buildings and warehouses of the total area of 93.2 thousand m^2 (in the 1st quarter of 2011 – 107 construction permits and 246.4 thousand m^2, respectively).

In the 1st quarter of 2012, 185 construction permits have been issued for construction of new single-apartment buildings of the total area of 39.1 thousand m^2 (in the 1st quarter of 2011 – 161 and 39 thousand m^2, respectively) and 49 construction permits have been issued for construction of new production buildings and warehouses of the total area of 41.3 thousand m^2 (in the 1st quarter of 2011 – 71 and 184.7 thousand m^2, respectively).

In the 1st quarter of 2012, the volume of construction work (in current prices) performed by Latvian builders abroad was LVL 12.9 million, if compared with the 1st quarter of 2011 (LVL 14.8 million), the volume of performed construction works has decreased by LVL 1.9 million. However, in the 1st quarter of 2012, foreign builders in Latvia have performed construction works in the amount of LVL 2378.9 thousand, which is by LVL 452.1 thousand less than in the 1st quarter of 2011 (LVL 2831 thousand).

In the 1st quarter of 2012, the construction costs have increased on average by 5.2% compared to the 1st quarter of 2011. The costs for machinery and machines' maintenance and use increased by 14.8%, but wages of workers – by 9%. The costs for construction materials have decreased by 0.4 percent.

The new *Draft Construction Law* is aimed mainly at significant simplification of the construction process and promotion of its transparency, as well as facilitation of development of the construction market and of the whole economy. An innovative construction sector with high value added is to be developed, as well as business environment is to be improved, and Latvia is to be made more attractive to local and foreign investors. The Draft Law contains the following principles that have to be observed within the construction process:

– Principle of architectonic quality – buildings are planned by balancing the functional, aesthetic, social, cultural heritage, technological and economic aspects of construction, as well as the interests of the customer and the society, by highlighting the individual identity of natural or urban landscape and easily integrating in the cultural environment, thus enriching it and creating quality living-space;
– Principle of engineering quality – engineering solution of a building is safe for using, as well as economically and technologically efficient;
– Principle of openness – the construction process is open and the society is informed about the planned construction and the decisions made in relation to it;
– Principle of sustainable construction – the construction process creates the quality aspect of living environment for present and further generations, inter alia by increasing the usage of renewable resources and promoting efficient usage of other natural resources;
– Principle of accessible environment – such environment is created in the construction process that is suitable for people to get around conveniently and use the buildings according to their function.

Recently, several **changes have been introduced to normative acts regulating the construction sector**.

By revising and adopting the Latvian Construction Standard LBN 201-07 *Fire Safety of Buildings* in 2011 requirements for planning of protection against lightning were introduced in the Latvian Construction Standard LBN 261-07 *Construction of Building Internal Wiring* (CoM Regulations No. 998 of December 27, 2011). The amendments to this construction standard (CoM Regulations No. 998 of December 27, 2011) include requirements for planning the lightning protection by defining buildings that require lightning protection based on the risks typical to their usage and respective degree of potential damages. General degrees of lightning protection are defined for planning of lightning protection systems. Since the applicable standards provide for a possibility not to install lightning protection, the regulations provide a possibility to analyse risks if the designer considers that it is possible not to install lightning protection systems of the degree defined by the law or use the analysis as a counterargument for installing lightning protection system of a higher degree. The term "a lightning protection system" has been defined in detail by extending its scope of application regarding any lightning-caused physical damage to a building (lightning strike, thermally melted holes in metal elements – both constructions and structures). Thus, the construction standard covers the requirements for planning the lightning protection for both internal and external lightning protection.

The *National Plan for the Implementation of Eurocode Standards for 2013–2014* (CoM Regulations No. 224 of May 17, 2012) envisages complete adaptation of the Eurocode standards in the legal system regulating construction by the end of 2014. In order to implement them, the standards are planned to be translated into Latvian and national annexes of the Eurocode standards are expected to be developed, as well as amendments to normative acts will be developed envisaging planning in accordance with the Eurocode standards. In order to inform construction planning professionals about the planning specificity in line with the Eurocode standards, information measures are planned to be carried out by preparing distribution materials and organizing seminars for practical workers.

The prepared amendments to the Latvian Construction Standard LBN 211-08 *Multi-Storey Multi-Apartment Residential Buildings* (CoM Regulations No. 231 of April 3, 2012) prescribe detailed standards arising out of the Latvian Construction Standard LBN 201-10 *Fire Safety of Buildings* (CoM Regulations No. 498 of June 28, 2011), and room insulation requirements stipulating the insulation applies to residential premises alone instead of the entire apartment. Yet, in order to improve availability of housing environment and ensure free access to a building for any person, further on construction of new buildings must meet environment accessibility requirements for the entrance block of a building, access to the first floor or elevator of a building irrespective of the funding source of construction.

Along with new construction materials entering the market, there is a need to increase market supervision as well. In order to make the supervision process easier and more transparent, Regulations of the Cabinet of Ministers of April 30, 2011 *Procedures for the Conformity Assessment of Construction Products in the Regulated Sphere* was amended by clarifying the application of national standards of other EU Member States regarding conformity of construction materials and clearly defining the circulation of documentation regarding conformity of construction materials.

As regards the **housing policy**, the development of *Draft Law on Residential Tenancy* launched in the first half of 2011 continues according to the effective legal framework by balancing the rights and obligations of the tenant and the lessor, improving record-keeping of rental agreements, specifying the rights and obligations of the tenant and his/her family members, the procedure for settlement of disputes, elements of rent payment and the mechanism for setting the rent payments, as well as observing the principles of free rental market operation.

In the second half of 2011, the regulation came into force, according to which one of the mandatory residential building management activities must be implemented – ensuring fulfilment of the minimum requirements for the energy efficiency of residential buildings.

In order to foster energy efficiency of multi-apartment buildings and to reduce payments for heating energy, the maximum acceptable consumption of heating energy has been set for multi-apartment buildings which are not being renovated, and if the maximum consumption is exceeded the energy efficiency measures must be carried out.

Whenever detecting conditions that cause heat loss, the multi-apartment buildings will be subject to the energy efficiency measures[1] related to equipping street doors with a closing mechanism, thermal insulation of heating system pipes and hot water pipes located in non-heated premises, as well as sealing of windows and street doors.

Since the economic downturn, **debts of tenants for heat supply** have become a topical issue in multi-apartment buildings. Having analysed the reasons for debts, it has been concluded that the main reasons are insufficient or reduced financial resources of residents,

[1] Energy efficiency measures should be performed in multi-apartment buildings where the average heat energy consumption over the last three calendar years (heating seasons of 2008, 2009 and 2010) exceeds 230 kWh/m² per year. According to the data of the JSC "Rīgas siltums" on heat energy consumption in 2.9 thousand multi-apartment buildings in Riga city within the time period from 2007 until 2010, the average heat energy consumption was up to 200 kWh/m² per year. Good practice shows that proper management and use of non-renovated buildings leads to consumption from 140 to 160 kWh/m² per year. Renovation of multi-apartment residential buildings may result in achieving heat energy consumption from 70 to 100 kWh/m² per year.

lack of payment discipline, lack of cooperation between the service provider or manager and the debtor (including failure to initiate debt recovery), different approach to development of social support policy making (including setting apartment benefits) in local municipalities.

In order to solve the problem, the draft law *Amendments to the Civil Procedure Law* was developed and submitted for consideration and approval to the Saeima at the beginning of 2011, envisaging that in the time period until December 31, 2014, requests for recovery of payments for residential building management and payments for services related to the use of living space, but not exceeding 10% of the amount received from sale of real properties encumbered by a pledge, are to be satisfied before the claims secured by a real property pledge.

In the second half of 2011, additional proposals have been developed: to impose an obligation on a manager to work with the debtor at the very beginning of the debt, i.e. to start communication with the debtor, foster debt recovery out of court, reduce the length of legal proceedings and the amount of the state fee for bringing an action for claims in cases of a small amount claim, etc.

The Ministry of Economics has developed and the Saeima has adopted the draft amendments to the *Law on Administration of Residential Houses* in the first reading on May 24, 2012. The draft law has been developed to:

– Divide the information to be entered in the register of residential building managers into information to be made public and information not to be made public;
– Impose an obligation on the manager to control payments of apartment owners for the use of apartment property.

In order to promote competiveness in the residential building management market and quality management of residential buildings, as of January 1, 2012, the Ministry of Economics has developed and operates the **Register of Residential Building Managers** in accordance with the procedure specified in the *Law on Administration of Residential Houses* and the Cabinet Regulations No. 343 *On Keeping and Updating the Register of Residential Building Managers* of May 3, 2011.

The main task of this register is to provide the latest information about persons operating or willing to operate in the residential building management market and conformity to the criteria for performing management activities defined by the law. Records from the manager register regarding services offered by a manager, service territory, qualification of the manager or his/her personnel and practical working experience in management of residential buildings is published on the website of the Ministry of Economics, as well as the register contains a reference to the rights of a manager to offer management services in the market depending on the obtained professional qualification and practical working experience in management of residential buildings. At the moment, 153 managers are registered in the Register of Residential Building Managers.

Ensuring **energy efficiency of buildings** is an essential part of sustainable construction. On June 21, 2012, the Saeima approved the draft *Law on the Energy Performance of Buildings* in the first reading. The new law is necessary to implement the *Directive 2010/31/EU*[1] of May 19, 2010 on the energy performance of buildings. The directive on energy performance of buildings is one of the instruments adopted to achieve the EU's energy efficiency targets.

The law is aimed at promoting efficient usage of energy resources by informing the public about energy consumption of buildings, as well as by improving energy performance of buildings. In order to achieve the objective of the law, the draft law provides regulation on the minimum energy performance requirements for buildings, defines cases when energy certification of buildings is required, requirements for inspection of heating and air conditioning systems, requirements for independent experts (including energy auditors) and their supervision, as well as the law gives potential tenants or buyers of a building the right to get acquainted with the energy certificate of the building.

The new *Law on the Energy Performance of Buildings* is expected to be adopted in the second half of 2012 and to come into force on January 9, 2013.

In 2012, implementation continued for the activity 3.4.4.1 **Improvement of Heat Insulation in Multi-Apartment Residential Buildings** of the European Regional Fund Operational Programme *Infrastructure and Services* (DMS activity).

Since the launch of the DMS activity from April 2009 until June 13, 2012, 966 project applications have been considered, 97 of which have been completed, contracts on implementation of 373 projects have been concluded and 70 have been approved (to be launched after signing the contract), 100 were under evaluation.

In terms of the number of submitted projects the activity differs in the planning regions – most of the project applications have been submitted from Kurzeme (272) and Vidzeme (236) regions, medium activity is in Zemgale (166) and Riga (excluding the city of Riga 170) regions, the lowest number of projects has been submitted from Latgale (38). Riga city has submitted 84 project applications, however, taking into account the large number of population and housing, the activity in Riga city is low.

The total funding available within the DMS activity is LVL 47.75 million. By June 13, 2012, LVL 38.6 million (81%) have been distributed or reserved, the remaining available amount is LVL 9.2 million (19%).

On May 8, 2012, the meeting of the Cabinet of Ministers considered the *Informative Report Possibilities of*

[1] Directive *2010/31/EU* of the European Parliament and the Council of May 19, 2012 on the energy performance of buildings recasting the *Directive 2001/91/EC* of December 16, 2002.

the Government Budget Overcommitments for Activities of the EU Structural Funds and the Cohesion Fund of the Planning Period 2007-2013, which supports the plea of the Ministry of Economics to undertake overcommitments in the amount of LVL 15 million for the implementation of the DMS activity. According to the minutes No. 25 § 26 of the CoM meeting of May 8, 2012, it was decided to undertake overcommitments that exceed the total amount of public (EU funds and national) financing. The financing will be available after adopting the amendments to the CoM regulations on implementation of the DMS activity by the Cabinet of Ministers.

The housing renovation process has also significantly influenced establishment of associations of apartment owners and corporate societies of apartment owners because most frequently, when agreeing on launching renovation, the residents of the buildings want to deal with building management issues on their own. According to the estimates of the Ministry of Economics, taking into account the total costs of finished projects and of projects to be implemented under concluded contracts, the construction sector has so far received about LVL 40 million from the implementation of this activity.

6.6. Tourism Policy

The tourism policy in Latvia is constructed to promote development of local and international tourism; its main goal is to improve competiveness of tourism products and services in the medium term, stimulating changes in the structure of demand and supply.

In 2010, the *Tourism Marketing Strategy of Latvia for 2010-2015* was developed and approved defining the vision of Latvian tourism development and objectives to achieve it, as well as identifying the priority products of the Latvian tourism, basic principles of development and target markets thereof. According to the priorities set in the strategy and by involving experts of the tourism sector, a new image of the Latvian tourism was developed, which now is a uniting idea and a common element for public and private sector products and marketing development activities.

In order to promote development of tourism sector, the following economic objectives have been set for the time period to 2015:

– increasing the share of foreign tourists staying 3 and more days;
– increasing the export of tourism services in comparable prices by 5–10% every year compared to the previous year;
– ensuring tendency of percentage growth in local tourism services to outpace the total percentage growth in export of tourism services.

One of the main tasks of the Ministry of Economics in 2012 is to set out objectives, directions and activities of tourism development for the next planning period. In order to ensure sustainable development of the tourism sector – stable increase in export of tourism services – in medium and long term, integrating the vision of its development, it is necessary to analyse external and internal factors of the present situation in detail, evaluate competitors and find innovative and creative solutions for further development. Latvia needs to critically review the achieved progress and set ambitious yet well-considered objectives and the most efficient directions for targeted and consolidated actions of all involved parties to ensure development of the tourism sector.

Box 6.9

Tourism development indicators

According to the data of the UN World Tourism Organization (UNWTO) international tourism has grown to 980 million tourists or 4.4% in 2011, as compared to 2010. Overall, Europe achieved the best results (+6%) among regions. According to the forecasts of the UNWTO, international tourism will continue growing in 2012, though at a slower pace. The number of tourists is expected to increase by 3% or 4%, by the end of the year, reaching the historical number of 1 billion.

The tourism sector is also a significant source of export income providing a considerable contribution to the national gross domestic product. The added value of tourism-related sectors (hotels and restaurants, passenger rail transport and road transport, water transport, air transport, transport ancillary services, vehicle rental, activities of tourism operators and travel agencies, recreational, cultural and sport services) in 2009 reached LVL 591.1 million, thus making a contribution of 5% to the total added value.

In 2011, the number of border crossings by foreign tourists in Latvia reached 5.54 million, which is by 9.9% more than in 2010. Comparing to 2010, the average duration of visits of tourists in Latvia has increased to 1.3 days. At the same time the average expenses of one tourist per day have slightly decreased – in 2011 it was LVL 53. Despite the decrease, the total expenses of foreign tourists in Latvia have increased to LVL 379.5 million.

In 2011, the tourism balance of payments has improved, though it is still negative. The total expenses of Latvian tourists abroad in 2010 have exceeded the expenses of foreign tourists in Latvia by LVL 23.1 million.

According to data provided by the CSB, at the end of 2011, there were 641 tourism campsites in Latvia, which is by 13 more than at the end of 2010. At the same time, also the number of persons served in hotels and other tourist campsites in 2011 has increased by 21 percent.

In order to ensure constant involvement of sectoral partners in implementation of the tourism policy, the Latvian Tourism Advisory Council is continuing its activity in 2012, and the Advisory Council of Latvian Tourism Development Agency (LTDA) composed of authorized representatives from professional and regional tourism associations, the advertising sector, as well as from the Ministry of Foreign Affairs, and the Riga Tourism Development Bureau also is working actively.

Support measures

In 2012, the key priorities of the LTDA is related to tourism marketing in local and foreign markets, development of tourism products and local tourism development of Latvian tourism service quality system and improvement of service quality provided by tourism service providers, training and increasing competence of tourism service providers, as well as cooperation with the Baltic States for implementation of joint projects and Baltic marketing activities in distant markets.

The annual state budget funding for 2011–2013 that is envisaged for promoting tourism development is earmarked as state co-funding for implementation of the Sub-activity 2.3.1.1.2 *Access to International Trade Markets – Strengthening International Competitiveness of Industry Sectors* of the Activity 2.3.1.1 *Access to International Trade Markets* of the supplement to the Operational Programme *Entrepreneurship and Innovations* of the European Regional Development Fund (ERDF). Within the framework of the Sub-activity, the following activities are supported:

– organizing national stands in international exhibitions abroad;
– organizing advertising campaigns abroad;
– providing consultancy services to entrepreneurs, local governments, and port administrations about foreign markets, including organizing direct visits, trade missions, and support to participation in exhibitions and searching for cooperation partners.

In 2012, the total amount of funding (state budget funding and the ERDF co-funding, as well as funding for implementation of projects AGORA 2.0 and EDEN VI) for tourism marketing is LVL 1.3 million.

Box 6.10

Activities of the Latvian Tourism Development Agency in the first half of 2012

By implementing the Tourism Marketing Strategy of Latvia for 2010-2015 and Action Plan for 2012, the LTDA:

– in cooperation with the Latvian tourism sector, organization of Latvian national stand's participation in 6 international tourism exhibitions (in Russia, Finland, Germany, Sweden, Estonia and Lithuania) has been implemented, ensured participation of Latvian national stand in specialised exhibition for families with children *Lapsimessut* in Finland and participation in the international tourism exhibition *Balttour* in Latvia;
– within the framework of international tourism exhibitions organized a range of measures for professionals of the sector – work seminar for journalists in Helsinki, work seminar and reception at Latvian national stand in Goteborg, Baltic press conference in Berlin, seminar and business matchmaking for tourism companies about medicine tourism opportunities and a press conference for mass media in Moscow, tourism forum *Russian focus* in Riga;
– implemented advertising campaigns in German and Russian internet media, thus raising awareness about Latvia and fostering demand of Latvian tourism products before active tourism;
– issued informative materials of Latvian tourism – tourism maps of Kurzeme, Latgale, Vidzeme, and Zemgale, tourism maps of Riga and its surrounding territories, Latvian tourism map, brochure *Top 10 Latvian tourism destinations of Latvian tourism*, Baltic tourism maps;
– organized a visit of Russian medicine tourism operators, visit of Russian sports event and camp organizers, German tourism operator business matchmaking;
– implemented publicity and marketing activities in Finnish, Swedish, Russian, and German tourism markets by implementing publicity measures for professional audience in target markets;
– ensured development of the Latvian tourism portal *www.latvia.travel* according to the demand of the target markets by ensuring the content of the portal in 9 languages;
– developed mobile applications of the tourism portal *www.latvia.travel* for IPhone and Android smart phones;
– launched information measure for local society about topical tourism issued in cooperation with Latvian mass media (newspapers, radio, television);
– in cooperation with Lithuanian and Estonian national tourism organizations, launched the tourism campaign of the Baltic States *Great Baltic Travel 2012* including 10 tourism destinations in Latvia and organizing marketing campaigns, as well as promoting tourist flow among the Baltic States;
– monthly issue of Latvian tourism newsletter in English, Russian, and German, distributing it to 12 500 foreign tourism professionals and journalists;
– granted Quality labels of the Latvian tourism service quality system *Q-Latvia* to t tourism enterprises to increase the quality level of tourism services provided by Latvian tourism enterprises;
– organized training measures for Latvian tourism sector for creating tourism products and developing tourism destinations according to the target market requirements.

Improvement of the legal framework

In order to implement the measures to support Latvian resorts development, in 2011 the draft law *Amendments to the Tourism Law* was developed in cooperation with the Jurmala City Council, the Ministry of Environmental Protection and Regional Development, the Latvian Balneology Association, the Latvian Resorts Association and resort rehabilitation centre "Jaunķemeri". At the moment the given draft law is being considered by the Saeima. It should be noted that in addition to the abovementioned amendments regarding resorts, several adjustments are being made to the *Tourism Law* in relation to provision of complex tourism services, LTDA competence, right of local municipalities' agencies to provide tourism services, activities of tourism guides, as well as conformity assessment and certification of tourism accommodations.

In 2012, the legal framework for resorts is planned to be completed by developing CoM regulations prescribing a procedure for granting or annulling the resort status to local administrative territory or its part, procedure for administration, as well as information and documents to be included in the application of local municipalities (to be developed in 6 months from coming into force of the amendments to the *Tourism Law*).

In order to ensure efficient enforcement of the European Council Directive of 13 June 1990 on package travel, package holidays and package tours, informing the consumers and other interested people about activities of entrepreneurs engaged in the sector, as well as promoting prevention of fraudulent situations in the sector, in 2010 the Ministry of Economics has developed the *Database of Tourism Agents and Tourism Operators (TATO) http://tato.em.go.lv*. Overall, 35 entrepreneurs were registered in the database from January 1, 2012 until May 19, 2 of them were registered as tourism operators, 12 – as tourism agents and operators, but 21 – as tourism agents.

<u>International cooperation in the field of tourism</u>

Latvia continues developing closer cooperation in the field of tourism with other countries, particularly with the high priority tourism target markets: Lithuania, Estonia, Finland, Sweden, Russia, and Germany. Issues related to promotion of cooperation in the field of tourism are regularly included on the agenda of foreign visits of intergovernmental commissions and chief state officials, marketing activities are being actively implemented in the high priority target markets.

Representation of Latvian interests in the tourism sector at international level basically is ensured by involvement in the work of the European tourism institutions. Latvia participates in the work of the Tourism Advisory Committee of the European Commission on a regular basis, as well as Latvia is a member of the European Travel Commission, which deals with raising awareness about European, including Latvian, tourism destinations.

Since 2005, Latvia is also a full member of the United Nations World Tourism Organization (UNWTO), however on May 10, 2012 the Saeima approved the draft law *On Denouncement of the Statutes of the World Tourism Organization* in 3rd reading envisaging denouncing the UNWTO statutes. Having analysed benefits from being a member of the UNWTO and the amount of annual membership fee, it was concluded that further participation in the organization no longer is a critical factor for Latvia to implement the set objectives and tasks for the development of tourism sector. It should be noted that after withdrawing from this organization, Latvia will still be able to continue cooperation with the UNWTO through cooperation mechanisms offered by the European Union.

6.7. Improvement of Business Environment

An important tool for evaluation of business environment in Latvia is the international survey of the World Bank *Doing Business*, as well as the *Study of Administrative Procedure Impact upon Business Environment* showing the opinion of entrepreneurs about the factors hindering their activity and help to prepare the list of tasks within the annual *Action Plan to Improve the Business Environment*.

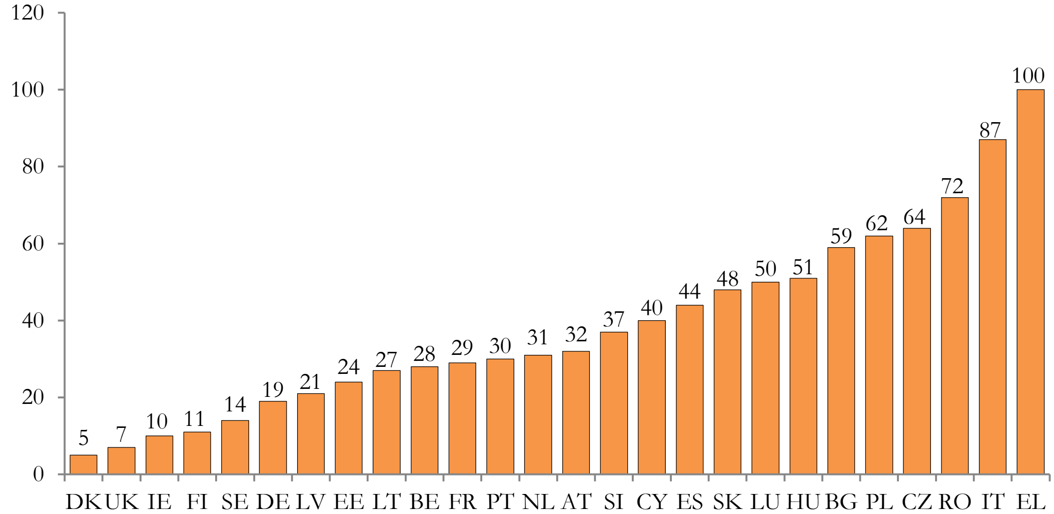
Latvia has achieved a significant progress in improving the business environment – **Latvia has improved its ranking in the World Bank's research Doing Business 2012 by 10 positions** moving from 31st place (*Doing Business 2011*) to 21st place (*Doing Business 2012*) among 183 world countries. Latvia is ranked 7th among the European Union Member States in the evaluation of entrepreneur-friendly environment which is by 2 positions higher than a year ago.

According to the *Strategic Development Plan of Latvia for 2010-2013*, the objective of Latvia is to reach the 19th position in the Doing Business index in 2013. In order to achieve the objective, it is necessary to carry out more rapid reforms and make decisions oriented towards long-term development of national economy, especially in the fields where the rank of Latvia is higher than the 50th position.

Figure 6.10

Rank of Latvia and other EU Member States in the World Bank's research *Doing Business* in 2012

(business environment in general)



Latvia improved its position in *Doing Business* by implementing such measures as:

– ensuring the possibility of registering enterprises with reduced capital and a possibility to apply for registration in the VAT payers' register along with application for registration of a merchant in the commercial register;
– increased amount of recovered claims of creditors within the insolvency process (from 31.9% in 2011 to 56.2% in 2012), introduced a new *Insolvency Law* that envisages in general reducing the duration and expenses of the insolvency process (the results will be assessed within the next research) and a possibility to reorganize the enterprise;
– completely introduced possibility for the Land register judges to verify payment of immovable property tax online;
– improved process for getting electricity – by implementing a simplified development of technical design for installation or reconstruction of electrical power network and other measures.

Table 6.4

Benchmarks of Latvia in the World Bank's research *Doing Business*

	2011	2012	Changes
Starting a Business	52	51	**+1**
Dealing with Construction Permits	103	112	**-9**
Registering Property	56	32	**+24**
Getting Credit	4	4	**0**
Protecting Investors	60	65	**-5**
Paying Taxes	64	67	**-3**
Trading Across Borders	15	15	**0**
Enforcing Contracts	14	17	**-3**
Closing a Business	86	32	**+54**
Getting Electricity	115	84	**+31**
Overall rank	**31**	**21**	**+10**

The objective of the *Action Plan to Improve the Business Environment* for 2012 is "simple and qualitative services in entrepreneurship – more e-services". It includes 30 measures for 2012. The following are the most important:

– **simplifying business start-ups –** as of August 20, 2012 online electronic registration of enterprises to be introduced on the portal *www.latvija.lv*, thus registration of an enterprise will take just a couple of minutes. It is also planned to reduce the number of documents to be submitted to the Register of Enterprises by entrepreneurs and to apply a fee reduced by 50% for registration of microenterprises until 2014, as well as to reduce the fee for electronic (online) registration of enterprises;

- **construction process** – adoption of the new *Construction Law* is urgent. Amendments to the Cabinet regulations related to the *Construction Law* are also planned to be developed in order to improve the construction process;
- **protecting investor rights –** in 2012, amendments to the *Commercial Law, the Financial Instrument Market Law* and *the Annual Accounts Law* are planned to be made;
- **tax –** to improve the EDS solution by developing error modules, simplifying VAT declarations, thus reducing the time required for a tax declaration, as well as to define preferential conditions regarding lost VAT debts, simplify the procedure for declaring tax on increase in capital;
- **registration of immovable property –** to revise the amount of state fee for corroboration of property rights in the land register;
- **employment relationships –** to develop amendments to the Labour Law envisaging strengthening the flexicurity principles in employment legal relationships;
- **enforcing contracts –** to revise regulation of arbitrators (currently *the Draft Mediation Law* is being developed and harmonized), reduce the number of instances (courts) required for commercial proceedings;
- **e-service development –** in 2012, the work on developing and improving the section for entrepreneurs will be continued on portal *www.latvija.lv*, among all, by developing roadmaps in the fields of *Doing Business*, thus providing a clear set of information about administrative formalities at a particular business stage irrespective of the responsible institution for the service. It is also planned to develop amendments to relevant normative acts envisaging a reduced fee or time for providing the entrepreneur-oriented services using electronic service request/receipt.

6.8. Small and Medium-Sized Enterprises

In Latvia, similar to other European countries, small and medium-sized enterprises (SMEs) form a major part of the national economy and play a significant role in GDP building and employment.

Box 6.11

The number of small and medium-sized enterprises in Latvia

According to the information of the CSB, there were 73 771 economically active individual merchants and commercial companies in Latvia in 2010 (excluding farms, and fish farms and self-employed persons, who perform economic activity), 99.5% of which belonged to the category of SMEs. The distribution of economically active SMEs in Latvia is the following: micro-enterprises – 83.9%, small enterprises – 12.9%, medium-sized enterprises – 2.6%, large enterprises – 0.5%. An important indicator characterizing economic activity is the number of economically active merchants and commercial companies per 1000 inhabitants. This indicator in Latvia has grown constantly over the last 10 years from 17 in 2001 to 33 in 2010.

However, it is equally important to emphasize the number of performers of individual work (self-employed persons) in 2010 – 49 063 (22 per 1000 inhabitants), as well as the number of farms and fish farms in 2010 – 13 133 thousand (6 per 1000 inhabitants). Taking into account the fact that there is no single methodological practice among the EU Member States for calculating such an indicator characterizing the economic activity as the number of enterprises per 1000 inhabitants, it is difficult to perform objective comparative analysis of this characteristic. The current practice of the responsible EU institutions shows that calculation of the number of enterprises per 1000 inhabitants includes not only individual merchants and commercial companies, but also performers of individual work, farms, and fish farms, etc. Therefore, by applying an analogous practice, in 2010 in Latvia there were 61 performers of economic activity per 1000 inhabitants.

According to the statistics of the Register of Enterprises in the year 2011, 19 942 subjects were registered and 4041 subjects were liquidated in the registers of the Register of Enterprises. While in the first five months of 2012, 8476 subjects were registered and 1797 subjects were excluded from the registers of the Register of Enterprises.

Definition of SMEs

Definition of SMEs is stipulated in the *Law on Control of Aid for Commercial Activity,* Regulations of the Cabinet of Ministers of November 25, 2008, No 964 *Regulations on Declaration Procedures of Commercial Companies According to Small or Medium-sized Commercial Company*, and *Commission Regulation (EC)* No. 800/2008:

medium-sized enterprises:
- number of employees: 50–249;
- annual turnover does not exceed EUR 50 million;
- total sum of annual balance is under EUR 43 million;

small enterprises:
- number of employees: 10–49;
- annual turnover does not exceed EUR 10 million;
- total sum of annual balance is under EUR 10 million;

micro enterprises:
- number of employees: 1–9;
- annual turnover does not exceed EUR 2 million;
- total sum of annual balance is under EUR 2 million.

Box 6.12

Activities of the EU in promoting entrepreneurship

On June 25, 2008, the European Commission approved the review of the *Small Business Act for Europe (Act)*, mainly aimed at integrating the use of *Think Small First* principle in the preparation process of political documents, improving the overall political approach to entrepreneurship, particularly promoting development of small and medium-sized enterprises, and helping to eliminate obstacles preventing their development. The Act includes proposals for 10 politically binding guidelines and several specific proposals for regulations of normative enactments.

In order to achieve the objectives of the Act, in 2012 already for the fourth year, the European Commission plans to organize a European scale campaign *European SME week – for small and medium sized enterprises* to provide information (seminars, conferences, discussions etc.) to existing and potential entrepreneurs about activities of the European Union, Member States, and local government institutions in entrepreneurship improvement, promotion and to honour entrepreneurs for contributing to European welfare, creation of jobs, innovations and competitiveness.

In order to provide exchange of experience and new knowledge for further business development to potential and existing enterprises, conferences, regional and thematic seminars on such issues as internet marketing strategy, intercultural communication, protection of intellectual property rights, consultations and solutions to promote exportability, current support programmes for enterprises, etc. were held in September and October in Latvia within the framework of the *SME week 2012*. Overall, more than 10 informative events for entrepreneurs were organized in Latvia involving over 800 entrepreneurs.

In order to foster development of small and medium-sized enterprises and the overall business environment, the policy is formed and implemented in three directions:

– development of support measures to promote micro-enterprise establishment and development;
– development of measures to promote business start-ups;
– providing enterprises access to finance.

Support measures to promote micro-enterprise establishment and development

On October 30, 2009, the Cabinet of Ministers approved the *Concept of Micro-enterprise Support Measures* with the aim of creating the necessary preconditions to encourage unemployed people to start business activity, to create business environment favourable to micro-enterprises, as well as to develop entrepreneur skills, thus increasing the share of entrepreneurs in the total number of working population. Currently, the Concept is being successfully implemented, and amendments to the relevant laws and regulations have been made.

Amendments to the *Commercial Law* of May 2010 significantly reduced costs required to start a business envisaging that a **limited liability company may be founded with reduced equity capital** (from LVL 1). At the same time, the state fees for registration of such a limited liability company were reduced. According to the data of the Register of Enterprises, 32 886 limited liability companies were registered within the time period from May 1, 2010 until May 31, 2012, 66% or 21 671 of them were limited liability companies with reduced equity capital.

In 2012, microenterprises still will be supported by applying a reduced fee for registration of microenterprises by 50% until 2014, as well as a reduced fee for registration of enterprises in case of electronic (online) registration.

Since September 1, 2010 legal and natural persons **can obtain the status of a micro-enterprise taxpayer** if they comply with certain criteria (members are natural entities, turnover does not exceed LVL 70 000 per calendar year, and the number of employees does not exceed 5) and make micro-enterprise tax payments in the amount of 9% (includes all state determined tax payments, except consumer taxes) of turnover or profit from economic activity. A total of 21 261 micro-enterprise tax payers were registered at the State Revenue Service from September 1, 2010 until May 31, 2012 (66% of them – newly-established enterprises). These enterprises are subject to simplified SRS formalities (declarations 4 times a year), and they also have an opportunity to use free-of-charge accounting software – about 4000 enterprises have used the offered opportunity from September 1, 2010 until May 31, 2012.

In order to prevent tax optimisation schemes allowed by the *Micro-enterprise Tax Law* that are mainly related to transforming employment contracts into staff secondment services, thus subjecting the employees to a rather unfavourable position, amendments to the *Law on Personal Income Tax* came into force on January 1, 2012 envisaging that in case such micro-enterprise services comply to certain criteria, they shall be deemed as staff secondment and thus imposing an obligation on the party seconding the personnel to apply the personal income tax and the mandatory state social insurance contributions from the income of the personnel on loan in accordance with the general procedure.

As of January 1, 2010, any natural entity performing economic activity in specific professions or operations **may choose to pay the patent fee**, which is a complete tax payment including personal income tax and mandatory state social insurance contributions for the economic activity of a natural entity in specific profession. Relevant social guarantees are ensured to all payers of the patent fee. A total of 3600 applications for patent fees have been submitted to the SRS from January 1, 2010 until May 31, 2012. The number of the patent fee payers on average is 210 patent fee payers per month. Typically patent fees payers are persons performing such economic activity as gathering nature gifts – berries, mushrooms, wild herbs, photographers, hair stylists, nail care specialists, dressmakers.

Continuing work on simplifying the legal framework and ensuring transparency thereof regarding small enterprises, on February 23, 2012, the Meeting of State Secretaries announced the concept ***On Consolidation and Simplification of Small Enterprise Taxpaying System***. The Concept envisages:

– reducing the number of simplified tax regimes by consolidating similar regimes, as well as introducing anti-evasion rules in laws;
– increasing the number of economic activity operators by achieving that unregistered economic activity operators make their activity legal and ensuring termination of operations of inactive economic activity operators;
– developing a mechanism for encouraging small enterprises not to hide their growth and become a part of the overall tax system;
– increasing long-term social guarantees of employees of small enterprises and micro-enterprises.

Business incubator programme

In order to foster establishment and development of micro, small, and medium-sized enterprises, IDAL implements the project *Development of Business Incubators in Latvia* co-financed by the European Regional Development Fund. A **business incubator** is a combination of infrastructure and personnel aimed at aiding new and small enterprises to develop supporting them in their early stage of development with infrastructure, day-to-day consultations, and services concerning basic business development issues.

The aim of the project is to foster establishment and development of new, viable, and competitive micro, small, and medium-sized enterprises in the regions of Latvia by ensuring the environment and consultancy services necessary for business activity.

Currently, the following business incubators are operating in Latvia:

– Ventspils High Technology Park located in Ventspils and Talsi;
– Kurzeme Business Incubator located in Liepāja, Saldus, and Kuldīga;
– JIC Business Incubator located in Jelgava and Dobele;
– JIC Business Incubator located in Aizkraukle and Jēkabpils;
– Valmiera Business Incubator located in Valmiera, Gulbene, and Valka (provides virtual incubation services);
– Business Incubator "Cēsis" – Magnus located in Cēsis, Madona, and Alūksne (provides virtual incubation services);
– Latgale Machinery Technology Centre located in Rēzekne, Balvi, and Ludza (provides virtual incubation services);
– Latgale Machinery Technology Centre located in Daugavpils and Līvāni;
– Riga Region Business Development Incubator located in Ogre, Limbaži, and Tukums;
– Creative Industry Incubator "HUB – Riga" located in Riga, Andrejosta.

By May, 2012, 428 micro-, small, and medium-sized enterprises providing (maintaining) 1271 work places have received services at ten business incubators. According to the provisions of the project *Development of Business Incubators in Latvia,* the IDAL will support micro, small, and medium-sized enterprises until October 31, 2014.

Providing access for enterprises to financing

The Mortgage and Land Bank of Latvia (the Mortgage Bank), which is 100% state-owned bank and performs the functions characteristic for a development bank, plays a substantial role in implementation of support instruments.

In 2012, the Mortgage Bank continues implementing the following support programmes:

– *Support Programme on Improvement of Competitiveness of the Enterprises* co-financed by the ERDF*;*
– Support programme for *Support for Self-employment and Business Start-ups* co-financed by the ESF;
– *Micro Crediting Programme of Latvia and Switzerland*,
– *SME Growth Loan Programme;*
– *Programme of Agricultural Liquid Assets;*
– *Agricultural Credit Fund Loans.*

Currently, the most significant support programme by means of the amount of credit implemented by the Mortgage Bank is the *Support Programme for Improvement of Competitiveness of the Enterprises* approved by the Cabinet of Ministers in May 2008. The support within the programme is provided to small, medium-sized, and large enterprises registered in Latvia, which have economically reasonable further activity plans, but cannot receive funding from credit institutions due to the increased risks. Within the programme, investment loans (up to LVL 5 million) and current assets loans (up to LVL 2.5 million) are granted, with the maximum loan amount per one enterprise not exceeding LVL 7.5 million. The loans are mainly intended for implementing projects of enterprises operating in the processing industry and for enterprises attracting funding of the EU Structural Funds grant programmes.

It is envisaged that until December 2013 the Mortgage Bank will grant loans for improvement of enterprise competitiveness in the amount of LVL 210 million.[1] Since the launching of the Support Programme on Improvement of Competitiveness of the Enterprises until the middle of May 2012, 382 loans have been granted in the amount of LVL 163.4 million, among which loans in the amount of LVL 113 million have already been issued. 70 loans in the amount of LVL 74.7 million were granted from the part of the programme funded by the ERDF including granted loans in the amount of LVL 40 million.[2] The sectors receiving the most funding are timber processing, electrical power industry, production of pharmaceutical products, and food production.

The programme *Support for Self-employment and Business Start-ups* co-funded by the ESF and approved by the Cabinet of Ministers in March 2009, offers complex support to business start-ups and newly established enterprises, i.e. consultations, trainings, and funding in a form of loans (up to LVL 54 thousand) and grants[3] for starting an economic activity.

Box 6.13

Transformation of the Mortgage Bank into a Development Bank

In December 2009, the Cabinet of Ministers accepted the concept *Transformation of the State Joint Stock Company "The Mortgage and Land Bank of Latvia" into Development Bank*. The aim of the concept was to select the optimal options for transformation of the Mortgage Bank into a development bank, by reducing the number of transactions of a commercial bank and focusing the work of the bank on directions currently crucial to the national economy. The 1st model of the concept was supported envisaging establishment of a development bank on the basis of the Mortgage Bank and gradual discontinuation of commercial bank's functions no later than by December 31, 2013. It is provided that in the process of transformation, the Mortgage Bank will annually implement new support programmes in the amount of LVL 70 million according to the priorities defined by the government in such fields as financing of SMEs and business activity start-ups, promotion of micro-enterprises and self-employment, financing of innovative, technologically intensive, and high value added projects, funding for production of goods and rendering of services that are competitive in the international market, implementation of energy efficiency measures, development of agriculture and rural areas, particularly focusing on fostering self-employment and engaging in commercial activity the specific socially sensitive population groups (for example, the disabled, unemployed, new families, national minorities).

In November 2011, the Cabinet of Ministers adopted a decision on the sales strategy of Mortgage Bank's commercial part envisaging the sale of the commercial part in 6 packages thus selling both assets and liabilities. Sales packages consist of the subsidiary companies of the Mortgage Bank, namely "HipoNIA", "Hipolīzings", and "Hipo fondi"; assets that might be interesting to SME-oriented universal commercial banks, assets that might be interesting to large customer-oriented commercial banks, as well as assets that might be interesting to real estate investors.

The sales process is planned to be completed in 2012. At the same time, the Cabinet of Ministers assigned the Ministry of Finance to establish an advisory council for coordination and improvement of national support programmes. Based on proposals of the advisory council, the Ministry of Finance in cooperation with the Ministry of Economics are assigned to submit to the Cabinet of Ministers a plan for establishing a single development financial institution, including an operational plan of the Mortgage Bank after alienation of the commercial part by July 1, 2012.

The amount envisaged in a business plan may not exceed LVL 60 thousand, and at the same time co-financing in the amount of at least 10% of the total amount of the plan must be provided for the projects with the loan amount exceeding LVL 5 thousand for the implementation of the business plan.

The total funding of the programme is LVL 23 million, including funding from the ESF and the state budget – LVL 14 million, and co-financing of the Mortgage Bank in the amount of LVL 9 million. In the framework of the total funding of the programme, LVL 16.5 million is envisaged for loans, while LVL 6 million – for grants, trainings, and consultations. It is planned that during implementation of the programme, 1200 start-ups will be trained by the end of 2013, while funding (loans and grants) will be granted to 800 persons.

The practical implementation of the programme was launched in August 2009. Since then, cooperation agreements with 2710 interested entrepreneurs have been concluded, 1371 clients have submitted business plans, including 718 start-up projects that have already been supported for the total loan amount of LVL 8.5 million. In cases of 670 projects, also grants have been awarded for the total amount of LVL 2.9 million.

Since January 2010, in the scope of the programme, training is available throughout the territory of Latvia for those programme participants whose theoretical and practical knowledge is insufficient to carry out commercial activity and to prepare a business plan. Training according to the modular approach is available in such modules as basics of business activity (small business organization), management basics, legal regulation of entrepreneurship, finance management of the enterprise, accounting and taxes of economic activity, and basics of marketing. So far, 1349 programme participants have been trained.

In September 2009, the Cabinet of Ministers adopted regulations *On Loans for Promotion of Development of Small (Micro), and Medium-Sized Enterprises*

[1] Currently, the total amount of programme resources amounts to LVL 140.2 million. Programme funding comprises resources of the Northern Investment Bank (NIB) (LVL 70.3 million) and ERDF (LVL 43.3 million), as well as funding of the Mortgage Bank (LVL 26.6 million).

[2] Information in this case and in case of other described programmes is given according to the situation as of November 29, 2011.

[3] A grant for starting an economic activity (up to LVL 3.6 thousand, but not exceeding 35% of the loan amount); a grant for repayment of a loan (up to LVL 2 thousand, but not exceeding 20% of the loan amount).

and Agricultural Service Cooperatives. In accordance with these regulations, in February 2010, the Mortgage Bank launched implementation of the *SME Growth Loan Programme*. The programme is aimed at improving access of economic activity operators registered in Latvia to financing, thus promoting development of national economy. It is envisaged that until December 2013, loans for liquid assets and investments in the amount of LVL 140 million will be available within the framework of the programme. The maximum amount for investment loans for one economic activity operator is LVL 300 thousand, farmers – LVL 2 million; the maximum loan amount for liquid assets is LVL 200 thousand. Besides, according to the conditions of the programme, the maximum amount of a loan within this programme per one micro-entrepreneur operating in service industry may not exceed LVL 30 thousand. By the middle of May 2012, 516 loans in the amount of LVL 25.1 million have been granted, including the loans in the amount of LVL 20.7 million that have already been granted within the framework of the programme.

In May 2010, the Mortgage Bank launched the *Programme of Liquid Assets Loans for Producers of Agricultural Produce***.** Producers of agricultural produce, as well as groups of fruit and vegetable producers may receive liquid assets loans from LVL 5 thousand up to LVL 700 thousand with a term of up to 1 year, while the maximum loan for agricultural service cooperatives can reach LVL 2 million. Guarantees of Rural Development Fund may be attracted for these loans. So far, 663 loans in the amount of LVL 22.6 million, including loans for LVL 20.6 million have been granted within the framework of the programme.

In September 2011, the Cabinet of Ministers approved the *Crediting Programme of Latvia and Switzerland*. The programme is aimed at improving the possibility of micro-enterprises to receive financial support for business start-up or development. The programme is implemented within the framework of the cooperation programme between Latvia and Switzerland, and the total funding of the programme is LVL 4.7 million,[1] including LVL 4.3 million that are earmarked for micro-loans, investments and liquid assets of up to LVL 10 thousand, as well as LVL 400 thousand – for grants to repay the loans.[2]

The programme will function until June 2015 when up to 650 micro-enterprises are expected to receive funding within the framework of the programme. So far, micro-loans have been granted to 338 micro-enterprises in the amount of LVL 2 million including granted loans in the amount of LVL 1.7 million.

SIA "Latvian Guarantee Agency" (LGA) is a state-owned capital company with the aim to promote access to funding for enterprises registered in Latvia. LGA offers seven different financial instruments to improve competitiveness:

- Direct instruments for enterprises
  - loan guarantees, with the aim to help enterprises to attract credit resources in cases when their collateral is insufficient to receive credit resources;
  - export loan guarantees, with the aim to support exporters covering political and commercial risks related to export transactions;
  - mezzanine loans aimed at providing long-term funding to Latvian enterprises in addition to the granted bank loans to cover all investment project costs in material and non-material assets.
- Indirect instruments for enterprises (through other institutions)
  - seed capital investments aimed at providing financing for pre-investigation, assessment and development of product or business idea concept. This instrument is implemented by Imprimatur Capital within the Holding Fund administered by the LGA;
  - start-up capital investments aimed at providing financing for development and first marketing of entrepreneurs' products. This instrument is implemented by Imprimatur Capital within the Holding Fund administered by the LGA;
  - venture capital investments aimed at providing financing for development and first marketing of products, growth and expanding activities of entrepreneurs by increasing production capacity, developing sales markets and products or attracting additional working capital. This instrument is implemented by BaltCap within the Holding Fund administered by the LGA;
  - commercial loans. This instrument is implemented by SEB banka and Swedbank within the Holding Fund administered by the LGA.

On March 10, 2009, the Cabinet of Ministers adopted Regulations on activity *2.2.1.3 Guarantees for Improvement of Enterprise Competitiveness of the Supplement to the Operational Programme "Entrepreneurship and Innovation"*. The goal of the regulations is to provide the enterprises with access to funding for development of commercial activities and for implementation of the EU funds projects by ensuring guarantees in situations when the collateral at the disposal of the enterprise is

[1] Within the framework of the programme, the Loan Fund has been established for providing financial support – micro-loans and grant; the Fund is administered by the Switzerland in the amount of 80% and the Mortgage Bank – in the amount of 20%. Yet, management costs of the programme are funded by Switzerland in the amount of 80% and the state budget – in the amount of 20 percent.

[2] The amount of the grant in Riga, its local governments and major cities is LVL 500, while the amount of the grant in the rest of Latvia is LVL 750.

not sufficient to attract sufficient credit resources, and the banks evaluate the enterprise as too risky, as well as to facilitate competitiveness of Latvian enterprises, to promote absorption of new markets and consolidation in the existing ones.

In April 2009, the LGA launched implementation of the activity *Guarantees for improving enterprise competitiveness*. At the moment the ERDF financing available within the activity is LVL 20 million.

The LGA issues guarantees for the following financial services: loans for investments; liquid asset loans; financial leasing; local factoring, as well as bank guarantees (tender, advance payment, payment, execution or time guarantee). The guarantees cover up to 80% of the principal amount of the financial service but not exceeding EUR 1.5 million per one enterprise.

Guarantees issued within the framework of the *Loan Guarantee Programme* since launching the activity until April 30, 2012:

- the number of applications – 1304 applications from 373 enterprises;
- the amount applied for – LVL 235.7 million;
- the number of issued guarantees – 242 guarantees for 200 enterprises;
- the amount of issued guarantees – LVL 65.5 million;
- the amount of guaranteed credits – LVL 166.2 million.

In May 2009, the Cabinet of Ministers adopted regulations *On Short-term Export Credit* establishing coverage and beneficiaries of short-term export credit guarantees, as well as the procedure for granting guarantees and the procedure under which the guarantor covers the loss. The LGA export credit guarantee covers up to 90% of the amount of deferred payment but not exceeding EUR 1 million or an equivalent in another currency. The deadline of the deferred payment may not exceed 2 years.

Guarantees issued within the framework of the *Export Loan Guarantee Programme* since launching the activity until April 30, 2012:

- the number of applications – 160 applications from 47 enterprises;
- the number of issued guarantees – 87 guarantees to 25 enterprises;
- the amount of issued guarantees – LVL 5.3 million.

All enterprises which signed the agreement represent the manufacturing industry. In the breakdown by countries, most of the guarantees are issued for the CIS country markets – Russia (49%) and Belarus (17%), as well as such countries as Nigeria (8%), Kazakhstan (7%), Germany (6%), Ukraine (3%), Azerbaijan (3%) and others.

In August 2011, the Cabinet of Ministers approved the *Regulations Regarding Mezzanine Loans for Improving Competitiveness of Economic Operators* setting the requirements for granting the support in a form of mezzanine loans for improving competitiveness of economic operators. The minimum amount of a mezzanine loan is LVL 100 thousand and the maximum amount is LVL 700 thousand. The amount of a loan does not exceed 40% of the total costs of an investment project. The total amount of the loans is LVL 17.7 million.

Mezzanine loans for investments to improve competiveness of enterprises will be launched in November this year therefore no mezzanine loans have been granted so far.

Mezzanine loans are aimed at providing long-term funding to Latvian enterprises in addition to the granted bank loans to cover all investment project costs in material and non-material assets related to establishing a new enterprise, expanding an existing one, diversifying production with new additional products or introducing a significant change in the general production process.

On January 2012, the activity 2.2.1.1 *Holding fund for the investment in guarantee, high-risk loans, and venture capital funds and other financial instruments* *(Holding Fund)* was taken over from the European Investment Fund.

By March 31, 2012, 30 loan contracts in the amount of LVL 9.45 million have been concluded within the framework of the *Holding Funds* loan instrument and 16 venture capital investment contracts of different stages in the amount of LVL 5.7 million have been concluded within the framework of venture capital instruments.

Considering the total amount of the fund (EUR 91.5 million) and the present progress of financing absorption within the activity, the LGA plans to implement additional financial instruments – growth capital fund (refined EIF's previous instrument that was suspended in the second half of 2011) with the expected budget in the amount of EUR 5-15 million. In 2012, it is expected to develop and launch implementation of these financial instruments.

On May 29, 2012 the Cabinet of Ministers approved implementation of new venture capital state support programme – the Growth Capital Fund to continue providing access for Latvian small and medium-sized enterprises to venture capital financing for business start-up and development, as well as improve competiveness and growth of enterprises. The Growth capital funds will improve and expand the venture capital sector in Latvia by complementing the range of other venture capital fund opportunities implemented by the LGA. The Growth capital funds allow receiving venture capital if an enterprise has insufficient own resources and the expected investment risk is too high to attract the required amount of financing from credit institutions.

The Growth capital funds will invest in micro-, small- and medium-sized enterprises operating in Latvia. An enterprise will be able to receive investments up to LVL 1 million to provide financing for pre-investigation, assessment and development of product or business idea concept, development of products, growth and expanding the activity by increasing the production capacity, developing sales markets and products. Growth capital funds will invest in enterprises with high growth potential. Growth capital funds will be funded by financing available within the sub-activity *Holding fund for the investment in guarantee, high-risk loans, and venture capital funds and other financial instruments* of the European Union structural funds. The total amount of the investments of the growth capital funds in Latvian enterprises is expected to reach EUR 40 million (about LVL 28 million).

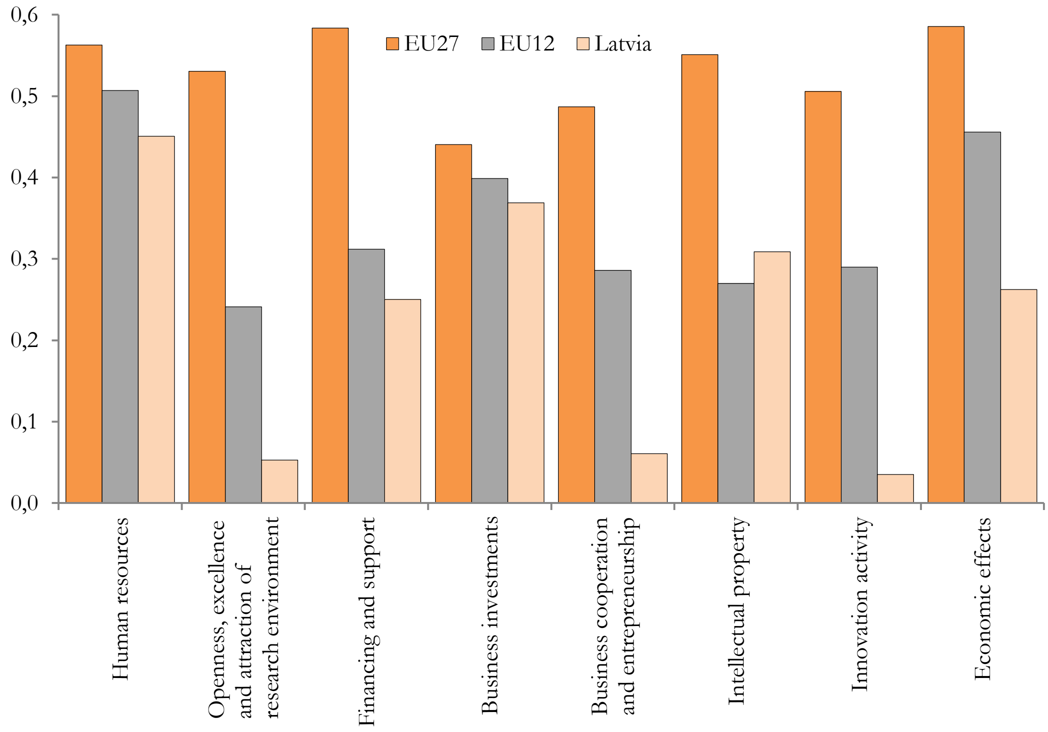
6.9. Innovation and New Technologies

The European Commission's annual research *Innovation Union Scoreboard 2011* has ranked Latvia the last among 27 member states of the European Union (Estonia – 14%, Lithuania – 25%). It must be noted that the average rise in the indicators of the research over the last five years in Latvia is 2.7% that is higher than the average indicator of the European Union member states – 0.85 percent.

Overall, Latvia has achieved rather good results in the area of human resources, company investments, intellectual property, and economic assets. Lower results are achieved in the area of research environment, financing and support, innovative enterprises, as well as collaboration between merchants and scientists. The only area where Latvia has improved its outcome in 2011, as compared to the previous year, is financing and support that comprises such indicators as R&D expenditure in the public sector and venture capital.

Figure 6.11

Innovation index components in 2011



Source: European Commission, Innovation Union Scoreboard 2011

According to the Eurostat data, during the time period from 2006-2008, about 24.3% of the enterprises in Latvia were innovative, while in the EU countries this indicator was 52 percent.

The share of products of high technologies in total exports is rather small. In 2011, this indicator was 12.8% (in 2010 – 14%). The share of products of medium-high technologies in the total exports was 20.4% in 2011 (in 2009 – 19%); however, the total share of export of high and medium-high technology products was 33.2% of the total export structure in 2011 (in 2010 – 33%).

The share of investments in research and development (R&D) in Latvia has increased in 2010 and was 0.6% of GDP in comparison with the previous year (in 2009 – 0.46%). Having analysed the R&D structure and dynamics, an increase is observed in all sectors, except for public and higher education institution financing that decreased by 0.17% of GDP in 2010. Foreign, including the EU structural funds financing was 0.2% of GDP. The private sector investments in R&D increased quite rapidly in 2010, constituting 0.23% of GDP (in 2009 – 0.17% of GDP). At the same time, it should be noted that the total investments of Latvia in research and development still are considerably behind the R&D investment objective of Latvia set in the *National Reform Programme of Latvia for the Implementation of the EU 2020 Strategy* (*the NRP of Latvia*) – to increase investments in research and development to 1.5% of GDP by 2020.

In the first half of 2012, the key innovation activities were implemented according to the main directions for fostering innovations until 2013 set in the *NRP of Latvia*:

- developing scientific activity potential;
- establishing a long-term platform for cooperation between enterprises and scientists;
- supporting development of innovative enterprises.

Development of scientific activity potential

In 2012, implementation of several measures were continued to develop scientific potential with aim to increase the number of employed in science and research, establish competitive scientific institutions with state-of-the-art materially-technical provision by consolidating state scientific institutions and strengthening their infrastructure, encouraging involvement of human resources in science, and increasing competitiveness of scientists.

In 2012, support is still provided to 5 *State research programmes* for cross-sectoral scientific research commissioned by the state within five priority scientific directions approved by the Cabinet of Ministers. Financing in the amount of LVL 4 million has been earmarked for implementation of the programmes.

In order to improve scientific and research equipment leading research centres of national importance, the EU Structural Funds activity *Development of Science Infrastructure* is implemented in 2012. The activity was implemented in two selection stages with the total public co-funding in the amount of LVL 102.7 million. The first selection stage in 2011 was organized to support state scientific institutions in improving their infrastructure – for purchasing scientific facilities and equipment, reconstructing and renovating buildings and premises, as well as creating state-of-the-art materially-technical base for research. At the end of 2011, 9 contracts on improvement of infrastructure were concluded in 9 research centres of national importance until 2015 for EU funds support in the total amount of LVL 56.3 million. At the beginning of 2012, the second selection stage of project applications submission was completed intended for both enterprises and scientific institutions to apply for support in project implementation development of research infrastructure that fosters development of research in the private sector and research service rendering to the private sector. 11 project applications have been supported for the total EU structural funds support amount of LVL 33 million within the second selection stage.

In 2012, implementation of the EU Structural Funds activity *Support to Research and Development* thus supporting implementation of practical research projects in the state priority science directions is continued. Overall, decisions on approval of 122 projects for total EU funds financing in the amount of LVL 33.6 million have been adopted in the activity.

In 2012, the *EUREKA programme* still provides support to implementation of projects for mutual cooperation between enterprises and scientific institutions to foster development and introduction of technologies and new and competitive products and services. Within the European scale joint programme EUROSTARS small and medium-sized research and development enterprises of Latvia have an opportunity to receive a support for implementation of projects aimed at developing innovative and market-demanded products, technologies, and services.

Establishing a platform for long-term co-operation between enterprises and scientists

The Competence Centre Programme is the key activity for cooperation between enterprises and scientists to carry out joint large-scale industrial researches and develop new products and technologies. In 2012, the conditions of the programme were revised improving the procedures for research service procurements, as well as conditions for cooperation between enterprises and the research sector. Competence centres are established in six sectors important to the national economy of Latvia (pharmacy and chemical industry, information and communication technologies, forestry sector, manufacturing of electric and optical equipment, environment, bioenergetics and biotechnology, as well as transport and engineering). The programme is planned to be implemented until 2015 and its total public funding is LVL 37.4 million and additional co-funding in the amount of LVL 20 million is expected to be attracted from the private sector. A total of 72 enterprises and 11 scientific institutions are involved in the Competence Centres.

In order to identify the need of enterprises for research results and the potential of higher education institutions or scientific institutes to provide research or product development services according to the needs of entrepreneurs, the activity of 8 technology transfer contact points at higher educational institutions were still supported in 2012, namely, at the University of Latvia, Riga Technical University, Latvia University of Agriculture, Riga Stradins University, Ventspils University College, Rezekne Higher Education Institution, Daugavpils University, and Art Academy of Latvia. Technology transfer contact points are structural units of higher education institutions supporting and promoting the activity of knowledge and technology transfer, for example, identifying the results of commercially accomplished researches, as well as developing and maintaining external relations, providing information about research activities and experience of organizations, as well as providing services of industrial property rights protection. The total EU structural funds financing available for the programme until 2013 constitutes LVL 1.69 million.

In the first half of 2012, IDAL is organizing selection of project applications in the *Cluster Programme*, within the framework of which 18 submitted project applications for the total requested support amount of LVL 4.9 million are being evaluated. The *Cluster Programme* funded by the EU structural funds consequently originates from the cluster support activities funded from state budget resources and implemented by the Ministry of Economics in 2009–2011. The Cluster Programme is aimed at promoting cooperation between mutually unrelated enterprises, research, educational and other institutions to improve competiveness of sectors and enterprises, export volumes, promote innovation and new products. The total financing available for the programme until 2015 constitutes LVL 3.4 million and at least 8 clusters are expected to be established as a result of the programme by attracting funding in the amount of LVL 0.5 million from the private sector.

Supporting development of innovative enterprises

In 2012, implementation of measures launched in the previous years was continued and work on development of new programmes was continued as well to promote development of innovative enterprises, by supporting investments in developing and introducing the new products in production, including purchase of equipment and technologies, supporting investments in developing new production plants and increasing labour productivity.

In 2012, IDAL continued providing financing to projects of enterprises approved within the first selection stage of project application of the programme *Development of New Products and Technologies* and the first and second selection stage of project application of the programme *Introduction of New Products and Technologies into Production* aimed at developing new or significantly improved products, technologies or technological processes. Within both programmes, 225 contracts for the total EU structural funds financing of LVL 45.8 million have been concluded, and 127 projects for LVL 14.8 million have been completed by the middle of 2012. The approved projects are expected to attract co-funding in the amount of LVL 90.5 million from the private sector.

In order to increase the potential of Latvian production enterprises to invest in knowledge or technology-based projects by supporting purchase of production equipment, construction or modernisation of production plants with the aim of promoting creation of new workplaces, in 2012, IDAL implemented the second selection stage of project applications in the *High Added Valued Investments Programme* for the total available EU structural funds financing of LVL 26 million. The second selection stage of project applications is evaluation of project applications submitted by 51 enterprises for the requested amount of LVL 82 million. At the same time, implementation of 23 projects was continued for the total financing of LVL 49.9 million approved within the first selection stage of project application that might attract additional financing in amount of LVL 80 million from the private sector.

In the second half of 2012, IDAL plans to launch implementation of the support programme *Development Programme of New Products and Technologies of Micro-, Small and Medium-Sized Enterprises* approved by the Cabinet of Ministers in late 2011. The programme provides support to small- and medium-sized enterprises for outsourcing to carry out researches, corroboration of industrial property rights and certification of new product or technology. The total EU structural funds financing available within the framework of the activity is LVL 2 million. The EU funds co-financing per one project will be available in the amount of 60%, and the maximum amount thereof is planned to be LVL 10 thousand. The programme is expected to support 200 enterprises introducing new products and technologies by attracting co-financing in the amount of LVL 1.2 million from the private sector.

In 2012, the work continues on development of a new support programme for promoting "green" industry and eco-innovations by attracting funding of the Norwegian financial instrument. A Technology Incubator is planned to be established within the framework of the programme providing support services and grants to technology-intensive enterprises focused on development and introduction of environmentally-friendly products and technologies in the amount of LVL 2.4 million. The total funding of the programme is LVL 7.9 million, and 120 enterprises are planned to be supported in the framework thereof. The Technology Incubator is likely to start operating at the end of 2012.

For the purpose of educating the society and raising public awareness of innovation and entrepreneurship, as well as encouraging people to start a business and focus on development and application of innovative solution, IDAL continued implementing the EU structural funds programme *Measures to Encourage Innovations and Business Start-ups* in 2012. Youth information seminars *Training course for authors of innovative business ideas* were organized in the first half of 2012, as well as a procurement procedure was organized for the implementation of the activity *Training seminars for promoting commercialization of technologies*. At the same time, the Mentoring Programme has been continuing since the end of 2011, competence seminars have been organized about topics *Developing products* and *Successful financial planning in an enterprise*, as well as a Latvian innovation portal *www.innovativelatvia.lv* was set up, and a procurement procedure was organized for updating and improving the content of the portal. The total EU structural funds financing available for the programme until 2013 is LVL 2.11 million.

In January 2012, implementation of the project *JOSEFIN (Joint SME Finance for Innovation)* of the transnational co-operation programme of the Baltic Sea region for 2007–2013 was completed. Latvia was represented by IDAL. Within the project, small and medium-sized enterprises received consultation services for preparation and development of innovation projects. The project supported 15 small and medium-sized enterprises by providing consultations in four topical directions (development of business plan market intelligence, attracting financing and financial matters of projects, protecting intellectual property, as well as marketing). As a result, complete business ideas were prepared for attracting funding from different sources – bank loans, private investments, as well as international research and development programmes.

6.10. Information Society

Information society is a social development phase based on free mutual information exchange, developing a knowledge-based economy. Information society consists of the technological base (infrastructure, software), a range of information services available to the society, and of the level of individual skills and knowledge. As a result of development of information and telecommunication technologies[1] (ICT), information and knowledge are more increasingly used in work and labour relations, education and everyday life (see Box 6.14).

Box 6.14

The role of the ICT sector

According to the CSB data, in 2010, the share of the ICT sector in GDP constituted 3.6%. In 2010, 2899 companies operated in the ICT sector in Latvia, employing more than 17 thousand persons, the companies' turnover reached LVL 1.45 billion, staff costs – LVL 159 million. The value added to the ICT production reached LVL 18 million, provision of the ICT services – LVL 347 million. The foreign trade balance of the ICT was negative: LVL 100.4 million, because imports amounting to LVL 370.8 million exceeded exports with LVL 270.4 million. It should be noted that in 2010 imports of the ICT products increased by 43% while exports – by 33.9% in comparison with 2009.

According to the data of the CSB survey *Computer and Internet Usage in Households,* 64% of all households had computers and an internet connection in 2011 (households with at least one person in the age group of 16–74 years). The best situation with accessibility to computers and internet was for households in the Pieriga (vicinity of Riga) region (computers – 74%, internet – 71%) and in the Riga region (computers – 69%, internet – 68%), while in other regions, the situation was not as good – in the Zemgale region (computers – 65%, internet – 64%), Kurzeme region (computers – 62%, internet – 62%), Vidzeme region (computers – 57%, internet – 60%[2]), and Latgale region (computers – 49%, internet – 47%). 66% of inhabitants in the age group of 16-74 years used a computer and internet on a regular basis (at least once a week). 53% of all households had a broadband internet connection.

At the beginning of 2011, 95% of all companies having 10 and more employees had computers, 92% of such companies had internet connection, and 53% of enterprises had their own website. In 2010, 89% of companies having 10 and more employees used internet for cooperation with the public and local government institutions. In 2011, 38% of all employees of enterprises used a computer connected to the internet.

At the beginning of the academic year 2010/2011, the number of computers per 100 pupils in general education schools was 10.9, in vocational education institutions – 13 computers per 100 pupils, in higher education institutions and colleges – 15.4 computers per 100 full-time students. At the beginning of the academic year 2010/2011, out of the total number of all education institutions, all higher education institutions and colleges, 99.6% of general education schools, and 89.8% of vocational education institutions had an internet connection.

Development of information society in Latvia is prescribed by the *Information Society Development Guidelines for 2006-2013* approved by the Decree of the Cabinet of Ministers of July 19, 2006. While solving sectoral issues in the coming years, the ministries have prepared guidelines setting out the overall goals, expected results, possible solutions, and planned financial sources, for example, the *Guidelines "e-Health in Latvia", Public Administration Policy Development Guidelines for 2008-2013, Policy Guidelines of Electronic Communication Sector of the Republic of Latvia for 2011-2016,* etc., as well as implementation programmes and action plans of these guidelines were developed, for example, the *Electronic Government Development Plan for 2011-2013*, etc.

In the course of solving issues occurring during implementation of certain information systems and looking for possibilities to cut maintenance costs of information systems and improve their security,

[1] The ICT sector is defined in accordance with the OECD definition which specifies inclusion of the following economic activities (NACE 2nd rev.): production of ICT (production of electronic components; production of electronic boards; production of computers and peripheral equipment; production of communication equipment; production of consumer electronic equipment; production of magnetic and optical data carriers), ICT wholesale (wholesale of computers, their peripheral equipment and software; wholesale of electronic equipment, telecommunications equipment and its components), and provision of ICT services (software publishing; telecommunications; computer programming, consulting and other related activities; data processing, hosting and other related activities, web portals; repairs of computers, their peripheral equipment and communication equipment).

[2] Since 2006, the overall number of households with access to the internet and also in other breakdowns exceeds the number of households with a computer. It is mainly due to the fact that many households in Latvia access internet through mobile phones.

several informative reports have been prepared, for example, *Informative report "On Hastening the Implementation of the Project "Developing Public Information Systems for Work with European Union Documents", Informative report "On Optimization of Information Technology Management, Infrastructure and Information System Development in Public Administration", Informative report "On Increasing Website Security", etc.*

The NGOs of sectors also actively participate in building information society. The Latvian Information and Communications Technology Association (LIKTA) has developed the ICT Sector Priority Charter. The charter is aimed at defining clear and measurable tasks for developing information society in Latvia for the next 5 years setting 6 key directions: a society educated in the field of ICT and equipped with the e-environment infrastructure, up-to-date e-government, ICTS-based competitive business environment, active welfare (e-health, lifelong learning) and easily accessible cultural heritage. The charter was signed by the NGOs and employers' organizations of sectors, leading higher education institutions, enterprises of sectors and other organizations on June 13, 2012.

Along with Latvia's accession to the EU, the EU initiatives related to development of the information society have become binding to Latvia.

A new aim has been set in the European Commission's communication *A Digital Agenda for Europe* adopted on August 26, 2010 – in relation to the *Europe 2020 Strategy* to gain economic and social benefit from the digital single market based on fast and particularly fast internet.

On May 22, 2012, the meeting of the Cabinet of Ministers considered the *Informative report "On Coordination of Implementation of the Flagship Initiative 'A Digital Agenda for Europe' of the Europe 2020 Strategy in Latvia"*, which sets an action plan for implementation of the programme (see Box 6.15). The Ministry of Environmental Protection and Regional Development was appointed the responsible institution for coordination of the programme.

Box 6.15

Action Plan for the *Digital Agenda for Europe*

The *Digital Agenda for Europe* sets seven priority measures (action areas): a vibrant digital single market, improving interoperability of ICT-based tools and services, building trust and security of users, fast and ultra fast internet access, research and innovation, enhancing digital literacy, skills and inclusion, ICT-enabled benefits for EU society, like, climate changes, health care and ageing population. The programme areas include 101 measures, among them 31 legislative initiatives and 23 measures to be implemented in the EU Member States.

The Action Plan emphasizes the following areas as particularly supported:

– *Fast and ultra fast internet access*. In order to ensure equal access to electronic communication services all across Latvia: national implementation plan for broadband network must be developed and implemented, relevant laws and regulations must be adopted to facilitate investments in broadband networks, fully absorb the EU structural funds and the Rural Development fund financing (see Sub-chapter "Broadband internet") and implement European radio spectrum policy programme;
– *Enhancing digital literacy, skills and inclusion*. In order to promote development of information society by giving Latvian population an opportunity to obtain e-skills according to their education and professional activity level: to implement long-term policy for e-skills and use of digital tools and properly encourage SME's and disadvantaged groups; to implement telecommunication regulation and the provisions of the Audiovisual Media Services (AMS) Directive regarding disability; to integrate e-learning in the national policy for the modernisation of education and training;
– *Trust and security*. In order to build public trust in use of internet: to join and use the European scale *Network of Computer Emergency Response Teams* (*CERT network*); carry out large scale attack simulation and test mitigation strategies; implement hotlines for reporting offensive or harmful online content, organise awareness raising campaigns on online safety for children.

The Action Plan includes measures also in the rest of action areas. The action area *Digital single market*: implement the key Directives supporting the digital single market, including the Services Directive, Unfair Commercial Practices Directive and the Telecoms Framework, as well as adapt laws on e-invoicing. The action area *Interoperability and standards*: Apply the European Interoperability Framework (including the geospatial information) and implement commitments on interoperability and standards in the Malmö and Granada Declarations. The action area *Research and innovations*: by 2020 double annual total public spending on ICT by attracting equal private funding, and engage in large scale pilots to test and develop innovative and interoperable solutions in areas of public interest. The action area *ICT-enabled benefits for EU society*: implement smart meters and agree on their additional functionalities, include specifications for total lifetime costs for all public procurement of lighting installations; improve interoperability of e-government; ensure conformity of single contact point of the Services Directive; agree on a common list of key cross-border public services; meet the requirements of the European Rail Traffic Management System.

The financing from the EU structural funds, as well as from the state and local government budget is used for development of electronic government and information society.

On December 1, 2011, the *Informative report on the implemented state information system development projects and on the proposals for development of state information systems* was reviewed during the meeting of the State Secretaries. The Informative report is a summary of information about 116 projects (22 implemented projects and 94 launched projects (see Box 6.16)) financed from different sources, but mainly by the European Regional Development Fund.

According to the information of the Ministry of Environmental Protection and Regional Development the total ERDF financing available for development of information systems and electronic services was LVL 96.9 million at the end of May 2012; LVL 60.5

million were available for the first selection stage of the projects and LVL 36.4 million – for the second stage. After carrying out the procurement procedures, the undivided ERDF financing constituted LVL 308 thousand. The funding is expected to be channelled to the project *Adapting Information Systems for Introduction of the Euro*. On May 8, 2012, the Cabinet of Ministers approved allocation of another LVL 2.5 million to this project, thus increasing the overcommitments of the EU structural funds' activities.

Box 6.16

Priority projects for development of electronic government and information society

The major projects completed in 2008 and 2009 are: *Information system of the Central Statistical Bureau*, *Information system of petroleum products, Improvement of the information system of unemployed registration and registered vacancies*, *Information system of tourism agents and tourism operators*, *Improvement of the Punishment Register*, *Improvement of the national visa information system*, *Improvement of the state social insurance information system*, *Improvement of the database of the state statistical reports on the health care sector*.

The main launched projects (with available financing in the amount of at least LVL 2 million) which are planned to be completed in 2011–2014 are: the individual project of Latvian and Swiss cooperation *Modernization of courts in Latvia*, the 2nd stage of development and introduction of *Joint State Archives Information System*, development of *Biometric Data Processing System*, the 2nd stage of *Development of the Portal www.skolas.lv*, development, improvement and maintenance of the *Electronic customs data procession system*, *Development of single workplace for natural and legal entities for communication with state and municipal institutions*, development of the *Health care provider information system* and its promotion, development of other institutions' information systems, the 2nd stage of *Development of Digital Library*, development of *Unified Welfare Information System (WelIS)*, information system of the sectors centralized functions and centralized ICT infrastructure, *Development of the Information System of the Register of Enterprises*, development of *Unified financial and management accounting system of public institutions* and their linking to the *Unified State Human Resources Management System*, development of *Client-Guided Services System for the Ministry of Agriculture and its subordinate institutions*, development of *Passport system and unified migration information system (UMIS)* for issuing electronic identification cards and electronic residence permits (cards), development of *Construction Information System*, the 1st and 2nd stage of the development of *Information System of Electronic Health Card and Integrity Platform*, development of e-tender and e-auction functionality of the *Electronic Procurement System*, development of *Geospatial Information System of the State Land Service geospatial data*, the 2nd stage for updating the *General catalogue of the National Holdings of Museums (GCNHM),* the 2nd stage for the development of the *Unified Environment Information System*, development of integration environment for the *Public Government Document Management System*, development of *Electronic Attendance Booking*, the 1st stage for the *Electronization of Health Care Job Flow*, development of the *Joint Geospatial Information Portal* and linking of the sectoral *Geographic Information System* (GIS) with the portal, development of e-catalogue functionality of the *Electronic Procurement System*, introduction of *Joint Municipal Information System* service centre software in regions, development of e-services for inhabitants, data migration to new platform, ensuring compatibility with the *State information systems* management integrator.

The Cabinet of Ministers has requested additional information on implementation of 5 projects as their implementation on due time is endangered: the 2nd stage of the *Public Education Information System*, the 2nd stage of *Development of the Portal www.skolas.lv*, the 2nd stage of development and introduction of *Joint State Archives Information System*, the 1st stage of *Electronic Prescriptions Information System*, development of *Construction Information System*.

Electronic services

According to the *Eurostat* data, Latvia had introduced 93% of 20 basic electronic services (the EU average – 84%) in 2010. The internet portal *www.latvija.lv* is developed as a single access point for the services of the state and local governments in Latvia. In total, information about almost 1940 services are available in the public services catalogue. Since June 2010, it is possible to register a new enterprise in the Register of Enterprises electronically.

Information on e-procurement and development of e-services is available on the website of the State Regional Development Agency (*www.vraa.gov.lv*), while the information on e-government and the policy of information society is available on the website of the Ministry of Environmental Protection and Regional Development (*www.varam.gov.lv*).

According to the data of the State Regional Development Agency, in the five months of 2012, the public and local government institutions have purchased goods in the *Electronic Procurement System* for about LVL 6.5 million (in 2011 – LVL 13.4 million thus achieving saving in the amount of about LVL 3.5 million on the account of reduced prices and administrative costs). The majority were procurements of computer technologies, medicaments, printing equipment and office supplies.

On April 2, 2012, issuing of the electronic identification cards (eID) was launched. About 22 000 cards have been issued in the first two months. The card is a person's identification document equal to passport, as well as the carrier of secure e-signature (it includes 120 free of charge timestamps for signing documents with secure electronic signature).

Broadband internet

According to the *Eurostat* data, the number of broadband internet access lines in Latvia in 2010 reached 18.8 (the EU average – 25.7) per 100 inhabitants (a broadband internet access line is a line, in which the data transfer rate is higher or equal to 144 kbit/s).

According to the data published on the internet speed measurement website *speedtest.net* of the internet research company "Ookla Net Metrics", at the end of June 2012, Latvia with the download speed of 27.1 Mbit/s is ranked 7th and upload speed of 18.2 Mbit/s is ranked 4th among 176 world countries. Such results are reached due to investments of the largest Latvian telecommunication enterprises in development of the optical network.

On November 9, 2011, the European Commission pursuant to the EU state support conditions approved the support scheme for LVL 71.5 million aimed at providing ultrafast broadband internet network all over Latvia.

The project *Development of Next-Generation Electronic Communication Networks in Rural Regions* is expected to be implemented within the period from October 2012 until August 2015 using the ERDF financing in the amount of LVL 16.2 million and private financing in the amount of LVL 2.4 million. The project will be implemented by the SJSC "Latvia State Radio and Television Centre", establishing about 165 internet access points and installing optical cable lines of 1900 km in length, thus providing quality internet with a speed from 30 to 100 Mbit/s to the citizens and enterprises and eliminating the gap between urban and rural areas.

In order to identity development directions of next-generation electronic communication networks, the meeting of the State Secretaries of May 24, 2012 considered the Draft Concept *Next-Generation Network Development for 2013–2020.*

Combating computer piracy

According to the data of the international software copyright protection organisation "Business Software Alliance", the level of computer piracy in Latvia in 2011 decreased by 2% and reached 54% compared to 2010. The losses to Latvian economy caused by piracy have constituted LVL 16 million.

E-commerce

According to the CSB data, 20% of Latvian population in 2011 have ordered goods or services online (the EU average – 43%), while 7.5% of the Latvian population ordered goods or services online from other EU countries.

In 2011, 24% of all enterprises (except the financial sector) with 10 and more employees had purchased goods or services over the internet or other computer networks (the EU average – 35%). However, 9% of all enterprises (except financial sector) with 10 and more employees had sold goods or services over the internet or other computer networks in 2011 (the EU average – 15%). The turnover of e-commerce constituted 6% of the total turnover of these enterprises (the EU average – 14%).

6.11. Competition Policy and Regulation of Public Utilities

6.11.1. Competition Policy

The Competition Council (CC) is responsible for implementation of the competition policy in Latvia ensuring protection of competition by promoting reduction of administrative obstacles, liberalisation of markets and enterprise activities under conditions of strong competition, to ensure that consumers can choose various high quality goods and services. In order to raise the overall public awareness about the positive impact of fair competition on public welfare, to enable the society to identify violations of competition rights and to become intolerant with respect to such violations, the CC carries out public information measures and other measures promoting competition.

The work of the CC is performed in compliance with the *Competition Law*, other regulatory acts, and the operational plan of the institution covering such significant activity directions as:

- protection of competition;
- promotion of competition.

Protection of competition

Protection of competition comprises activities directed against the following violations of the *Competition Law*: prohibited agreements and abuse of dominant position. The CC also controls mergers of enterprises.

In the 1st quarter of 2012, the CC has adopted 10 decisions; five of them are related to prohibited agreements, three – abuse of dominant position and two – mergers of enterprises. Also, six new cases are under investigation.

The priority of the CC is identification and prevention of the most severe breaches of the *Competition Law* – prohibited agreements and dominant position abuse.

The *Competition Law* defines several areas, where agreement between market participants is prohibited, because its purpose or consequences hinder, restrict, or distort the competition, including – agreement on action or inaction that makes it difficult for a potential market participant to enter specific market. The CC detected a breach of this particular norm in the activities of SIA "PALINK" (see Box 6.17).

Box 6.17

The CC identifies breaches in contracts of SIA "PALINK" with lessors of shopping centre space

On March 23, 2012 the CC adopted a decision identifying that SIA "PALINK" has breached the prohibited agreement provision by including a prohibition to rent space to other enterprises without the consent of SIA "PALINK" in contracts with lessors of shopping centre space. A fine in the amount of LVL 13 thousand has been imposed on the company.

Restrictive provisions were included in 23 contracts, yet another 12 contracts containing similar provisions were terminated during the investigation. The CC has been identified similar breaches in the activities of RIMI group companies and SIA "MAXIMA Latvija".

By keeping the right to decide on renting space of the particular shopping centre, SIA "PALINK" not only could impose restrictions on potential lessees but also could unreasonably restrict the lessor's rights to freely run its business.

Since the restrictive provisions in the contracts were never applied in practice, the fine imposed on the company was reduced. Moreover, by amending the breaching contracts on its own initiative, SIA "PALINK" eliminated the breach and provided complete and true information to the CC which was essential for the investigation.

The CC obtained the information on the breach during surveillance of the rental market of shopping centre space. This surveillance was launched after identifying a prohibited agreement between RIMI group companies and owners of shopping centre space last year resulting in lessor's refusal to lease space to SIA "Daudznozaru kompānija "Daugava"". Then CC emphasized that denying the specialized food shops to operate at the shopping centres hinders their development. At the same time, the producers become increasingly dependent on retail supermarkets because the possibility for them to develop efficient, sufficiently large and easily accessible alternative distribution channels by establishing their own chain of specialized shops is denied.

The European Union competition regulations stipulate that any market participant in a dominant position is prohibited to abuse it in any way within the EU single market and in a significant part thereof, among all directly or indirectly impose unfair sales prices or other unfair trade conditions. AS "Air Baltic Corporation" submitted a complaint to the CC regarding such a breach (see Box 6.18).

Box 6.18

The CC imposes a fine on the Riga international airport for a breach of the European Union competition law

On February 10, 2012, the CC adopted a decision identifying that Riga International airport has abused its dominant position by applying a considerably lower charge for airport services to the airline *Ryanair* than to the airline *airBaltic* without reasonable justification.

A fine in the amount of LVL 50 thousand has been imposed on the airport, as well as a legal obligation to apply reasonable and non-discriminatory payments to its services by providing clear and comprehensible information to airlines about the price for each service of the airport.

As the CC compared charges applied to both airlines, it concluded that for equal services – luggage processing, passenger ramps, pushing out the aircraft before departure, etc. – *airBaltic* has paid by 82% more than *Ryanair*. Besides, *airBaltic* had to pay administrative costs which *Ryanair* did not, thus making the given percentage difference even greater.

As a result, *airBaltic* was forced to pay for certain services that cover airport expenses and ensure profit, while payments of *Ryanair* do not even cover the airport expenses. Thus, by applying discriminatory payments, the airport has caused a negative impact on competiveness of *airBaltic* in relation to *Ryanair*.

Discriminatory payments were charged from November 1, 2009 to December 31, 2010. During this period, an independent company SIA "North Hub Services" started to provide the given services at the airport and further rendered services to *airBaltic* according to the EU directive.

The CC points out in its decision that in general, *airBaltic* brings more revenues to the Riga airport than *Ryanair*.

The airport determined the amount of charges to be paid by the airlines according to different methods – *airBaltic* for servicing of each aircraft, but *Ryanair* constantly for each passenger. The CC states in its decision that, although the airport is entitled to apply different methods for calculating the payments for different airlines, these payments must not be discriminatory. In this case, different methods applied failed to ensure calculation of non-discriminatory payment, thus being unacceptable.

Since the breach by the airport affected trade between the member states, the CC identified that a breach of Article 102 of the Treaty on the Functioning of the European Union has occurred which basically corresponds to the prohibition of abuse of dominant position under the *Competition Law* of Latvia.

The CC carries out merger control of market participants, if the total turnover of the merging participants in the preceding financial year has been at least LVL 25 million or if their total market share in the particular market exceeds 40%. The *Competition Law* stipulates that before the merger, these market participants have to submit a notification about the planned operation to the Competition Council.

The Competition Council with its decision is entitled to prohibit a merger, as a result of which a dominant position is created or strengthened, or which may significantly reduce the competition in any particular market. If the planned merger has no significant impact on the competition, the CC adopts a decision permitting the merger. Yet, in order to prevent negative consequences regarding the competition in market, the CC may permit the merger, determining binding provisions for the relevant merger participants. The CC has given such a permit for purchase of AS "Latvijas Neatkarīgā Televīzija" (see Box 6.19).

Box 6.19

The CC determines provisions for the purchase of AS "Latvijas Neatkarīgā Televīzija"

On May 11, 2012, the CC adopted a decision permitting *MTG Broadcasting AB* to purchase AS "Latvijas Neatkarīgā Televīzija". Binding provisions have been determined for the transaction thus preventing potential harm to the competition. At the same time, in order to prevent the merger from inflicting a serious harm on the market and consumers due to changes in the market and its legal framework, the CC reserves the right to demand the merger participants to sell a part of their assets by the end of 2017.

The decision permitting the merger was adopted to offer the Latvian population more possibilities to access quality, free of charge Latvian produced television shows designed for local audience.

In its decision, the CC points out that successful existence in the market of both televisions alone was prevented by both the economic crisis and high costs of implementation of digital television. Although the merger of television companies would reduce competition, it would also allow the television companies to make their activities more efficient and assure the quality demanded by consumers and also as varied information as possible.

Since the merger increases market concentration, the CC has determined binding provisions to prevent any harm to the competition and to protect the interests of advertisers, television content distributors and end consumer – television audience.

Thus, the CC decision stipulates that in case of a merger, the TV3 and LNT programs have to remain public at least until December 31, 2013, furthermore, the two programs have to keep independent and permanent news editorial offices, as well as the current amount of news broadcasts. The job description of broadcast editors should include a separate note about their editorial independence from the media owner. The CC has also specified that LNT and TV3 channels must fill at least 21% of their air time with original content made in Latvia.

As regards advertising market, the merger participants are not allowed to increase prices for broadcast time of advertising in channels *TV3*, *TV6*, *3+* at least until late 2012, however, in case a contract with any advertiser has been signed for a longer period, then until the expiry of the given contract. After 2012, the increase in the prices for advertising may not exceed the annual inflation rate. The merger participants are not allowed to link their TV packages in relation to advertisers – for example, if a commercial is broadcast on LNT program group, the advertiser should not be obliged to broadcast the given commercial on other MTG channels, including in Estonia and Lithuania.

In order to prevent the merger from inflicting any harm to enterprises purchasing television shows from the merger participants for further distribution to end consumers (audience), the CC has imposed an obligation on the merger participants to ensure a possibility to purchase their programs both separately (to buy one program without any obligation to buy another program in a bundle), and bundled, receiving a discount, which does not exceed 20% of the whole price, for purchasing bundled programs.

The merger participants may not involve mediators in distribution of their programs, besides, rebroadcasting right of the programs must be provided on equal conditions, thus avoiding favourable conditions for the company VIASAT AS owned by *MTG Broadcasting AB*.

In order to ensure efficient control of imposed provisions, *MTG Broadcasting AB* is obliged to submit an annual report to the CC containing data on the average price changes audited and confirmed by an international auditing company, including data on sales revenues from *MTG Broadcasting AB* "conventional advertising" and data on sales of advertising placement services for previous year summarized by an independent media research agency. The company in 2014 also has to submit complete information on activities in Latvia and financial state, activities in certain markets and impact of the merger on the markets.

Yet, considering possible changes in the market caused by changes in legal regulation in relation to ensuring digital television and observing the "must-carry" principle, the CC decision stipulates that by the end of 2017 the CC is entitled to request the merger participants to carry out structural changes by dispossessing a part of their assets.

Before the merger, *MTG Broadcasting AB* in Latvia has decisive influence over SIA "TV3 Latvia", VIASAT AS and SIA "Star FM". AS "Latvijas Neatkarīgā Televīzija" has decisive influence over SIA "TV5", SIA "Latvijas Ziņu Kanāls" and SIA "Mūzikas Kanāls".

Competition promotion

This direction of activities includes market supervision and research, as well as development of the competition culture in the society. The task of the CC is to focus on gathering and analyzing comprehensive information on competition situation in different markets, promotion of competition in markets with no competition or insufficient competition, improvement of public awareness about the positive impact of competition on public welfare.

By obtaining information on specific markets in the framework of market supervision, the CC analyses the competition situation, and if necessary, develops and submits proposals for improvement of the competition situation to responsible authorities, as well as checks the supervised markets for violations of the *Competition Law*.

In connection to initiated case for possible breach of the *Competition Law*, the CC posted a message on its home page asking that such people and enterprises respond, which have purchased or rented a property and have had to deal with a request by AS "Latvijas Gāze" to pay natural gas debts of the previous owner or tenant. This will help the CC to evaluate the legality of action of AS "Latvijas Gāze" – failure to duly recover debts, thus increasing the debt amount and refusing to restore natural gas supply until the new owner or tenant pays the debt. Within examination of merger notification, the CC asked the interested market participants to give their opinion regarding the impact that the merger of AS "Rīgas piena kombināts" and AS "Valmieras piens" would have on competition.

Market participants and other interested persons can get acquainted with information about the most significant events of competition supervision institutions of the *European Competition Network* (ECN) member states, including Latvia – the most interesting examined cases, performed researches and market supervision, latest laws and other important issues related to competition policy included in the ECN newsletter. It is prepared every 2 months and is available on the Competition Council home page (*http://www.kp.gov.lv/?object_id=522*) and the European Commission home page.

6.11.2. Regulation of Public Utilities

The Public Utilities Commission is a multi-sector regulator implementing regulatory functions in the sectors of energy, electronic communications, postal services and railway transport, water management and municipal waste management. The task of the Commission is to ensure the opportunity to receive uninterrupted and safe services to all users at economically reasonable prices and to ensure the possibility for enterprises providing public utilities to develop profitably according to the economic situation.

The Commission adopts its decisions independently and it is not subject to decisions of the government or other public authorities. The members of the Commission's Board are appointed by the Saeima, and only a court may declare decisions taken by the Commission substantively unlawful and cancel them. Activities of the Commission are financed from the state duty paid by enterprises for regulation of public utilities on the basis of the turnover of the regulated public utilities.

Functions of the Commission include governing the regulated sectors and enterprises that operate therein, protecting the interests of users, and fostering development of public utility providers, setting tariff calculation methodologies and approving tariffs in accordance with the laws governing each sector, issuing licenses and registering electronic communications and mailing service entrepreneurs, promoting competition in the regulated sectors, settlement of disputes, and supervising the compliance of the provided services with license or general authorisation conditions and set quality requirements.

Regional structural units of the Commission have been established and are now operating in Latgale, Kurzeme, and Vidzeme regions, located respectively in Daugavpils, Saldus, and Cēsis.

On July 14, 2011, the Saeima adopted amendments to the law *On Regulators of Public Utilities*. The amendments to the Law strengthen the legal status of the Commission pursuant to the requirements of the European Union legislation stipulating that the Commission is institutionally and functionally independent, lawful, self-governing subject of public law and may independently use its budget under the law.

The amendments to the Law envisage efficient procedure for consideration of disputes arising out of public utilities rendering relationships, defining the consideration process of disputes and the procedure for appealing the Commission's decision more precisely.

At the same time, amendments to the law more precisely define the functions of the Commission in the field of monitoring energy supply enterprises, the procedure for assessing tariffs, for calculating and paying the state fee for public services, the procedure for adopting decisions of the Commission and restrictions imposed on the members of the Commission's Board.

6.12. Export Promotion and Foreign Investment Attraction Policy

Guidelines for Export Promotion of Latvian Goods and Services and Attraction of Foreign Investment in 2010–2016 define the basic principles, aims, and results to be achieved in export promotion and foreign investment attraction policy. The guidelines define three main directions of action:

– increase of export competitiveness;
– availability of support instruments;
– contractual security.

Particular measures in these directions of action are implemented pursuant to the *Action Plan for Export Promotion of Latvian Goods and Services and Attraction of Foreign Investment in 2010–2011*.

Attraction of Foreign Direct Investments

In order to compete successfully in foreign investment attraction market and improve progress of local and foreign investment projects of national importance, since 2010 IDAL has been implementing the investment attraction methodology *Polaris* envisaging unified and coordinated activity of ministries, municipalities, infrastructural companies, and public institutions in implementing strategically important domestic and foreign investment projects, as well as involvement of the private sector, universities, and research institution.

The Coordination Council for Large and Strategically Important Investment Projects established in 2010 ensures coordinated interagency cooperation for successful implementation of investment projects; the Council is composed of the Ministers for Economics, Transport, Finance, Foreign Affairs, Environment, Agriculture, Regional Development and Local Governments, Education and Science, as well as the involved representatives from state and municipal institutions, infrastructural companies, non-governmental organizations and other experts.

The Council meetings deal with issues of investment attraction strategy and activities to be carried out; identify problematic issues that hinder investment project progress, for example, improvement of electricity connection and its quality in industrial areas, as well as instructions to solve such issues have been assigned to the responsible institutions thus ensuring successful implementation of investments projects.

On August 25, 2011, the meeting of the Coordination Council for Large and Strategically Important Investment Projects approved the *Strategy for Foreign Direct Investment Attraction* which defines the target sectors, target countries, strategic activities directions, support stimuli, and a plan of measures for 2011–2017.

In order to focus the available resources and increase return to FDI attraction, the following main principles for further activities are set:

– extended and active FDI attraction methodology – *POLARIS process*, according to which further investment attraction-related activities are implemented;
– investment attraction marketing activities.

Considering the limited resources, activities for FDI attraction in 2012–2013 are planned to focus on few target countries (the Nordic countries, Germany, the United Kingdom) and certain target sectors – metal processing and engineering industry, wood industry and information technologies, including establishment of shared service centres.

Besides the present tax stimuli, at the beginning of 2012, in order to promote investments and develop business-friendly environment in Latvia, the Cabinet of Ministers approved a new support programme co-financed by the EU Structural Funds for projects creating new jobs aimed at increasing the number of well-paid jobs and growth of added value and export. In addition, a new support programme is being developed for construction or reconstruction of production premises aimed at promoting development of manufacturing companies.

Additional information on attracted foreign direct investments is available in Section 4.3.3 of the Report.

Export support instruments

Latvian exporters are offered a wide range of direct export support services, covering consultations on export-related issues, including foreign markets, specific trade requirements and search for business partners. Furthermore, export skills and informative seminars about external markets are organized and identification and fostering of export and investment projects is carried out.

In 2012, the IDAL plans to arrange national stands of Latvian enterprises in 16 international sectoral exhibitions abroad.

Essential contribution to the export promotion of Latvian merchants and attraction of foreign investments is rendered by ten Foreign Economic Representative Offices of Latvia located in Germany, Great Britain, Sweden, France, Russia, the Netherlands, Denmark, Norway, Japan, and Poland, Lithuania and Ukraine, and in early 2012, the Foreign Economic Representative Office of Latvia was opened in China; thus, there are 13 actively operating Foreign Economic Representative Offices of Latvia abroad, and a representative office is expected to be opened also in Belarus in 2012.

The representations provide support to Latvian companies in developing and keeping business contacts implementing external marketing measures, and provide information about requirements of particular foreign markets. Services of the Foreign Economic Representative Offices of Latvia and the IDAL are provided to the entrepreneurs according to the one-stop agency principle: when looking for business partners abroad, entrepreneurs can access stable, fast and capable support system: *merchant – IDAL – the Representative Office*. Thus, the representative offices provide individual business visits of entrepreneurs, support participation of enterprises in international exhibitions abroad, process export requests/projects, as well as process consultation requests/information applications in the field of foreign investment attraction.

On May 15, 2012, the Cabinet of Ministers approved establishment of Council for Coordination of Foreign Economic Policy run by the Minister for Foreign Affairs. The Council is composed of the Ministers for Economics, Transport, Agriculture, the President and representatives for the office of the Prime Minister, as well as the director of the Investment and Development Agency of Latvia, director general of the Employer's Confederation of Latvia and the chairman of the board of the Latvian Chamber of Commerce and Industry. The main objective of the established council is to ensure coordinated cooperation between public institutions and entrepreneurs in developing and implementing successful foreign policy to improve competiveness of Latvian economy and strengthen exportability.

Activity 2.3.1.1 *Access to International Trade Markets – External Marketing* is implemented within the framework of the measure *Entrepreneurship Support Activities* of the Operational Programme of the EU Structural Funds for 2007–2013 *Entrepreneurship and Innovations*. Within the framework thereof, merchants are offered broad support in implementation of external marketing measures – participation in exhibitions, matchmaking, trade missions, organizing seminars and conferences. Since the launch of the activity 851 contracts for the EU funds co-financing in the amount of LVL 5.3 million have been concluded.

In order to promote the increase of the total export volume of enterprises (especially to countries with a high risk degree) and expand export markets (CIS region, rapidly growing economies, etc.), as well as strengthen the positions in existing export markets, the short-term export credit guarantees are available and described more detailed in Section 6.7 of the Report. Since the launch of the activity until April 30, 2012, 242 guarantees have been issued to 200 enterprises for the total amount of LVL 65.5 million. All contracted enterprises represent the manufacturing industry (for example, production of communication equipment, production of household appliances, production of veneer plates and wooden panels, production of soap, detergents, cleaning and polishing agents, production of food products, etc.).

In order to appreciate and honour the most successful Latvian entrepreneurs for producing both new and exportable products and providing high quality local products to the domestic market, the Investment and Development Agency of Latvia and the Ministry of Economics will hold the annual *Export and Innovation Award 2012* in 2012 as well.

6.13. Consumer Rights Protection and Market Surveillance

The Consumer Rights Protection Centre (CRPC) is the main and coordinating institution in the field of supervision of laws and regulations regarding consumer rights protection, and its operations are aimed at ensuring protection of consumer rights and interests.

In order to ensure implementation of the institution's functions, the CRPC implements activities for supervision of consumer rights observation (both in the field of protection of consumers' economic interests and supervision of consumer rights observation in draft contracts and contracts concluded by consumers and producers, sellers, or service providers), considers consumers' complaints, provides information and consultations to consumers and entrepreneurs, implements supervision measures of unfair commercial practice, e-commerce, and advertisements, supervision measures of safety and conformity of goods and services, carries out national metrological supervision, supervision of dangerous equipment and investigation of dangerous equipment accidents.

Box 6.20

Performance of the CRPC in the 1st quarter of 2012

In the 1st quarter of 2012, the **CRPC has rendered 9851 consultations to consumers and legal entities** which are by 3% more than a year ago. When requesting a consultation, consumers most often have been interested in issues related to their rights if they have purchased a product or received a service that fails to comply with contract provisions, as well as regarding failure to observe the principle of legal equality of the contracting parties. Entrepreneurs in their turn are more interested in various issues related to market surveillance.

Within the three months of 2012, **CRPC has received 554 consumer complaints and applications**. A decrease in the number of submitted complaints by 14% is observed in comparison with the corresponding period of 2011; this might be explained with the improved awareness of consumers and entrepreneurs of consumer rights, well-considered purchases, as well as increasing economic activity of the population. Most often consumers have filed complaints concerning the purchased goods incompliant with contract provisions, services incompliant with contract provisions, and regarding failure to observe the principle of legal equality of the contracting parties. Out of all received complaints, the majority have been about footwear, electronic goods, and mobile phones. In the field of services, the majority of complaints have been about aviation, electronic communications, rent, and public utilities services, as well as services provided under distance contracts. A significant increase in the number of complaints concerning services provided under distance contracts is observed; that might be explained with the fact that consumers prefer purchasing goods and services on the Internet which often leads to various problems. The impact of economic downturn on consumers' financial capacity can still be felt, and issues related to consumer crediting have also been topical during the reporting period. In the 1st quarter of 2012, the majority of complaints concerning failure to observe the principle of legal equality were received in relation to consumer crediting contracts and creditors' conduct.

The CRPC **for supervision of consumer rights** in 2012 has set such priority areas as protection of collective interests of consumers in the field of electronic communication services, consumer crediting contracts, vehicle rental services, supervision of commercial practice applied outside regular point of sales or service provision place, supervision of commercial practice in the volatile oil sector, supervision of commercial practice in the outdoor advertising sector, supervision of security guarantees issued by complex tourism service providers to consumers, and supervision of contract provisions. Considering the increasing number of complaints and request for consultations, one of the priorities is also observance of consumer rights in collective online shopping portals.

In the field of protection of collective interests of consumers and contract supervision, implementation of the project supervision of security guarantees issued by complex tourism service providers and contract provisions launched in 2011 was completed in early 2012. The project was implemented based on the new Cabinet Regulations *Regarding the Rights and Duties of Tourism Operators, Tourism Agents and Clients, the Procedures for the Preparation and Implementation of a Package Tourism Service, the Information to be Provided to a Client and the Procedures for Depositing Monetary Security Guarantee* in force since June 14, 2010, envisaging several changes in the field of complex tourism services.

In order to improve the field and ensure observance of consumer rights, 27 tourism service providers were inspected. In 67% of the cases, it was found that tourism operators have failed to provide a security guarantee for the money paid by a customer. As a result of the project, 11 tourism service providers have submitted written resolution not to apply unfair contract provisions included in contracts that have already been concluded with consumers, 1 decision has been made regarding violation of consumer rights, while 7 enterprises have partially eliminated the detected nonconformities and shortcomings. As a result of implementing the project, 2 enterprises have registered in the Database of Tourism Agents and Tourism Operators as defined by the amendments to normative regulations and 6 enterprises have provided security guarantees for the money paid by a customer by concluding relevant insurance agreements.

The surveillance project is also a major step forward; it was completed in 2012 and in its framework, the CRPC initiated 32 administrative cases by carrying out all necessary inspections to assess the conformity of commercial practice applied by internet websites to the law. Material violations of consumer rights were detected in all of the cases, even several violations on each website at the same time. Upon a request of the CRPC, the detected violations in 29 websites were voluntary eliminated while in one case a decision was made to impose a legal obligation on the violating party to terminate the existing unfair commercial practice and to prohibit potential unfair commercial practice.

The project results allow for a conclusion that in addition to surveillance activities, more active information and education measures for entrepreneurs and consumers are required to raise awareness of legislation requirements and observance thereof.

The European Consumer Centre (ECC Latvia) continues providing support and information to consumers in case of unsuccessful **EU cross-border purchases**. ECC Latvia is a member of the European Consumer Centres Network (ECC-NET) operating within the framework of the Consumer Rights Protection Centre with the support of the European Commission. In the cross-border context, consumers most often have turned to the ECC Latvia about issues related to air services, as well as questions about goods or services purchased remotely (ordering on the Internet or choosing from a catalogue).

Box 6.21

Improvement of the Legal Framework

In April, 2012, the Ministry of Economics submitted the amendments to the Cabinet of Ministers *Regulations On Consumer Crediting* of December 28, 2010 for discussion. The draft regulations have been developed to implement the European Commission Directive *2011/90/EU* of November 14, 2011 amending Part II of Annex I to *Directive 2008/48/EC* of the European Parliament and of the Council providing additional assumptions for the calculation of the annual percentage rate of charge. The draft regulations envisage providing more accurate calculation of the annual percentage rate (APR) by implementing the requirements of the directive.

In 2012, the work on development of legal framework of out-of-court recovery (*Draft Law on Out-Of-Court Debt Recovery)* was continued to ensure fair, proportional and reasonable debt recovery from a debtor – a natural entity and encourage voluntary debt payment. The draft law envisages setting the requirements for activity of debt recovery service providers, the requirements for communication between the creditor and the debt recovery service provider and debtor regarding the debt recovery process, and dealing with the issue related to the use of natural entity data in debt recovery process. On February 9, 2012, the draft law was approved by the Saeima on second reading.

In order to improve the legal framework for exchange of information in debt commitments and model for institutional implementation thereof (establishment of credit bureau), a draft information report *Legal Aspects of Exchange of Credit Information and Institutional Model* has been prepared and it was announced at the meeting of State Secretaries on March 1, this year. The draft information report contains such issues as defining the aims of the credit bureau and data processing, defining the legal status of the credit bureau and control mechanism, identifying the potential employees and data sources of the credit bureau, evaluating the legal aspects of personal data processing, defining the mechanism for exercising customer rights and procedure for dispute settlement, identifying the necessary legal framework, etc. The development of legal framework for the credit bureau is expected to be launched as soon as the information report is approved by the Cabinet of Ministers.

In the first half of 2012, discussions continued regarding the proposal for the Directive of the European Parliament and of the Council on consumer credit agreements relating to immovable property approved by the European Commission on March 31, 2011. The Draft Directive envisages setting requirements for advertising mortgage crediting services, information to be provided prior to signing the contract, verifying consumer's creditworthiness, calculation of annual percentage rate, early clearing of the credit, access to databases for assessing the creditworthiness, as well as a surveillance mechanism of credit intermediaries and creditors, and requirements for competence of the given service providers. An agreement on the draft project with the European Council is expected to be achieved in June, 2012 prior to launching discussions on comments by the European Parliament in summer 2012.

Also, in the first half of 2012, discussions continued regarding the European Commission proposal for *the Directive of the European Parliament and of the Council on Alternative Dispute Resolution (ADR) and the Regulation of the European Parliament and of the Council on Online Dispute Resolution (ODR) for consumers* approved in November, 2011. Both draft laws have been developed to strengthen consumers' and entrepreneurs' confidence in cross-border transactions in the EU single market. The draft directive imposes an obligation on the EU member states to ensure conformity of the ADR structure to such quality criteria as professionalism, impartiality, transparency, efficiency and fairness, as well as an obligation of enterprises to inform consumers about the ADR structure that can solve a potential contractual dispute between them. The draft regulation on consumer ODR envisages developing a European scale online platform as a single access point for consumers and entrepreneurs to solve contractual disputes by automatic forwarding of the consumer's complaint to the competent ADR structure. An agreement on both proposals with the EU Council of Competiveness Ministers is expected to be reached in May, 2012.

In 2012, the CRPC in the field of **market surveillance** has identified priority directions to improve safety and conformity of such goods as vehicle components, electric goods, toys, personal protective equipments, surveillance of general safety of goods and services and machinery. In the field of dangerous equipment and state metrological supervision, surveillance of dangerous equipment at the place of its use is planned to be performed, along with conformity surveillance projects of measurement equipment market and the content amount and labelling of pre-packed goods. The surveillance project of construction products launched in 2011 is also continued.

In 2012, 4 projects have been launched for the improvement of goods safety and conformity for the following groups of goods: personal protective equipment, toys, sub-project of general safety of goods and services –food imitation products and subproject of vehicle components – children safety systems-car seats.

The accident at the skiing track "City Track" of SIA "Olimpiskais centrs "SIGULDA"" in early 2012, in which an 11-year-old skier was injured, resulted in surveillance activities of dangerous equipment. Investigation of the accident lead to a conclusion that additional inspections are required in other tracks as well, thus, 5 other skiing complexes were inspected during the reporting period. A number of problems were detected in the field of ski lift operations, as well as general safety of the service. In order to significantly improve the situation in the upcoming season, the CRPC has started work on the *Skiing Track Safety Guidelines* by involving experts from the Skiing Track Association of Latvia, as well as the *Latvian Association of Ski and Snowboard Instructors*.

In the field of **state metrological supervision** the CRPC has carried out inspections for evaluating conformity of measurement equipments to the normative requirements at the place of use in 19 manufacturing, trading, and service rendering enterprises in the 1st quarter of 2012. 1688 units of measurement equipment (including non-automatic scales at trading enterprises) were subjected to metrological monitoring. So far, the **control measures of pre-packed goods** included in the CRPC action plan have been implemented by carrying out control of pre-packed goods content amount and conformity of labelling intended for distribution at manufacturing and wholesale enterprises.

6.14. Quality Assurance

6.14.1. Quality Structural Policy

The main task of public authorities in the field of product and service conformity assurance is to promote adequate application and observance of the laws and regulations in the regulated and non-regulated sphere, as well as to improve the base of the laws and regulations in accordance with the European Union requirements, taking into account the needs of the national market and economy, hence ensuring compliance of the products and services, and fostering better competitiveness of the entrepreneurs and reduction of obstacles to international trade.

The quality assurance infrastructure system in Latvia is regulated by the *Law on Conformity Assessment*, *the Standardization Law*, and *the Law on Uniformity of Measurements*, as well as other related normative acts.

The main directions of the policy are as follows:

- maintenance and improvement of the conformity assessment infrastructure (including testing and calibration laboratories, inspection and certification institutions, environmental verifiers) with the needs of the Latvian national economy, in order to protect the consumers and environment from low-quality products and services and to promote growth of merchants' competitiveness and trustworthiness of Latvian production, as well as services provided by Latvian merchants;
- improvement of the respective informative and consultative base;
- ensuring participation of national institutions of accreditation, standardization, and metrology in international organizations, by maintaining their international recognition and compliance of the Latvian quality assurance system with international requirements;
- maintenance and international comparison of the national base of metrology standards in order to ensure the necessary traceability of measurements and to protect the society from inaccurately performed measurements;
- promoting introduction of quality management, environmental quality and other voluntary management systems in enterprises in order to ensure manufacturing of high-quality products, service rendering, and competitiveness of Latvian merchants in international markets;
- promoting efficient market surveillance, in order to provide equal conditions to all market participants, and to protect consumers from potential unfair competition of merchants.

The offices Standardization Bureau, Latvian National Accreditation Bureau, and Metrology Bureau forming the Limited Liability Company with share capital "Centre of Standardization, Accreditation and Metrology" under the supervision of the Ministry of Economics, carry out the functions and tasks of national standardization, accreditation, and metrology institutions.

6.14.2. Accreditation, Standardization, Metrology

Since July 1, 2009, the Limited Liability Company "Centre of Standardization, Accreditation and Metrology" has been carrying out the tasks in the field of standardization, accreditation, and metrology as stipulated in the *Standardization Law*, *Law on Conformity Assessment*, *Law on Uniformity of Measurements*, as well as in other related laws.

Standardization

The Standardization Bureau (LVS) of SIA "Standardization, Accreditation, and Metrology Centre" in capacity of the national standardization organization in compliance with the *Standardization Law* manages and coordinates activities of Latvian merchants and organizations in the field of standardization.

The main functions of LVS are to set up a fund of Latvian standards and to issue Latvian standards in cooperation with international and European organizations of standardization.

Since 2004, LVS is a full-fledged member of the European Committee for Standardization (CEN) and of the European Committee for Electrotechnical Standardization (CENELEC). LVS is also a corresponding member of the International Organization for Standardization (ISO) and an associate member of the International Electrotechnical Commission (IEC).

In accordance with the approved plans, the priority directions of the activity by LVS is distribution of standardization information, updating and maintaining the totality of Latvian standards, improvement of the electronic sales system of standards and cooperation with international, European, and national standardization organizations.

Until May 1, 2012, 35 810 standardization documents have been registered in the LVS, including 29 920 European standards adapted to the status of a Latvian standard. In 4 months of 2012, 50 standardization technical committees and 4 working groups coordinated by the LVS have adapted 463 European standards, 38 mandatory applicable standards and Eurocodes have been translated into Latvian. Standardization information services have been provided to 653 legal and physical persons.

Continuing the improvement of the electronic sales system of standards, more than 64% of all standards have been sold via e-shop.

The automatic electronic information notification system introduced by LVS has provided a free of charge service *Monthly Report on the Standards Registered in Latvian Standard Status and Cancelled Latvian Standards*

In order to link legislation with standards and make information searching easier, a contract has been signed with the official journal of RL *Latvian Herald (Latvijas Vēstnesis)* on exchange of information and interlinking portal *www.likumi.lv* and website of the Standardization Bureau *www.lvs.lv*, as well as information on applicable standards regarding Latvian legislation has been updated.

In order to support small- and medium-sized enterprises and to promote broader use of standards, prices for purchase of standards have been reduced as of January 1, this year.

Accreditation

The Latvian National Accreditation Bureau (LNAB), which is a structural unit of SIA "Standardization, Accreditation, and Metrology Centre", ensures the activity of the national accreditation system. In compliance with *Regulation (EC) No 765/2008 of the European Parliament and of the Council*, LNAB acts in capacity of the national accreditation institution and as such is announced (notified) to the European Commission.

The increase in the number of accredited institutions observed over the recent years proves the importance and stability of the accreditation process in the sphere of conformity assessment. An increasing number of new institutions want to prove their competence by gaining accreditation. Many of the institutions are expanding their field of activities. At the moment, the status of accreditation is maintained for 220 accredited institutions. New accreditations have been awarded to one laboratory in Kazakhstan and one laboratory in Azerbaijan. The conformity of one laboratory is maintained in compliance with the Principles of Good Laboratory Practice. One institution has been accredited according to the requirements of the environmental management and audit scheme (EMAS). LNAB continues providing accreditation services in Ukraine, where one institution for personnel certification has been accredited. Information about the accredited institutions is available on the website of the LNAB *www.latak.lv*.

LNAB has approved conformity of the accreditation system to the Multilateral Recognition Agreement (MLA) of the European Cooperation for Accreditation (EA) in six spheres of accreditation. In order to continuously conform to these requirements and harmonize accreditation procedures, employees of LNAB participate in several committees – EA Inspection and Certification Committee, EA Laboratory Committee and working groups, meetings of the Multilateral Recognition Agreement Committee and General Assemblies.

In the framework of international cooperation, LNAB also collaborates with accreditation institutions of Belarus, Ukraine, and Uzbekistan. Cooperation with the accreditation institution of Georgia is continued by assisting in fulfilment of the European and international requirements.

LNAB has also fostered participation of national laboratories in international inter-laboratory comparative testing programmes and has organized examinations of skills. Furthermore, training seminars are organised for conformity evaluation institutions and LNAB involved experts.

Metrology

Since July 1, 2009, the Metrology Bureau of SIA "Standardization, Accreditation and Metrology Centre" (LATMB) is the national metrology institution of Latvia and its aim of activity is to ensure and develop credibility and traceability of measurements in the country. The Metrology Bureau fulfils assignments in the field of metrology stipulated in the *Law on Uniformity of Measurements*.

In order to maintain conformity of national measurement standards to current EU requirements, a set of standard mass scales of E1 class was purchased in June.

The national inter-laboratory comparison calibration project on mass measurements SP3-2012 Calibration of *Non-automatic scales* was prepared from January to March and implemented in March.

The National measurement standards are calibrated and standard maintaining procedures of the standards are fulfilled according to the schedule in the national metrology institutes of the European Union (NMI).

Calibration of national electrical resistance standard (from 1 mΩ to 100 MΩ), national DC standard 7000 and multi-functional calibrator 4808 is being carried out at the Finnish NMI. In august, calibration of national length standards and surface unevenness standards are expected to be carried out in August at the National Metrology Institute of Finland MIKES.

At the beginning of the year, stability analysis and drift assessment of national electric measurements and length standards were carried out over a period of the calibration. 8 reliability validation procedures for calibration results have been fulfilled in the field of CMC (Calibration and Measurement Capabilities).

By May 1, 2012, conformity of 9 measurement equipment types was evaluated and certified, including re-evaluated conformity of measurement equipment types and extended certificates for 2 types. The list of approved types available on the website of the Metrology Bureau is updated on a regular basis. 12 consultations on regulated metrology issues have been provided.

The annual quality management system report of LATMB has been prepared and submitted for consideration to the Technical Committee for Quality (TC-Q) of the European Association of National Metrology Institutes (EURAMET). All the necessary measures for maintaining international recognition of calibration and measurement capabilities CMC have been carried out by using the database KCDB of the International Bureau of Weights and Measures (BIPM).

In 2012, LATMB continues cooperation with the EURAMET, as well as the International Organization of Legal Metrology (OIML) and the European cooperation in legal metrology (WELMEC). Cooperation with metrology institutions of Lithuania and Estonia continues.

Cooperation with Latvian metrology institutions still continues. 62 reference standards, as well as 3 mass comparators of SIA "National Metrology Bureau of Latvia" have been calibrated.

6.15. Privatization

The goal of privatization is, by changing the owner of a property owned by the state or local government, to create favourable environment for private capital operation in the interests of economic development of Latvia and to narrow the business activity performed by the state and local governments.

Box 6.22

Law on the Completion of Privatization of State and Local Government Property and Use of Privatization Certificates

The *Law on the Completion of Privatization* stipulates:

– the deadline of August 31, 2006, by which every legal or natural person might propose to bring any state or local government property to privatization;
– the procedure, by which a privatization proposal submitted by a person is reviewed, and a decision on bringing the state or local government property to privatization is adopted;
– that privatization may be denied, and the state or local government property remains in its possession, if the property is necessary to perform public administration functions or commercial activity of the state or local government;
– that the Cabinet of Ministers or a local government had to adopt decisions on bringing a state or local government property to privatization by December 30, 2010;
– that decisions on bringing the state or local government property involved in dispute regarding property rights to privatization shall be adopted in four months from coming into force of court decision or a notarial act;
– that the state joint stock companies "Latvenergo", "Latvijas pasts", "International airport "Riga"", "Latvijas dzelzceļš", "Latvijas gaisa satiksme" and "Latvijas valsts meži" are not subjected to privatization or alienation;
– the deadlines for the persons willing to buy out land allocated for permanent use have to submit an application on buying land property (August 31, 2006 or November 30, 2007), as well as by which a land boundary plan or confirmation of the land redemption payment made with privatization certificates before concluding the land redemption contract has to be submitted to the State Land Service (September 1, 2008), as well as for the application for a decision on the allocation of the property for payment has to be submitted (May 31, 2010 or August 31, 2011) and that the land purchase agreement has to be concluded by December 30, 2011;
– that privatization certificates do not have an expiry term, but may be only used within the framework of the privatization process;
– the procedure for completion of the issuance of privatization certificates. The final deadline by which applications for granting of privatization certificates could be submitted was December 28, 2007.

Box 6.22 continued

In order to ensure successful and open progress of privatization completion processes, the Cabinet of Ministers has set the procedure on how the institutions implementing privatization and land reform have to set up publicly available registers of privatization proposals and land property buy-outs.

As the goal of mass privatization in Latvia has been basically achieved, the *Law on the Completion of Privatization of State and Local Government Property and Use of Privatization Certificates (Law on the Completion of Privatization)* came into force on September 1, 2005, prescribing the procedure of completing the privatization process and land reform and ensuring completion of the use of privatization certificates (see Box 6.22).

Privatization of state property and land

Privatization of state property and land is carried out and privatization proposals are summed up by the state joint stock company Latvian Privatization Agency under the *Law on Privatization of State and Local Government Property.*

A decision to bring a state property object, including capital shares and vacant land to privatization is made by the Cabinet of Ministers, while a decision to bring a building land, on which there are buildings owned by another person, to privatization is taken by the Latvian Privatization Agency. The decision is made on the basis of a privatization proposal submitted by any natural or legal person.

From September 1, 2005, when the *Law on the Completion of Privatization* came into force, until May 1, 2012, 636 proposals for privatization of real estate, 57 proposals for privatization of state capital shares and 4350 proposals for privatization or privatization continuation of land have been registered in the Register of Privatization Proposals of the Latvian Privatization Agency. After August 31, 2006, in the Register of Privatization Proposals those privatization proposals were registered, which were submitted by mistake to other state and local government institutions up to that date and later were transferred to the Latvian Privatization Agency according to its competence.

A natural or legal person eligible to acquire movable or immovable property in Latvia can be the subject of privatization of state-owned property (real estate, capital shares, land). Payments for the property objects have to be made in lats (LVL) and/or privatization certificates.

From April 17, 1994 until May 1, 2012, the privatization provisions in the statutory procedure have been approved for 2486 state property objects (excluding land). 94 companies were transformed to public joint stock companies, thus emitting 439.14 million shares into public circulation. During this period, income obtained from privatization of state-owned property objects (excluding land and selling of shares and alienation of capital shares emerged as a result of capitalization of debts) amounted to LVL 1.666 billion, of which LVL 399.960 million was in cash and LVL 1.266 billion in nominal values was for privatization certificates. New owners took over obligations of privatized state companies (enterprises) for the value of more than LVL 187.95 million. The amount of the specified investments was LVL 146.35 million, while the amount of investments actually made reached LVL 267.54 million.

The Latvian Privatization Agency carries out privatization of state-owned land since 1997. By May 1, 2012, 5056 state land lots were privatized (purchase agreements signed). The total sales price for the privatized state land constitutes LVL 200.235 million, of which LVL 97.29 million was in cash and LVL 102.95 million in property compensation certificates. On May 1, 2012, income from privatization of these land lots amounted to LVL 187.21 million, of which LVL 90 million was in cash and LVL 97.21 million – in property compensation certificates.

Privatization of local government property objects and land

A decision concerning privatization of local government real estate is made by the council of the municipality (city). The decision is made on the basis of a privatization proposal submitted by any natural or legal person.

A natural or legal person eligible to acquire local government property in Latvia within the process of privatization can be the subject of privatization of local government property (real estate, a deemed part of the real estate, capital company, capital shares, land). Payments for local government property objects have to be made in lats (LVL) and/or privatization certificates.

Privatization of local government property in the municipality area is ensured by the property privatization commission of the respective municipality (city, district).

Compliance of privatization projects, regulations, and announcements approved by a municipality with the provisions of the *Law on Privatization of State and Local Government Property* and the *Law on the Completion of Privatization* is ensured by the Ministry of Economics.

From February 17, 1994 until May 1, 2012, the Ministry of Economics has reviewed and accepted for information 3305 privatization projects for the total estimated price of LVL 159.9 million (*inter alia* payments in certificates for the nominal value of LVL 58.42 million).

From January 1, 1997 until April 1, 2011, the Ministry of Economics has reviewed and accepted privatization provisions in respect to 1671 building land lots and vacant local government land lots (separate announcements of privatization of building land lots as from September 1, 2005) for the total value of land in the amount of LVL 26.4 million (of which LVL 13.3 million must be paid in property compensation certificates).

The Article 41(2) of the *Law on Privatization of State and Local Government Property Objects* imposes an obligation that the council of municipality submits a decision on approval of privatization project of local government property object, and the approved privatization project to the Ministry of Economics. The submission of a decision on approval of provisions (announcement) regarding privatization of a building land lot or a vacant land to the Ministry of Economics is voluntary and is not imposed by the law.

According to Article 5(7) of the *Law on the Completion of Privatization*, after August 31, 2006, the local governments on a quarterly basis must provide the Ministry of Economics with data regarding the received privatization proposals for local government property objects and building land and land that has not been built on, decisions on bringing these property objects and land to privatization, the sale price and the amount of privatization certificates to be used for payment.

Privatization process of residential buildings

Privatization of residential buildings in Latvia was initiated in 1995. It was implemented by the Central Privatization Commission of Residential Houses (since January 1, 2004 – State Agency "Housing Agency" (*"Mājokļu aģentūra"*), since January 1, 2008 – the Construction, Energy and Housing State Agency, since July 1, 2009 – Latvian Privatization Agency), as well as by the local government residential building privatization commissions in compliance with the procedure stipulated by the *Law on Privatization of State and Local Government Residential Houses*.

On May 31, 2012, 482 residential buildings and 1806 state apartment properties were in the possession of the Latvian Privatization Agency, out of which 1002 state apartment properties are placed in residential buildings in possession of the Latvian Privatization Agency and 804 state apartments are placed in residential buildings that are handed over to management apartment owners.

The privatization process of the state residential houses – decisions on bringing 5120 residential houses to the privatization have been made by May 31, 2012, within time period from November 1, 2011 to May 31, 2012 – 12 decisions. By May 31, 2012, privatization announcements have been sent to 50 169 state apartment tenants, within time period from November 1, 2011 to May 31, 2012 – 43 announcements. By May 31, 2012, 44 308 state apartments have been privatized, and from November 1 2011 until May 31, 2012, 31 contract on purchasing state apartment properties have been concluded.

The privatization process of local government residential buildings – data on the privatization process of local government residential buildings and their transfer to the possession of apartment owners are currently no longer being updated, therefore the data stored in the databases of the Latvian Privatization Agency does not reflect the actual situation.

The management of state residential buildings and apartments – 3891 state apartment building have been handed over to owners of apartment properties by May 31, 2012, within time period from November 1, 2011 to May 31, 2012 – 17 residential buildings. Within the period from November 1, 2011 to May 31, 2012, 85 non-privatized parts of residential buildings with 987 non-privatized apartment properties have been handed over to the possession of local governments of republic cities, towns and counties.

Land reform

The main goal of the land reform is to rearrange the legal, social, and economic relations of land use and ownership from the command economy to the market economy.

The state land reform process includes allocation of vacant land and land pertaining to the state for permanent use, restoration of ownership rights and redemption (purchase) of the land allocated for permanent use, as well as privatization (alienation) of land owned by the state or local government. Redemption (purchase) of land allocated for permanent use and restoration of ownership rights to land allocated for permanent use and land for completion of the land reform are carried out with regard to the rural and urban land reform being implemented in the country.

In cities and rural regions, allocation of land for the use has been completed. According to the *Law on Completion of Privatization* (revision on May 31, 2012) land redemption (purchase) agreements for the allocated urban or rural land had to be concluded by December 30, 2010.

Amendments to the Law on Completion of State and Local Government Property Privatization and Utilization of Privatization Certificates came into force on June 1, 2011, that envisaged resumption of allocation of urban and rural land for payment as of June 1, 2011, as well as conclusion of a land redemption (purchase) agreement with the Mortgage Bank of Latvia.

According to the amendments to the *Law on Completion of Privatization*, city land commissions as of June 1, 2011 will resume the decision-making process regarding allocation of land for payments to the users of urban land – to owners of residential buildings and orchard users, who had submitted a confirmation of pre-payment by September 1, 2008, and had carried out the cadastral survey by August 31, 2009, but had not submitted an application and relevant documents for the decision for allocating land property for payments or had received a refusal on redeeming (purchasing) the land.

According to the amendments to the *Law on Completion of Privatization,* rural land users could submit the application for allocation of land in rural areas for payment to the State Land Service from June 1, 2011 until August 31, 2011, on a condition that privatization certificates have been transferred by September 1, 2008, and a land boundary plan of the requested land has been submitted for the entry in the Cadastre Information System by August 31, 2010. By August 31, 2011, 56% out of 670 persons, respectively, 33% in Latgale, 31% in Zemgale, 13% in Kurzeme, 12% in Vidzeme and 11% in Riga, have used the opportunity to submit an application for allocation of land in rural areas for payment.

All those urban and rural land redeemers, who have received the decision of allocation of land for use by the day of entering into force of the amendments to the *Law on Completion of Privatization*, will be entitled to conclude the redemption agreement with the Mortgage and Land Bank of Latvia until December 30, 2011.

Overall, during the land reform until December 30, 2011, the Mortgage Bank had concluded 174 231 agreements on 181 945 land units of more than 1.2 million hectares.

If a land redemption (purchase) agreement with the Mortgage Bank was not concluded before the prolonged term in the *Law on Completion of Privatisation* – until December 30, 2011, both urban and rural land redeemer lost the opportunity to redeem the land at its cadastral value, as well as lost the advance payment already made with privatization certificates before the cadastral survey.

By December 30, 2011, about 5464 persons had failed to take the opportunity to pay for and conclude an agreement with the Mortgage Bank on 7154 rural land units of 24 848.43 ha claimed for redemption.

The Article 16(1) of the *Law On Completion of Land Reform in Rural Areas* envisaged that the former land owners or their heirs, as well as former land owners who before July 21, 1940 had started to redeem real estate from the General Agriculture Bank or State Land Bank left in Latvia by German emigrants or their heirs whose ownership rights to the land have not been restored or the compensation certificates have not been granted, would have an opportunity to claim land units of equal value allocated for completion of the land reform by a decision of the local government until December 30, 2009.

If the former land owners or their heirs wanted to restore their ownership rights to land, according to the *Law On the Completion of Land Reform in Rural Areas* they had to submit a proposal to the Central Land Commission (CLC) by December 28, 2007, but documents confirming ownership and hereditary rights had to be submitted by September 1, 2008.

Regulation of the Cabinet of Ministers of December 20, 2008 *Procedure on Reviewing Requests Submitted to the Central Land Commission* prescribes the procedure according to which former land owners or their heirs must restore land ownership rights to land planned for completion of land reform.

Before starting the process of restoring land ownership rights, the State Land Service (SLS) in cooperation with the local governments examines whether:

– ownership rights to the claimed land have not been already recognized or restored to the submitter of proposal or to another person;
– property compensation certificates have not been received;
– the proposal on restoration of ownership rights has been submitted in the corresponding local government by June 20, 1991;
– the documents confirming ownership and hereditary rights to the claimed land have been submitted by June 1, 1996;
– the land has been allocated for permanent use or rights to permanent use have been terminated and a land lease agreement for this land has been concluded with the local government.

After performing the said examination, the CLC decided on the priority group for reviewing applicants' claim.

The former owners or their heirs who had submitted a claim for restoring ownership rights and documents confirming ownership or hereditary rights by June 20, 1991, but have not received the land or property compensation certificates, as well as former land owners who by July 21, 1940 had started to redeem the real estate left in Latvia by German emigrants from the General Agriculture Bank or State Land Bank, are considered as the first priority claimers regardless of the claim submission date.

The status of the second priority claimers corresponds to those former owners or their heirs, who had submitted a claim for restoring ownership rights by June 20, 1991, as well as had submitted documents confirming ownership and hereditary rights by July 1, 1996.

The status of the third priority claimers corresponds to those applicants, who had submitted the claim after June 20, 1991, or documents confirming ownership or hereditary rights after July 1, 1996.

14% of all claimers for land allocated for completion of the land reform are the first priority claimers, 3% – the second priority claimers, but the third priority claimers constitute the largest number of claimers for land allocated for completion of the land reform, i.e. 83 percent.

In order to ensure restoration of ownership to land allocated for completion of the land reform, local government and regional level commissions for completion of land reform have been established in the SLS regional branches, as well as a state level commission for the completion of land reform has been established in the central structure of the SLS. The commissions established by the SLS organize sending a land unit list to the applicants and summarize the land units selected by the applicants. A representative of the particular local government who is authorized to sign the allocation schemes of land distribution allocated for completion of the land reform and land boundary schemes intended for restoring ownership rights must participate in the work of these commissions.

After the auction, the SLS commission for completion of the land reform sends the auction minutes and a land boundary scheme signed by the claimer to CLC for preparing a statement and sending it to the claimers for continuing the processing of ownership rights.

The process for the restoration of ownership rights to the first priority claimers was commenced in 2010. Since August 2010, the state level commission for completion of the land reform established by the State Land Service has examined claims of 91 first priority claimers.

Examination of claims of the first priority claimers in commissions for completion of land reform of local government and regional level, as well as in state level was completed at the end of March 2011.

After receiving the CLC statement on restoration of ownership rights, the first priority claimers carry out cadastral survey of land units. After the cadastral survey, the CLC makes decisions on restoration of ownership rights, and the claimer thereby obtains the rights to record the property in the Land Register.

In April 2011, the preparation of lists of land units planned for completion of land reform and sending thereof to second and third priority claimers for selecting the respective land units was launched at local government or regional level. Those claimers having insufficient area for compensating the inheritable land at regional level were offered an opportunity to select land units at state level within the territory of Latvia.

A total of 35 claims of second priority claimers for selection of land planned within the land reform have been examined, the majority of former properties of second priority claimers were located in the territory of former Ludza district, Valka district, Cēsis district, Preiļi district and Balvi district. Land boundary schemes were selected and signed for a total of 37 land units for an area of 155.5 ha. 30% of second priority claimers refused to choose land units. Examination of claims of second priority claimers at local government, regional and state level was completed in November 2011.

The total number of third priority claimers is 690, 36% in Latgale, 20% in Zemgale, 19% in Vidzeme, 16% in Kurzeme and 9% in Riga, respectively. Riga regional commission completed work on examination of applications for the territory of former Tukums district submitted by third priority claimers in October 2011, for the territory of former Ogre district – at the beginning of May 2012. Zemgale regional commission completed the work in September 2011, Kurzeme regional commission – in December 2011. Vidzeme regional commission is still examining two applications of third priority claimers for the territory of former Valmiera and Limbaži districts. Latgale regional commission continues examining applications of third priority claimers in the territory of former Daugavpils, Rēzekne and Preiļi districts. Overall, by June 2012, 529 applications of third priority claimers for selection of land planned for completion of the land reform for a total area of 4777.09 ha have been examined, while 46 of third priority claimers refused to choose land units.

In some areas of Latvia, there is insufficient land planned for the land reform for the third priority claimers, namely, in the territory of former Cēsis district, Jelgava district, Ventspils district, Tukums district and several other districts. Therefore, 189 third priority claimers will be offered an opportunity to select land units within the entire territory of Latvia. Thus, the state level commission for the completion of land reform of the State Land Service plans to start working in late July 2012.

Privatization certificates

A privatization certificate is a state-allocated dematerialized security that can be used only once as the means of payment for a state or local government property to be privatized.

Privatization certificates are issued and used according to the *Law on Privatization Certificates*. By May 1, 2012, 104.4 million privatization certificates have been issued to 2.4 million people for the time they have lived in Latvia, including 794.7 thousand privatization certificates granted to 41.4 thousand politically repressed persons. 8.01 million property compensation certificates have been issued to 117.2 thousand former owners or their heirs, including 691.7 thousand certificates for property alienated for the state needs at the privatized specialized state agricultural enterprises, 4896.4 thousand for land in rural areas, 970 thousand for house ownership, 814.7 thousand for urban land, 461 thousand for companies and other property units, 89.8 thousand for property taken away from politically repressed persons and 85.6 thousand for property alienated illegally.

As of May 1, 2012, 211 property compensation certificates have been issued to two heirs of former owners.

As from December 1, 2007, in accordance with the Article 27 of the *Law on Completion of Privatization*, 58 thousand persons have lost their rights to transfer 1.64 million privatization certificates to their accounts.

According to the *Law on Privatization of Land in Rural Areas*, 11 076 decisions on payment of cash compensations for former land ownership in rural areas have been made by May 1, 2012. Compensations in the total amount of LVL 17.46 million have been paid to 8411 persons, thus cancelling 0.63 million property compensation certificates.

Table 6.5

Use of Privatization Certificates
(as of May 1, 2012)

Type of property	Amount	Number of privatization certificates	including property compensation certificates
		(million)	(thousand)
Residential buildings	446 thousand apartment privatization units	38.0	589.8
Enterprises and other properties	no exact data	7.3	109.6
Capital shares (stocks)	no exact data	44.5	954.0
including:			
in public offering	128.7 million shares	37.1	858.0
Land	317.1 thousand land lots	17.3	5155.9
Total:		**107.0**	**6809.3**
% of total certificates issued		95.2%	85.0%

Cash compensations in the total amount of LVL 4.64 million were paid to 26.2 thousand politically repressed persons by May 1, 2012, thus cancelling privatization certificates. According to the provisions set in the Article 27 of the *Law on Completion of Privatization,* 3.4 thousand persons have lost their rights to cancel 15.9 thousand certificates.

By May 1, 2012, 107 million privatization certificates or 95.2% of the total number of issued certificates have been used for privatization of state and local government property (see Table 6.5). From April 1, 2008 until May 1, 2012, instead of 435.9 thousand property compensation certificates 556.2 thousand privatization certificates have been used.

On May 1, 2012, 2.13 million privatization certificates or 1.9% of the total number of granted certificates, including 122 thousand property compensation certificates were stored on the accounts of 381 thousand natural persons.

On May 1, 2012, 760 thousand privatization certificates or 0.7% of the total number of granted certificates, including 6 thousand property compensation certificates were stored on the accounts of legal entities.

On May 1, 2012, holders of privatization certificates could use services of 9 licensed intermediary capital companies for transactions in the market of privatization certificates. The total amount of monthly transactions with privatization certificates (buying from natural persons and selling) performed by intermediary capital companies on May 1, 2012, varied from 10.17 thousand privatization certificates in February to 56.44 thousand privatization certificates in March and from 0.59 thousand property compensation certificates in April to 1.15 thousand property compensation certificates in March.

6.16. National Economy Council

The National Economy Council (NEC) of the Ministry of Economics is an advisory institution established by its founder organizations – the Ministry of Economics, Latvian Chamber of Commerce and Industry, Latvian Association of Local and Regional Governments, Free Trade Union Confederation of Latvia, and Employers' Confederation of Latvia, and it takes part in the process of solving issues related to business policy and acts in accordance with Subparagraph 6.11 and 7.2 of the Regulations No. 271 *Regulations of the Ministry of Economics* of the Cabinet of Ministers of March 23, 2010, *Agreement on Cooperation in the National Economy Council* concluded on February 17, 1999, and *NEC Bylaws No 1-11-3* of April 7, 2010.

In order to represent the interests of sectors professionally, as well as to improve cooperation between the Ministry of Economics and other state institutions, NEC invites sectoral associations, representing entrepreneurs of the respective sector and their interests, as well as independent experts – economists, representatives of education and science – to participate.

The objective of NEC activity is to promote development and implementation of policy of favourable business environment in Latvia, as well as introduction of principles of sustainable development of national economy and to encourage the process of sustainable development of the state and participation of the society in it, to identify circumstances hindering entrepreneurship, and to perform all the necessary activities to eliminate them, to participate in drafting the laws and regulations and policy programming documents that promote commercial activity, and to promote innovations and external trade.

NEC reviews and monitors settlement of issues, draft normative documents, national economy development concepts, the state budget, and other documents important for the development of Latvian economy. NEC prepares proposals and adopts recommending decisions on these issues. NEC carries out a dialogue between the entrepreneurs and the Ministry of Economics, as well as with other state institutions and public organizations.

The decisions adopted by NEC are of recommending nature.

Box 6.23

NEC personnel and work organization

Based on the decision of the Managing Committee, NEC personnel are approved by the Minister for Economics.

NEC Managing Committee is a consulting and coordinating institution that takes part in settlement of issues related to business policy and is responsible for assessment and approval of issues of the agenda of NEC meetings and action plan of NEC, as well as for ensuring and improving efficiency of NEC activity.

The personnel of the Managing Committee are approved by the Minister for Economics. The Managing Committee is composed of representatives of NEC founders, who at the same time are NEC members:

- representative from the Ministry of Economics;
- representative from the Free Trade Union Confederation of Latvia;
- representative from the Employers' Confederation of Latvia;
- representative from the Latvian Association of Local and Regional Governments;
- representative from the Latvian Chamber of Commerce and Industry;
- representative from the Foreign Investors' Council in Latvia;
- representative from the Latvian Academy of Sciences.

NEC consists of 26 NEC experts designated by NEC Managing Committee.

A representative from the Riga Technical University participates in NEC meetings as an observer.

Decisions on changes or additions to the composition of NEC are made by the NEC founders in the meetings of NEC Managing Committee.

NEC is managed by the Chairman elected by the members of the NEC Managing Committee from among its members in a rotation sequence for a term of office of one year.

NEC meetings are held on average once in a month.

The work of NEC is provided by the Secretariat of the National Economy Council, activity of which is ensured by the Ministry of Economics.

Between NEC meetings, recommending decisions of NEC are made by the NEC Managing Committee.

NEC cooperates with the Cabinet of Ministers, ministries, and other state institutions to achieve that the proposals suggested by NEC necessary for improving the business environment are included in the laws and regulations prepared by the responsible institutions.

On May 21, 2009, NEC, the Ministry of Economics, and the Ministry of Finance signed a cooperation memorandum on *Growth, Competitiveness, and Employment*. The cooperation memorandum is aimed at cooperation and harmonized action of NEC, the Ministry of Economics, and the Ministry of Finance to promote economic growth, employment, and competitiveness of Latvia, as well as active participation in development and implementation of sustainable strategy of Latvia.

In order to represent professionally the interests of economic sectors, the Ministry of Economics has set up a model for cooperation with the national economy sectors.

Box 6.24

NEC on priorities of economic policy

NEC believes that Latvia should continue work on development of stable macroeconomic environment. In Latvia a balanced budget must be formed. Competition control must be intensified and competition development must be promoted in all sectors of national economy in the interests of the society, by timely identifying the risk sectors where violations of the competition rights are possible, by limiting administrative and other barriers to the competition.

NEC still considers taxation policy and administration, labour force education, macroeconomic stability, and non-predictability of amendments to the legislation as the most problematic spheres.

NEC also believes that the normative acts must be assessed, already during their drafting process, in order to identify and prevent possible violations of competition rights, technical barriers to trade, and discriminating conditions within the sector of free movement of goods and services and business rights. The state support and procurement monitoring must be improved, thus achieving high transparency level for projects of state support.

Establishment of an efficient and competitive sectoral structure must be facilitated, research and development and innovations must be promoted, especially within the private sector, measures must be developed and implemented facilitating co-operation of education, research, and national economy sectors by ensuring transfer of knowledge and technologies.

Faster absorption of Structural Funds and new export markets and consolidation in the existing ones must be promoted. The export promotion institutional base, as well as raising its capacity, development of Foreign Economic Representative Offices, accessibility of financial instruments, and support to enterprises in export marketing must be provided.

NEC reviews proposals for the improving legislation submitted by the institutions-associations representing the entrepreneurs. Sectoral associations evaluate and give an opinion on the draft legislation.

The Ministry of Economics in its turn informs the drafters of the laws and regulations about proposals for improving the legislation submitted to NEC. NEC carries out other measures to implement the programmes for the development of national economy and improvement of business environment approved within the framework of the government declaration.

At the moment, 14 sectoral associations are represented in NEC (chemistry and pharmaceutics, finance, transport – transit, logistics, power engineering, information and communication technologies, IT cluster, trade, electrical engineering, electronics, light industry, wood industry, engineering industry and metal working, construction, tourism, hotels and restaurants, food, publishing).

By signing the memorandum of understanding, the parties agreed to unite their resources for the development of programming documents, take measures for the implementation of the programmes on the improvement of economic development and business environment adopted within the framework of the declaration by the government, and that sectoral associations will assess and give an opinion on draft legislation elaborated by the ministries.

In the first half of 2012, 5 National Economy Council meetings have been held, in which the following main issues have been considered:

- *The EU multiannual financial framework for 2014–2020*;
- *Report on National Competition*;
- Development of industrial policy;
- *Tax Policy Strategy for 2012–2014*;
- Development of the priorities of *the National Development Plan*;
- Priorities for the next planning period, priorities of the NDP and a system of financing absorption for implementation of priorities;
- Efficiency of the judicial system and improvements thereof;
- *Fiscal Policy Guidelines for 2013–2015*;
- Medium-term and long-term forecasts of the labour market;
- Framework of cross-industry employment policy.

7. RECOMMENDATIONS

Successful achievement of the objectives set in policy documents of Latvia is related to certain structural changes in allocation of economy resources in favour of:

- Production of goods and services with higher value added;
- Export-oriented sectors;
- Higher investments in new technologies, innovation and ICT;
- Improvements of education system and support for science.

The Ministry of Economics is currently developing the National Industrial Policy of Latvia based on the latest world practices and approaches and aimed at changing the economic structure in favour of production of sophisticated goods and services with higher value added. It is a new, though very necessary approach in the economic policy of Latvia, providing clear vision of Latvia's activities, objectives and state support instruments for achievement of objectives.

Measures to improve the business environment are essential for strengthening competiveness, especially the measures related to institutional framework (laws, tax policy and support institutions) and improvement of infrastructure. The government's decision on a gradual decrease of personal income tax (PIT) as of 2013 is an important step forward. As economic activity and government budget revenues keep growing, a more rapid reduction of the labour tax burden should be carried out in the first place, by carefully assessing fiscal effects and risks. Lower labour taxes are important not only for the competiveness of Latvia in relation to neighbouring countries, but also for fostering economic activity, creating new better-paid jobs, investments in development and productivity. Bigger reduction of PIT rate would be a strong encouraging call for the enterprises operating in the grey economy. These reasons should serve as a leitmotif in further changes of tax policy.

Although the economic disproportions, which developed in the years of rapid growth, have diminished during the crisis, nevertheless, due to the remaining budget imbalance of public and private sectors (households and enterprises), the so called process of balance sheet effect still continues, *int. al.*, debt restructurization. The EU debt crisis creates a considerable risk to the economic development of Latvia. Therefore, economic development possibilities should be carefully considered within budget planning, avoiding too optimistic budget formation. Cyclical revenues that exceed the expected should be used for reducing the government debt.

In order to prepare and adapt to the significant structural changes, pre-emptive changes should be carried out in the labour market. Thus, the employment policy must ensure not only services for the unemployed, but also provide proactive help in developing skills and competences of the population required in the labour market. This policy should consider also emigration tendencies. So far people who have emigrated have not received a clear signal that they are welcome back and economic development of Latvia needs their skills, knowledge and experience.

The launched higher education reform should be continued to stimulate quality, strengthen conformity to market demand and link with scientific research institutions, and eliminate fragmentation of budget resources. The social support system must be strengthened and reformed to make it more efficient and at the same time protect the poor population. It is necessary to carry out targeted organization and to increase the motivation to work.

Taking into account the abovementioned, in our opinion, the immediate tasks of the economic policy are as follows:

- **for implementing the industrial policy:**
  - to direct the available financing for strengthening competitiveness of entrepreneurs through support and financial institutions, as well as actively involve entrepreneurs in the policy development process;
  - to promote entering into foreign markets (export support services, guarantees, external marketing measures, promotion of cooperation and collaboration between Latvian enterprises, etc.);
  - to improve investments in human resources (secondary vocational education, engineering sciences, strengthening the system of lifelong learning) based on closer involvement of entrepreneurs in organising training by giving certain incentives;
  - to attract foreign direct investments to export-oriented sectors;

- **for securing macroeconomic stability:**
  - to ensure fulfilment of Maastricht criteria so that Latvia is ready to join the euro zone in 2014;
  - to ensure development of sustainable countercyclical fiscal policy by strengthening national legal framework and medium-term budget planning, as well as by stipulating clear conditions for defining fiscal objectives;
  - to reduce grey economy by supporting honest entrepreneurs and creating favourable conditions for transition to official economy, to continue transformation of the SRS into a support institution for entrepreneurs;

- **for improving business environment and ensuring competitiveness:**
  - to restructure the tax system, by making it socially fairer and business-friendlier. In the medium-term, it must be achieved that the tax burden on entrepreneurship and employment is decreased;
  - to reduce the time required for dealing with tax administration by simplifying report forms and avoiding repeated request of information;
  - to carry out measures to improve management and efficiency of the judicial system, especially to reduce the number of pending cases and length of legal proceedings. To improve insolvency process and regulation of arbitration courts, to introduce a mediation process;
  - to revaluate participation of a public person in business activities and implement reform of state assets (capital companies, capital shares) administration;
  - to promote development of e-government and e-services. The establishment of the state mega-system ("the list of registers") must be completed, functionality of the e-signature must be expanded, and the usage of electronic procurements must be facilitated;
  - to ensure introduction of the one-stop agency principle with regard to availability of the state and local government services;
  - to invent completely functioning electronic registration of enterprises and thus to reduce the time for registration process;
  - to develop an updated legal framework of construction process and new construction standards, including adaptation of the Eurocode standards into the system of laws governing the construction sector, thus creating pre-conditions for development of a sustainable and competitive construction sector;
  - to invent one-stop shop agency principle for real estate data registration, by providing data exchange between the State Real Estate Cadastre Information System and State Unified Computerized Land Register;
  - to improve mutual coordination of data and terms for entering data in state registers and other information systems and to ensure maximally complete and quick updating of information stored in the registers in order to prevent discrepancy of information between the registers and the actual situation, as well as to avoid repeated requests of information from respondents;
  - to actively address the most severe violations of the *Competition Law* – prohibited agreements and abuse of dominant position. As regards the abovementioned violations, particularly identification of cartels, preventive measures are of big importance, therefore analysing the situation and inspections in markets, which are subject to increased risk of prohibited agreements, are to be set as priority;

- **for improving protection and supervision of consumer rights:**
  - to develop guidelines for improvement of market surveillance system and consumer rights protection, ensuring efficient, adequate, well-coordinated and result-based market surveillance system and consumer rights protection, at the same time developing a friendly business environment;
  - to continue the work on improving efficiency of the licensing system of non-bank creditors, at the same time ensuring their increased supervision;
  - to strengthen consumer protection in the field of financial services by introducing recommendations laid down in the World Bank's *Research on Consumer Protection and Financial Possibilities in Latvia*;
  - to continue development of a conceptually new legal framework to improve the out-of-court debt recovery sector;
  - to develop draft laws envisaging new administrative penalty policy in the field of consumer protection and safety of goods and services to ensure quick and efficient prevention of violations applied to consumer rights and interest protection;

- **for developing knowledge-intensive economy:**
  - to apply corporate income tax relief to research and development costs for development of enterprise research activities in Latvia;
  - to facilitate cooperation between the scientists and entrepreneurs by supporting competence centres in order to promote cooperation between research and manufacturing sectors for implementing industrial research, new products, and technologies, as well as to support technology transfer contact points for purposeful development of the necessary research competence at universities and research institutions and to promote introduction of research results in production;
  - to support development of new products and technologies by fostering entrepreneurs to develop industrial research by introducing new products, services and technologies in production;
  - to ensure access to financing at all business development stages, especially at an early (business start-up and pre-seed and seed) stage;
  - more actively support development of science potential by concentrating it in areas where Latvia has comparative advantages;
  - to improve the laws regulating research activity by establishing that research institutions can be the owners of the intellectual property resulting from state-funded research;

- **for the use of the EU funds:**
  - to reduce the time necessary for administrative procedures, by simplifying the procedure for developing and approving the conditions of activities implementation;
  - to direct the EU funds to viable projects, taking into account priority sectors approved by the government;

- **for promoting exports:**
  - to continue ensuring access to export credit guarantees in order to increase access to the markets with a higher risk degree and to promote exports of Latvian goods and services;
  - to continue supporting the participation of entrepreneurs and their unions in international exhibitions and trade missions, in order to foster absorption of new markets;
  - to develop and expand the network of Latvian foreign economic representation offices thus providing the Latvian entrepreneurs with a range of state export support services broadly and easily accessible in export markets;
  - to ensure representation of Latvian external economic interests in the framework of a multilateral, bilateral and regional trading policy to improve contractual conditions of international trade;
  - to continue addressing protective measures by eliminating trade barriers faced by Latvian entrepreneurs both in the EU internal and foreign export markets, thus fostering access to third country markets and exportability of Latvian entrepreneurs;
- **for establishing flexible labour market:**
  - to identify timely disparities between labour supply and demand based on labour market development tendencies by providing information to education policy makers; to improve cooperation among different institutions in implementation of pre-emptive changes in the labour market;
  - to improve lifelong learning system to prevent the currently existing mismatches in the labour market and to reduce the risks of structural unemployment;
  - to pay particular attention to the youth who are neither involved in any training nor are employed, by returning them to the education system to acquire qualification and practice;
  - to encourage active participation of employers in improvement of education quality – establishing practice places, participating in development and improvement of education programmes, as well as development and implementation of active labour market policy measures;
  - to develop interdisciplinary education/study programmes, particularly promoting development of business abilities;
  - to develop the 1st level vocational higher education (colleges) – reduced training period, saved state and private financing;
  - to review the regulation of legal labour relations by expanding the flexibility opportunities between employer and employee;
  - to promote conformity of training to the requirements of labour market, by improving (changing) the existing planning system of labour training by reviewing the former methodology of short-term labour market forecasting and procedure for defining training directions in order to take into consideration labour market forecasts, as well as medium-term and long-term development objectives of the economy;

- **for improving energy efficiency:**
  - to make energy efficiency a cross-industry policy objective, by including it in other policy areas, for example, regional and urban development, transport, manufacturing policy, agriculture, international relations, education and training;
  - to continue improving energy efficiency in multi-apartment buildings;
  - to revise the minimum requirements for energy efficiency of building envelopes and engineering technical systems, considering the most optimal costs that causes the lowest costs during the estimated lifetime;
  - to set the requirements regarding construction of low or nearly zero energy consumption buildings;
  - to promote public awareness of various methods and practices for improving energy efficiency of buildings, to promote application of good practice of energy efficiency of buildings to public sector buildings;
  - to promote production of energy in high-efficiency cogeneration stations by developing a new heat supply infrastructure;
  - to strengthen support for research, development and implementation of new energy efficient technologies, thus providing a possibility for dynamic development of energy efficiency solutions, as well as innovations and new jobs;
- **for ensuring efficient, safe, and sustainable energy supply:**
  - to create stable environment for long-term investments in order to promote long-term energy production by use of local renewable energy resources;
  - to promote a broader use of renewable energy resources in the sectors of electric energy, heat supply and transport by using co-financing of the EU structural funds and other support mechanisms;
  - to identify priority projects of the energy infrastructure development thus giving a possibility to integrate renewable energy sources, ensure safe supply and increase energy efficiency and promote their implementation;
  - to create legal and investment environment for development of new electricity production capacity with guaranteed supply of the used energy resources, thus promoting sustainable energy and increasing state self-sufficiency regarding production capacity and electricity;
  - to continue active work and ensure implementation of energy infrastructure development projects and energy market integration measures within the *Baltic Energy Market Interconnection Plan*;
  - to foster possibilities to diversify energy sources by implementing the creation of a regional liquefied natural gas terminal;
- **for managing residential buildings:**
  - to prepare the legal framework necessary for dealing with the debts related to the use of apartment property;
  - to create favourable conditions for development of the residential rental market.

A consistently implemented structural policy will promote revival of Latvian economy, which will form the basis for increasing the standard of living of the population. Successful development and economic growth of Latvia will depend not only on the work of public institutions, but also on personal initiative of any person anywhere in Latvia under the conditions of mutual public understanding and dialogue.