Ministry of Economics
Republic of Latvia

# ECONOMIC DEVELOPMENT OF LATVIA

# REPORT

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December 2011

Comments, questions or suggestions are welcomed:

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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, evaluates the situation in the economy and presents forecasts of its development.

The year 2011 has been remarkable because the Latvian economy was able to recover from the deep recession and grow faster than even the optimistic experts expected. In accordance with the evaluation of experts of the Ministry of Economics, the GDP growth could reach 5.5% in 2011. 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. 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.

At the same time, it should be noted that unfortunately not all inhabitants have felt the effect of moderate economic growth which is mainly observed in the manufacturing sector. In 2011, emigration tendencies continued, and the unemployment rate still was quite high though kept decreasing. The data of the household survey of 2010 show a decrease in income. However, also a stable increase in retail turnover was observed in 2011 showing gradual recovery of private consumption.

We expect the year 2012 with uncertainties and hopes at the same time. Uncertainties about what lies ahead of us and hopes that maybe it will be better than expected. The great unknown issues are related to the European Union (EU) and global economy, future of the euro zone and ability of Latvia to implement reforms required for further economic growth.

One of the major issues at the government level in 2012 will be the EU budget for the next planning period from 2014 to 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 jointly must also work on cross-sectoral reforms under the Declaration of the Government and the Government Action Plan.

In particular, five priorities should be mentioned regarding the work of the Ministry of Economics in 2012. Firstly, an agreement with the Ministry of Finance and the partners should be reached in a timely manner for reducing labour taxes for a three year period starting from 2013, which is a major precondition for entrepreneurs to create new jobs and continue improving their competitiveness. Secondly, a preliminary framework for the industrial policy and support mechanisms for its implementation should be developed in 2012 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. Thirdly, the state enterprises management reform must be implemented, thus introducing transparent and understandable principles to the society, as well as give potentially higher revenues in the state budget. Fourthly, the Ministry of Economics will continue the work on the *Energy Strategy 2030*. This document will determine long-term directions for the safety of energy supply, competitiveness, energy efficiency and also for the use of renewable energy. Besides, state support mechanisms for energy production from renewable resources are planned to be reviewed. The last but not least priority task for 2012 is development of an outstanding business environment, including adoption of the *Construction Law* in the Saeima envisaging simplification of administrative procedures of construction and creation of up-to-date legal regulation for the construction process. Furthermore, the Competitiveness Report of Latvia is going to be published already in spring 2012, allowing us to identify more precisely the areas that need to be improved and developed within the business environment to promote international competitiveness of Latvia. In order to achieve the set objectives, we will continue the dialogue with entrepreneurs and their representing non-governmental organizations.

This 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.

At the end 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 progress, problems and perspectives of the economy of Latvia, and that it will encourage exchange of ideas between public institutions, various organisations, and representatives of different interest groups.

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

December 2011

**Daniels Pavļuts**
Minister of Economics

# CONTENTS

# ABBREVIATIONS

**Abbreviations**

| | |
|---|---|
| CC | Competition Council |
| CF | Cohesion Fund |
| CHP | Combined Heat and Power Plant |
| CIF | Cost, insurance and freight |
| 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 |
| FDI | Foreign direct investment |
| FIFG | Financial Instrument For Fisheries Guidance |
| FOB | Free on board |

| | |
|---|---|
| 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 |
| OP | Operational Programme |
| PJ | Petajoule |
| SEA | State Employment Agency |
| SME | Small and Medium-Sized Enterprise |
| 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 | Luxemburg |
| 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 | European Union | SE | Sweden |
| FI | Finland | SI | Slovenia |
| FR | France | SK | Slovakia |
| HU | Hungary | UK | United Kingdom |

**Symbols**

| | | | |
|---|---|---|---|
| – | Magnitude zero / absent | ... | Data not available or too uncertain |

# 1. Economic Situation: Brief Overview

**Since the end of 2009, the economic recession in Latvia is over and growth has resumed.**

After the huge decrease of GDP by ¼ and the rapid increase of unemployment during the crisis, economic activities have been gradually increasing already for eight quarters in a row. Since the lowest point of economy in the 3rd quarter of 2009 until the 3rd quarter of 2011, the GDP has increased by 9.6%. Taking into account that the growth resumed from a rather low level, the GDP in 2010 in total was by 0.3% lower than in 2009. However, the estimates of the Ministry of Economics for 2011 show that GDP exceeded the level of the previous year by 5.5 per cent.

The exacerbating debt crisis in the euro zone and uncertainty about the expected fiscal consolidation in most of the developed countries has forced international institutions to reduce forecasted global economic growth rate for 2012. Taking into account the abovementioned, **the Ministry of Economics forecasts the growth of the economy of Latvia between 1.5-3% in 2012.**

Table 1.1

**Latvia: Key Economic Development Indicators**

| | 2008 | 2009 | 2010 | 2011e | 2012f |
|---|---|---|---|---|---|
| (growth, in comparison with the previous year, %) | | | | | |
| Gross domestic product | -3.3 | -17.7 | -0.3 | 5.5 | 1.5..3.0 |
| Private consumption | -5.8 | -22.6 | 0.4 | 4.7 | 3.7..4.0 |
| Public consumption | 1.6 | -9.4 | -9.7 | 1.9 | -0.9..1.0 |
| Gross fixed capital formation | -13.8 | -37.4 | -12.2 | 23.7 | 1.8..7.0 |
| Exports | 2.0 | -14.1 | 11.5 | 12.5 | 1.9..5.0 |
| Imports | -10.8 | -33.3 | 11.5 | 19.2 | 4.3..8.3 |
| Consumer prices | 15.4 | 3.5 | -1.1 | 4.4 | 2.3..2.5 |
| (% of GDP, unless indicated otherwise) | | | | | |
| General government sector balance | -4.2 | -9.6 | -8.2 | -4.0 | -2.1 |
| General government debt | 19.8 | 36.7 | 44.7 | 44.3 | 44.4 |
| Export-import balance | -13.6 | -1.5 | -0.8 | -1.1 | -5.7 |
| Changes in the number of employed (aged 15-74 years) | 0.5 | -12.2 | -4.6 | 3.0 | 1.5 |
| Unemployment rate (share of job-seekers in economically active population aged 15-74 years, %) | 7.5 | 16.9 | 18.7 | 15.4 | 13.4 |

e – estimation; f – forecast

**Exports have become the economic driver in recent years.** Export volumes of goods and services have been growing already for the tenth quarter in a row and are now reaching the highest level ever. The increase in exports is related to the increase in external demand, as well as improving competitiveness of Latvian producers reached on the account of reducing labour costs and increasing productivity.

Revenues from exports of goods in the eleven months of 2011 exceeded the level of the corresponding period of 2010 by 29.6%. Exports of metal and wood products, as well as chemical industry and engineering industry products ensured more than a half of the total increase in the exports of goods.

Further growth opportunities of exports will depend on both changes in external demand and competitiveness of Latvian producers. It should be taken into account that the improvement of Latvian competitiveness so far was mainly due to the cuts in labour costs, however, as from now the ability to increase productivity will play a crucial role.

**Production volumes of manufacturing continue growing due to remaining positive export tendencies**. In January-November 2011, production volumes of the sector were by 11.9% higher than a year ago. Production volumes continue increasing in all manufacturing sectors, especially in wood processing, metal processing, and manufacturing of electric appliances, machinery and equipment. At the same time it should be noted that one of the largest manufacturing subsectors – food industry is recovering slower from the crisis compared to other sectors. In general, manufacturing ensures on average 1/3 of the total economic growth.

In 2011, growth was observed in all key sectors of the economy. It was relatively high in transport and communications, construction sector, as well as in trade services. However, it should be taken into account that growth in construction and trade has resumed from a low level.

**Positive tendencies are observed also in the domestic market.** An increase in employment and gradual rise in wages foster an increase in private consumption. In the 3rd quarter of 2011, it exceeded the level of the corresponding quarter of 2010 by 5.4%. However, in total, private consumption is increasing at a slightly slower rate than GDP, and in the 3rd quarter of 2011 it was only 85.6% 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 indebtedness of households.

In connection with the absorption of the EU structural funds, including public investments in infrastructure and corporate investments in production equipment, investments increased rapidly in 2011. The increase in investments in the three quarters of 2011 exceeded 20% in comparison with the corresponding quarters of the previous year. Despite the significant increase, investments still are at a rather low level. Latvian entrepreneurs consider low demand and financial difficulties to be the main factors limiting investments though influence of these factors is slightly decreasing. More rapid increase in investments is prevented by slow restoration of crediting and insufficient own resources for investment financing.

Both the increase of demand for intermediate consumption goods in manufacturing **and improving situation in domestic market fosters increase of imports.** In the three quarters of 2011, the growth rates of imports exceeded the growth of exports, and thus the negative export-import balance increased to 5% of GDP. The fast growing imports is mainly based on increasing investments. Such an increase is justified because it is more related to an increase in investments and less to the increase in private consumption. 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.

After the deflation caused by the crisis when 12-month consumer price inflation decreased to -4.2% in February 2010, **prices are 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, food prices in the world) on consumer prices will decrease. However, the increase in natural gas tariffs and rise in prices for heating energy will have a certain impact on consumer prices at the beginning of 2012. Fuel prices are very uncertain as they are also influenced by the fluctuations of exchange rate of the euro and US dollar. **According to the estimates of the Ministry of Economics, the average consumer price level in 2012 may reach 2-2.5 per cent**.

After facing the crash of financial market at the end of 2008 and at the beginning of 2009, the **monetary indicators of Latvia are stabilising**. As of the 4th quarter of 2009, an increase can be observed in deposits attracted from residents.

Since the end of 2009, the **interest rates have stabilised**. The weighted average interest rate of short-term loans granted in lats was 5.8% in the 3rd quarter of 2011, but the weighted average interest rate of long-term loans granted in lats – 9.2%, which are one of the lowest interest rates over recent years. The weighted average interest rate of short-term loans granted in euro has not changed considerably over the last 2 years and was 4.2% in the 3rd quarter of 2011. The weighted average interest rate of long-term loans granted in euro was 7.4% in the 3rd quarter of 2011.

However, **the balance of bank loans granted to residents continues decreasing.** In the 3rd quarter of 2011, the balance of bank loans granted to residents was by 8.4% lower than a year ago. A total of 22.9 thousand loans in the amount of LVL 454.7 million have been granted anew in the banking sector in the 3rd quarter of 2011, which is by 10.4% more than in the 2nd quarter.

Almost 136 thousand loans for the total amount of nearly 1.4 billion lats have been granted anew since the beginning of 2011. In the three quarters of 2011, the most loans have been granted to the transport, agriculture, forestry and trade sectors, if evaluated by sectors. Since the sum of paid loans still exceeds the amount of loans granted anew, the balance of loans granted to sectors of the national economy continued decreasing in 2011 and at the end of the 3rd quarter of 2011, it was by 9.1% lower than a year ago.

The share of loans with overdue payments in the total loan portfolio continued increasing at the beginning of 2011, however, the situation improved slightly in the 3rd quarter, and loans with overdue payments constituted 26.2% of the total banks' loan portfolio (in the 3rd quarter of 2010 – 28.5%). Accommodation and catering services, transactions with real property and construction sectors have the highest amount of loans with overdue payments for the total amount of loans granted to the sector, if evaluated by sectors of the national economy.

**Deterioration of the economic situation in Latvia has had a significant impact on the fiscal situation.** The budget deficit of the general government sector in Latvia was LVL 1256.6 million or 9.6% of GDP in 2009, and it slightly decreased to LVL 1050.6 million or 8.2% of GDP in 2010. According to the provisional estimations of the Ministry of Finance, general government budget deficit was 4% of GDP in 2011.

In total, consolidation measures with fiscal impact in the amount of 16.6% of GDP have been carried out from 2008 to 2011, out of which about 6.7% of GDP are measures on the revenue side while measures on the expenditure side constitute about 9.9% of GDP.

On December 15, 2011, the Saeima approved the budget for 2012 envisaging the national budget deficit below 2.5% of GDP pursuant to the European Commission's ESA'95 methodology. The fiscal consolidation measures for 2012 approved by the government constitute in total LVL 156.1 million including both reducing the central government consolidated budget expenditures by about LVL 89.7 million and increasing revenues by about LVL 66.4 million. In comparison with the plan for 2011 (with amendments), the draft law envisages an increase in revenues for the amount of LVL 255.1 million or 6% and a decrease in expenditures for the amount of LVL 113.5 million or 2.4%. In 2012, funding in the amount of LVL 993.9 million or 30.6% of the total national government budget expenditures is allocated for implementation of the European Union policy instruments and projects and measures financed and co-financed by other foreign financial support.

The general government deficit is expected to be below 1.9% of GDP in 2013 and 1.1% of GDP in 2014. By achieving these objectives, the excessive budget deficit will be prevented and the Maastricht criterion on the budget deficit will be fulfilled in a sustainable way.

**The situation in the labour market is improving along with increasing economic activities.** The labour market reached the lowest point in the 1st quarter of 2010 when the number of employed people decreased to 916 thousand, and unemployment rate reached 20.5%. Since the beginning of 2010, the situation in the labour market has been gradually improving – the number of employed is increasing and the unemployment rate is dropping. According to the estimation of the Ministry of Economics, the number of employed in 2011 has increased by approximately 3% in comparison with 2010. Within a year, the average unemployment rate in the country has significantly decreased. Estimates show that the average unemployment rate constituted 15.4% in 2011 which is by 3.3 percentage points lower than in 2010.

The registered unemployment rate has also been decreasing since March 2010. At the end of December 2011, the registered unemployment rate was 11.5%. In total, the number of registered unemployed has decreased by 32.2 thousand or by almost 20% in comparison with the end of 2010. The highest unemployment rate at the end of December 2011 still remained in Latgale region (19.8%), but the lowest – in Riga (7.8%).

Situation in the labour market is expected to continue improving also in the first half of 2012 based to a great extent on the positive growth inertia. However, in the second half of the year, the labour market will be recovering at a more moderate pace along with gradual slowdown of economic growth pace. In total, the number of employed may increase by about 1.5% in 2012 in comparison with 2011.

Further development of Latvian economy 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 recovery of the financial sector considering also secondary influence of real sector downturn upon it. Financial problems and the need to reduce the excessive government sector budget deficit of several countries to ensure sustainable finances of the countries may have a negative impact on further growth of the European Union. The Latvian economy will grow at a slower pace in 2012 along with slowdown of global growth.

The medium-term growth of the economy of Latvia will depend to a great extent on two factors. Firstly, what solutions 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, how efficient will be the structural policy implemented by the Latvian government for the improvement of economic competitiveness under limited access to financing, including state budget.

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

# 2. Development of the World Economy[1]

Almost three years after the beginning of the global financial crisis, the global economic growth is still unstable. The growth is still weak in countries where economy was particularly imbalanced before the global crisis, while in some countries the economic activities remain steadily high.

The global growth so far has been influenced by such factors as less favourable external environment, reducing growth rates in the USA, continuing adjustments of balance items, as well as rising tension in the financial sector due to concerns about the severity of fiscal and financial problems in the euro zone.

Table 2.1

**GDP Growth**

(percentage in comparison with the previous year)

| | 2009 | 2010 | 2011f | 2012f |
|---|---|---|---|---|
| **World,** including: | **-0.7** | **5.2** | **3.8** | **3.3** |
| USA | -3.5 | 3.0 | 1.8 | 1.8 |
| Japan | -6.3 | 4.4 | -0.9 | 1.7 |
| EU including: | -4.2 | 2.0 | 1.6 | -0.1 |
| Eurozone countries | -4.3 | 1.9 | 1.6 | -0.5 |
| CIS | -6.4 | 4.6 | 4.5 | 3.7 |
| China | 9.2 | 10.4 | 9.2 | 8.2 |

Source: *The World Economic Outlook Update January 2012, International Monetary Fund*; f – forecasts

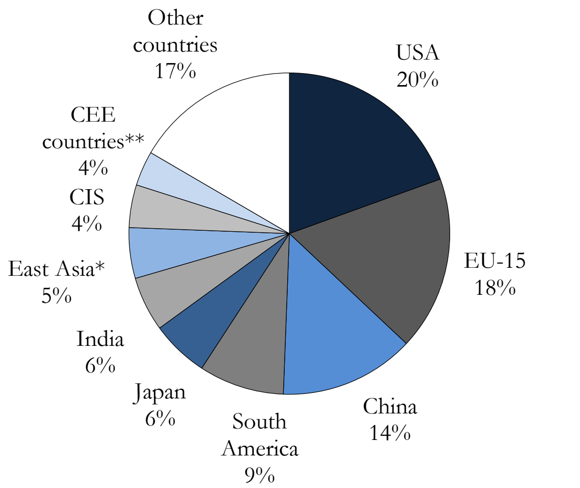
The IMF forecasts show that the global growth will decrease to 3.3% in 2012 in comparison with 5.2% in 2010. The low real GDP growth rates are expected in the developed countries – just 1.6% in 2011 and 1.2% in 2012. These forecasts are based on an assumption that the EU economic policy will be focused on limiting the crisis in the euro zone, but the USA economy will find a balance between the support to economy and fiscal consolidation in the medium term, as well as no new signs of instability will be observed in the global financial market. The growth rates in developing countries and the rapidly growing economies will slightly slow down in 2011 though still considered as high in comparison with the developed countries.

The economy growth of **the USA** slowed down in 2011. Although the growth was expected to slow down mainly in relation to a decreasing external demand due to the earthquake in Japan, as well as the declining domestic demand due to the rapid rise in oil prices, the decrease in economic activities was steeper than expected. Deteriorating confidence of households and enterprises, as well as downgraded USA credit rating and rising tension in the EU should also be noted. At the same time, inflation begins to retreat after the rapid increase. It is due to the slow rise in wages, which, on the other hand, relies on the slow increase in the number of jobs and economic slack.

Figure 2.1

**Breakdown of the World's GDP by Groups of Countries in 2010**

(structure, GDP by purchasing power parity units)




Source: *The World Economic Outlook September 2011*, 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

The economic growth of the **USA** is evaluated at 1.8% in 2011. Also in 2012, the economy of the USA is expected to grow by 1.8%. The negative influence of the earthquake in Japan and the rise in prices for energy resources became weaker in the second half of 2011, the payroll tax is to be temporarily reduced and insurance in case of unemployment is to be temporary raised in 2012. However, consumer and entrepreneurs confidence is reduced due to current losses in the stock market, low housing prices, as well as huge debt commitments.

[1] In the preparation of the section, periodicals *World Economic Outlook September 2011, International Monetary Fund* and *European Commission European Economy 6/2011* are used

In 2012, the unemployment rate, which currently exceeds 9%, is expected to remain high all year round. However, the output gap of its potential level, as well as the dropping prices in world commodity markets will determine the decrease in inflation rates from 3% in 2011 to 1.3% in 2012.

The growth of **Asian countries** has been comparatively steady and rapid both during and after the crisis, though it slightly slowed down in 2011 due to the weaker external demand.

Further on, the growth of the region is expected slightly slower yet steady on a condition that tensions in global financial markets will not rise. The decrease of external demand is planned to be compensated by domestic demand.

The growth in the Asian region is estimated at 6.2% in 2011. The most rapid growth was observed in China and India, while Japan went through a slight recession. Yet, the growth of the region in 2012 is expected to be slightly more rapid – by 6.6% due to economic development in Japan.

Table 2.2

**The Main Macroeconomic Indicators of the EU Member States**

(per cent)

| | GDP growth | | | Consumer prices | | | Current account balance (% of GDP) | | | Unemployment | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2010 | 2011f | 2012f | 2010 | 2011f | 2012f | 2010 | 2011f | 2012f | 2010 | 2011f | 2012f |
| **EU, total** including: | **2.0*** | **1.6*** | **-0.1*** | **2.0** | **3.0** | **1.8** | **-0.1** | **-0.2** | **0.0** | **...** | **...** | **...** |
| Austria | 2.1 | 3.3 | 1.6 | 1.7 | 3.2 | 2.2 | 2.7 | 2.8 | 2.7 | 4.4 | 4.1 | 4.1 |
| Belgium | 2.1 | 2.4 | 1.5 | 2.3 | 3.2 | 2.0 | 1.0 | 0.6 | 0.9 | 8.4 | 7.9 | 8.1 |
| Denmark | 1.7 | 1.5 | 1.5 | 2.3 | 3.2 | 2.4 | 5.1 | 6.4 | 6.4 | 4.2 | 4.5 | 4.4 |
| Finland | 3.6 | 3.5 | 2.2 | 1.7 | 3.1 | 2.0 | 3.1 | 2.5 | 2.5 | 8.4 | 7.8 | 7.6 |
| France | 1.4* | 1.6* | 0.2* | 1.7 | 2.1 | 1.4 | -1.7 | -2.7 | -2.5 | 9.8 | 9.5 | 9.2 |
| Germany | 3.6* | 3.0* | 0.3* | 1.2 | 2.2 | 1.3 | 5.7 | 5.0 | 4.9 | 7.1 | 6.0 | 6.2 |
| Greece | -4.4 | -5.0 | -2.0 | 4.7 | 2.9 | 1.0 | -10.5 | -8.4 | -6.7 | 12.5 | 16.5 | 18.5 |
| Ireland | -0.4 | 0.4 | 1.5 | -1.6 | 1.1 | 0.6 | 0.5 | 1.8 | 1.9 | 13.6 | 14.3 | 13.9 |
| Italy | 1.5* | 0.4* | -2.2* | 1.6 | 2.6 | 1.6 | -3.3 | -3.5 | -3.0 | 8.4 | 8.2 | 8.5 |
| Luxemburg | 3.5 | 3.6 | 2.7 | 2.3 | 3.6 | 1.4 | 7.8 | 9.8 | 10.3 | 6.2 | 5.8 | 6.0 |
| The Netherlands | 1.6 | 1.6 | 1.3 | 0.9 | 2.5 | 2.0 | 7.1 | 7.5 | 7.7 | 4.5 | 4.2 | 4.2 |
| Portugal | 1.3 | -2.2 | -1.8 | 1.4 | 3.4 | 2.1 | -9.9 | -8.6 | -6.4 | 12.0 | 12.2 | 13.4 |
| Spain | -0.1* | 0.7* | -1.7* | 2.0 | 2.9 | 1.5 | -4.6 | -3.8 | -3.1 | 20.1 | 20.7 | 19.7 |
| Sweden | 5.7 | 4.4 | 3.8 | 1.9 | 3.0 | 2.5 | 6.3 | 5.8 | 5.3 | 8.4 | 7.4 | 6.6 |
| United Kingdom | 2.1* | 0.9* | 0.6* | 3.3 | 4.5 | 2.4 | -3.2 | -2.7 | -2.3 | 7.9 | 7.8 | 7.8 |
| Bulgaria | 0.2 | 2.5 | 3.0 | 3.0 | 3.8 | 2.9 | -1.0 | 1.6 | 0.6 | 10.3 | 10.2 | 9.5 |
| Cyprus | 1.0 | 0.0 | 1.0 | 2.6 | 4.0 | 2.4 | -7.7 | -7.2 | -7.6 | 6.4 | 7.4 | 7.2 |
| Czech Republic | 2.3 | 2.0 | 1.8 | 1.5 | 1.8 | 2.0 | -3.7 | -3.3 | -3.4 | 7.3 | 6.7 | 6.6 |
| Estonia | 3.1 | 6.5 | 4.0 | 2.9 | 5.1 | 3.5 | 3.6 | 2.4 | 2.3 | 16.9 | 13.5 | 11.5 |
| Hungary | 1.2 | 1.8 | 1.7 | 4.9 | 3.7 | 3.0 | 2.1 | 2.0 | 1.5 | 11.2 | 11.3 | 11.0 |
| Latvia | -0.3 | 4.0 | 3.0 | -1.2 | 4.2 | 2.3 | 3.6 | 1.0 | -0.5 | 19.0 | 16.1 | 14.5 |
| Lithuania | 1.3 | 6.0 | 3.4 | 1.2 | 4.2 | 2.6 | 1.8 | -1.9 | -2.7 | 17.8 | 15.5 | 14.0 |
| Malta | 3.1 | 2.4 | 2.2 | 2.0 | 2.6 | 2.3 | -4.8 | -3.8 | -4.8 | 6.9 | 6.3 | 6.2 |
| Poland | 3.8 | 3.8 | 3.0 | 2.6 | 4.0 | 2.8 | -4.5 | -4.8 | -5.1 | 9.6 | 9.4 | 9.2 |
| Romania | -1.3 | 1.5 | 3.5 | 6.1 | 6.4 | 4.3 | -4.3 | -4.5 | -4.6 | 7.6 | 5.0 | 4.8 |
| Slovakia | 4.0 | 3.3 | 3.3 | 0.7 | 3.6 | 1.8 | -3.5 | -1.3 | -1.1 | 14.4 | 13.4 | 12.3 |
| Slovenia | 1.2 | 1.9 | 2.0 | 1.8 | 1.8 | 2.1 | -0.8 | -1.7 | -2.1 | 7.3 | 8.2 | 8.0 |

Source: *The World Economic Outlook September 2011, International Monetary Fund*
* According to latest data of *The World Economic Outlook Update January 2012, International Monetary Fund*
f – forecast

High budget deficit and government debt along with lower manufacturing potential and uncertainties in global financial market determine the deteriorating growth in the **developed EU countries**.

After the comparatively high growth in early 2011, it has been decreasing in the euro zone since the 2nd quarter of 2011. The growth slowdown is to a great extent influenced by reducing real household income due to a rise in prices observed in global commodity markets, fiscal restrictions, as well as the low consumer and entrepreneur confidence at the beginning of 2011. The growth of domestic demand in the developed EU countries still lags behind the GDP growth mainly due to the weak household consumption. Furthermore, external demand continues decreasing and will remain moderate in the near future.

Growth rates in the developed EU countries dropped from 2% in the first half of 2011 to 1% in the second half of the year. Along with increasing risks, the IMF has reduced the economic growth forecast of the EU countries for 2012 from 1.4% to -0.1%. Yet, the growth still differs among countries of some regions. Denmark, Germany, the Netherlands, Sweden, and Switzerland are closer to growth of the pre-crisis period, while the situation is much more severe in such countries as Ireland, Greece, and Portugal.

After the deep economic downturn in **the Baltic States,** the growth has resumed since the end of 2009. In 2011, the growth rates in the Baltic States were among the highest in the EU.

The economic growth of the Baltic States is based on a significant increase in export fostered by external demand, as well as by improving competitiveness of producers during the crisis. Also, the situation in the labour market has been considerably improved in comparison with 2010.

The growth rates in 2012 will be slower along with the declining external demand; however they will still be above the average EU indicator.

Due to the remaining high prices in the world commodity markets, the economy of **the CIS countries** continues recovering though not as fast as during the pre-crisis period. Private demand is still low in countries with comparatively weaker financial systems. Also money transfers by people working abroad and capital flows are at a much lower level than shortly before the crisis. Global recession and caution of investors raise concerns about further access to financial resources.

In the CIS countries group, growth by 4.5% in 2011, while in 2012 – by 3.7% is expected.

The growth in Russia is likely to be slightly below the average rate of the region. Although oil prices will remain high, they will be slightly lower than expected. Also capital flows still lag behind the pre-crisis level due to the coming presidential elections and uncertainties in the business environment.

Table 2.3

**Main Macroeconomic Indicators of the CIS**

(per cent)

| | **2010** | **2011f** | **2012f** |
|---|---|---|---|
| GDP growth* | 4.6 | 4.5 | 3.7 |
| including Russia | 4.0 | 4.1 | 3.3 |
| Consumer prices | 7.2 | 10.3 | 8.7 |
| including Russia | 6.9 | 8.9 | 7.3 |
| Current account balance (% of GDP) | 3.8 | 4.6 | 2.9 |
| including Russia | 4.8 | 5.5 | 3.5 |

Source: *The World Economic Outlook September 2011*, *International Monetary Fund*

* According to the latest data of *The World Economic Outlook Update January 2012*, *International Monetary Fund*

f – forecast

**The main risks to the global growth are related to the slowdown of the USA growth rates, as well as to the concerns about instability of financial sector in the euro zone in relation to huge budget deficits and high government debt commitments. Further growth will depend on efficiency of policy measures for ensuring stable financial sector and reducing macroeconomic imbalance.**

# 3. GROWTH

## 3.1. Gross Domestic Product and Aggregate Demand

### 3.1.1. Development Trends

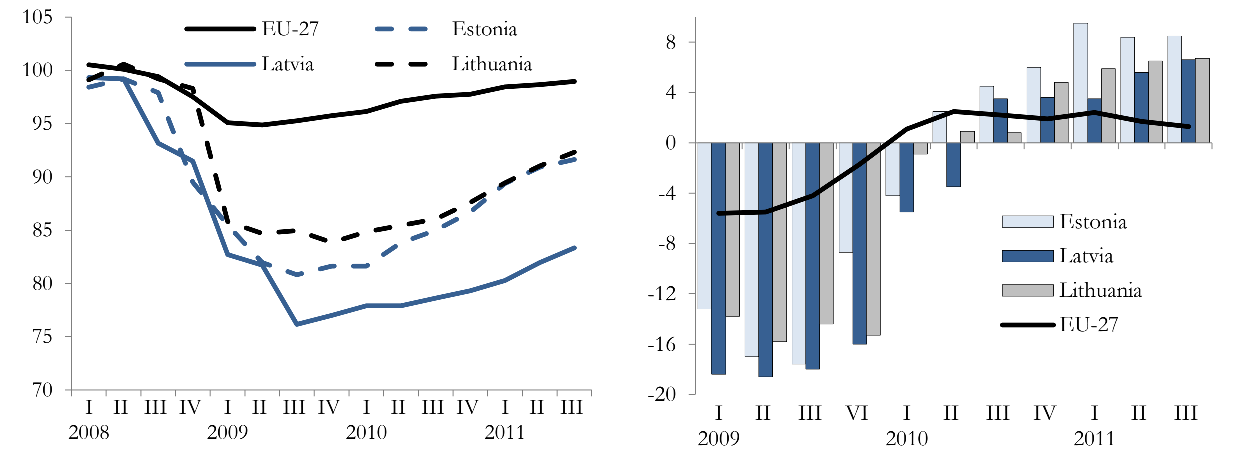
The global financial crisis severely affected the national economy of Latvia. During the crisis, gross domestic product decreased approximately by 25%. Since the 4th quarter of 2009, GDP started increasing and in 2010 increased on average by 0.9% every quarter. As a result, the average GDP level of 2010 slightly lagged behind the indicator of 2009.

In the 3rd quarter of 2011, GDP exceeded the level of the corresponding period of 2010 by 6.6%. GDP was by 9.6% higher than in the lowest point of the crisis in the 3rd quarter of 2009. Overall, in three quarters of 2011, GDP exceeded the level of first three quarters of 2010 by 5.4 per cent.

Figure 3.1

**GDP Dynamics by Quarters**

Seasonally adjusted data, 4th quarter of 2007 = 100 | Against the respective period of the previous year, %




Recovery of the economy is mainly based on an increase in export, the volumes of which has already reached the pre-crisis level. The demand for export of Latvian goods had a positive impact on the growth of tradable sectors – particularly on the growth of the key industry – manufacturing.

The increase in export 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 the 3rd quarter of 2011, the export volumes have increased by 10.3% in comparison with the 3rd quarter of 2010. Volumes of goods and service export have increased by 31.2% if compared to the lowest point of the crisis in the 1st quarter of 2009 and have now reached the highest indicator ever.

Table 3.1

**GDP of Latvia by Expenditure Items**

| | 2008 | 2009 | 2010 | 2011 I-IX | 2008 | 2009 | 2010 | 2011 I-IX |
|---|---|---|---|---|---|---|---|---|
| | changes compared to the corresponding period of the previous year, % | | | | contribution to growth, % | | | |
| Private consumption | -5.8 | -22.6 | 0.4 | 4.5 | -4.3 | -16.2 | 0.3 | 3.1 |
| Public consumption | 1.6 | -9.4 | -9.7 | 1.5 | 0.2 | -1.4 | -1.6 | 0.2 |
| Gross fixed capital formation | -13.8 | -37.4 | -12.2 | 24.6 | -5.1 | -12.2 | -3.1 | 5.0 |
| Inventories | – | – | – | – | -2.3 | -2.5 | 4.6 | 1.8 |
| Exports | 2.0 | -14.1 | 11.5 | 13.2 | 0.9 | -6.3 | 5.4 | 6.9 |
| Imports | -10.8 | -33.3 | 11.5 | 20.5 | -7.3 | 20.9 | 5.9 | -11.6 |
| **GDP** | **-3.3** | **-17.7** | **-0.3** | **5.4** | **-3.3** | **-17.7** | **-0.3** | **5.4** |

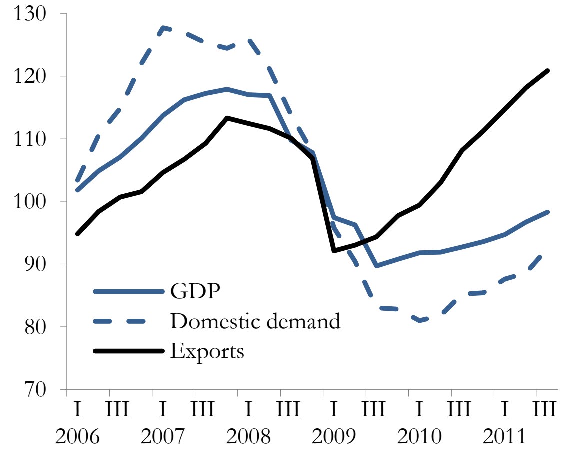
Increased profits from export have fostered the growth of domestic demand. Domestic demand has been growing since the beginning of 2010.

The GDP increased by 9.8% in the 3rd quarter of 2011 compared to the 3rd quarter of 2010. In comparison with the lowest level of domestic demand during the crisis (the 4th quarter of 2009), it has grown by 11.9%. The increase in domestic demand in the three quarters of 2011 is related, to a great extent, to increasing investments and private consumption.

Figure 3.2

**GDP and Major Expenditure Items**

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




As domestic demand decreased during the crisis, also volumes of import shrunk fast and the export-import balance of Latvia significantly improved though remaining negative overall in 2010. In 2010, the balance was -1.4% of GDP (in 2007 and 2008, the negative export-import balance was approximately 33% of GDP).

Currently, both the increasing export volumes and the improving situation in the domestic market are fostering the growth of import.

The increase in import in 2011 was particularly based on the rapid rise in investments, thus increasing the negative export-import balance of foreign trade to 2.9% of GDP. Such increase is justified because it is more related to the increase in investments and less to the increase in private consumption.

## 3.1.2. Private and Public Consumption

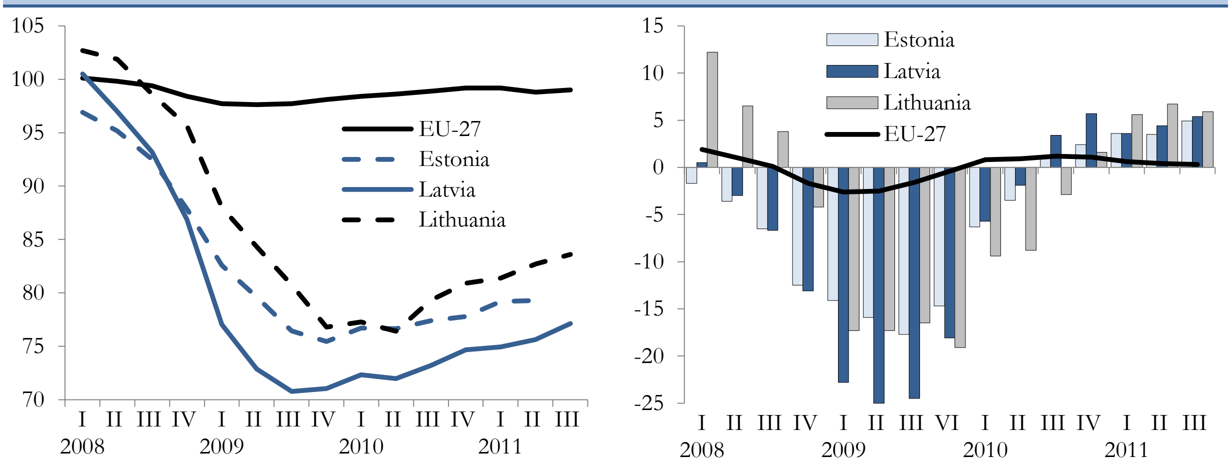
The decrease of **private consumption** started at the beginning of 2008 and reached the lowest point in the 3rd quarter of 2009. During six quarters of the crisis period, private consumption reduced by 30% (if compared with the 1st quarter of 2008). The decreasing private consumption was mainly based 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, fostered by the improving situation in the labour market (an increase in employment and wages). Overall, private consumption continued growing in 2010; however, since it began growing from a relatively low level, private consumption only exceeded the indicator of 2009 by 0.4 per cent.

Figure 3.3

**Changes in Private Consumption**

Seasonally adjusted data, 4th quarter of 2007 = 100 | Against the respective period of the previous year, %

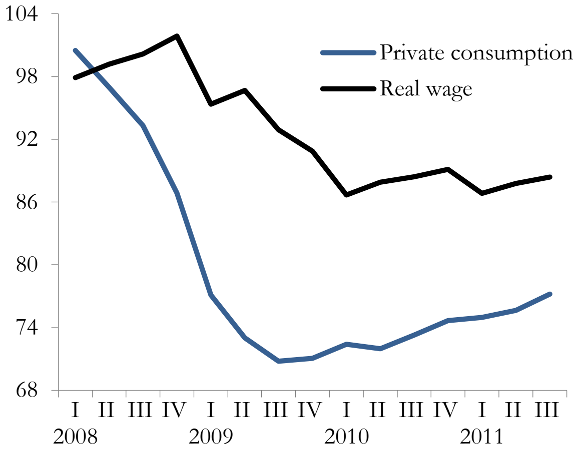



In 2011, the positive growth trends continued, and in the 3rd quarter of 2011, private consumption exceeded the level of the 3rd quarter of 2010 by 5.4%. The growth is based on both increasing employment and gradual increase in wages. Private consumption is growing at a slower pace than GDP. It lags behind the level of 2008 by 76.8 per cent.

Figure 3.4

**Dynamics of Real Wage and Private Consumption by Quarters**

(4th quarter of 2007 = 100)

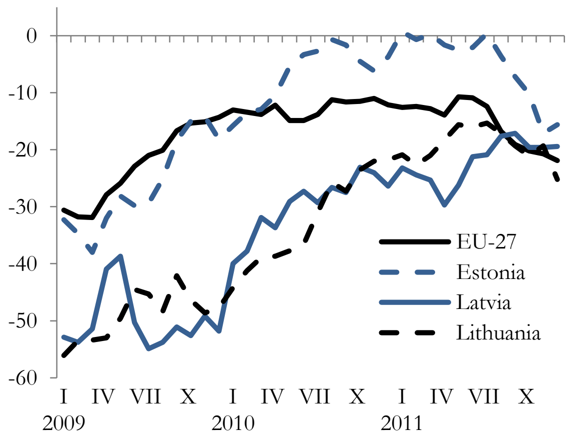



Consumer confidence is improving. Since August 2009, consumers are no longer that pessimistic though their confidence is still negative. (It should be noted that consumer confidence has been negative also during the rapid growth years.)

Figure 3.5

**Consumer Confidence Indicator***

(response balance, seasonally adjusted data)



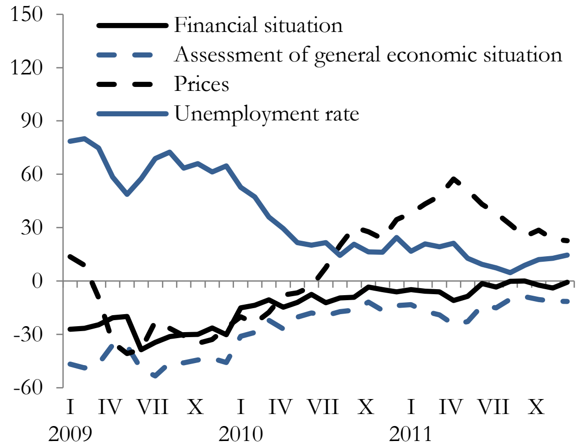

* Consumer confidence indicator is calculated as the average balance amount of responses to the 4 questions regarding financial situation, general economic situation, evaluation of unemployment and savings for the following 12 months

In December 2011, consumer confidence was by 7 points higher than in December 2010, contrary to the average consumer confidence in the European Union which is worsening during this period.

Figure 3.6

**Consumer Expectations for the Next 12 Months**

(response balance, seasonally adjusted data)

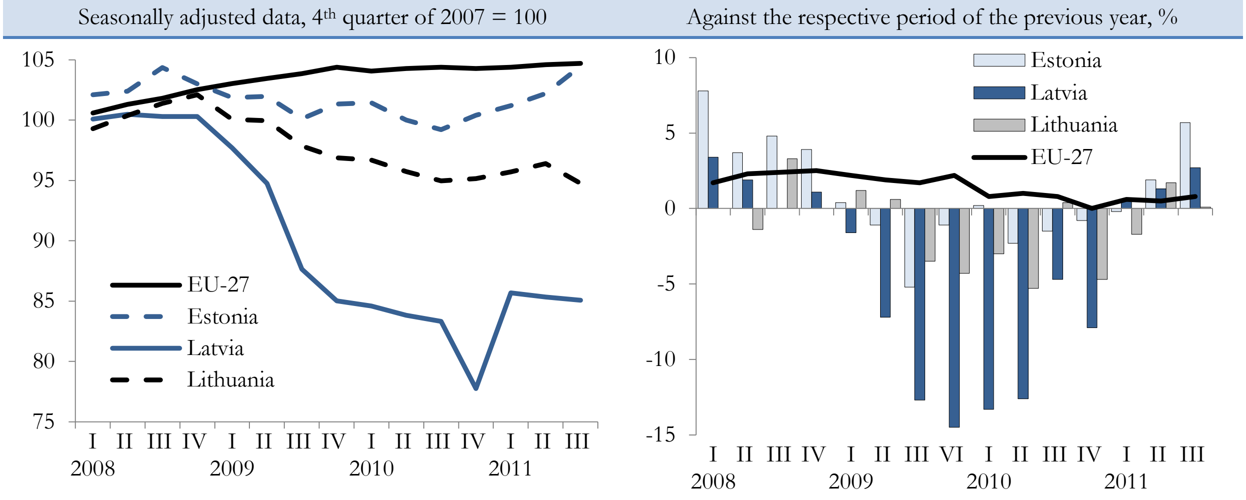



**Public consumption** or public services amount to 15% of the total domestic demand, and its value is determined by the volume of the provided public services. The volumes of public consumption are related to implementation of the state budget consolidation measures. Therefore, public consumption decreased during the crisis. Its share in GDP structure was 19.6% in 2009 and 17.2% in 2010.

Despite budget consolidation measures, the amount of public services is increasing in 2011 (in the 3rd quarter of 2011 – by 2.7%).

Figure 3.7

**Changes of Public Consumption**




## 3.1.3. Investments

Investments are characterised by rather strong cyclical fluctuations. The range of fluctuations in terms of investment amounts in Latvia was much wider than in other EU Member States.

The depth of investment adjustments in Latvia was intensified by the huge debts of enterprises accumulated during the rapid growth years, as well as by worsening creditworthiness of the Latvian banking system. The investment volumes in the national economy of Latvia in 2008 decreased by 13.8%, but in 2009, the volumes were decreased 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 on 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.

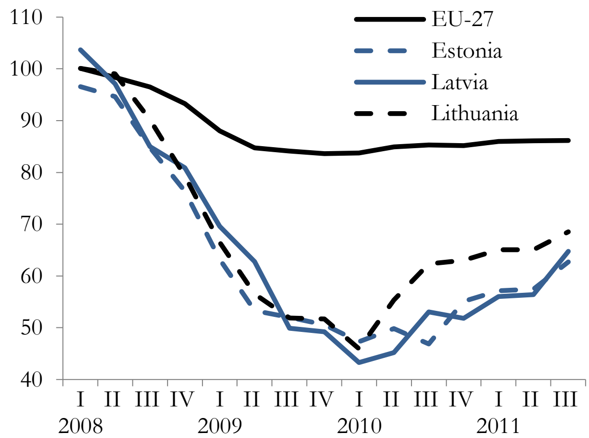
In 2010, investments in the national economy of Latvia were by 19.6% lower than in 2009. But in 3 quarters of 2011, in comparison with the corresponding period of the previous year, investments increased by 24.6%. The investment adjustment over the course of three years has been much more intense than the GDP adjustment. Since 2008, the investment volumes have decreased by a half and in 2010 constituted only 19.5% of GDP (in 2007 – 34.1% of GDP).

A significant decline in investments during the recession was observed also in other 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 EU countries have decreased on average by 13.5% 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 (in 2010 compared with 2007, investments increased by 6.2%). However, the decrease of investment volumes in the Baltic States and Ireland has exceeded the EU average almost four times.

Figure 3.8

**Changes in Investment Volumes in the Baltic States**

(4th quarter of 2007 = 100)




In 2009, the investment dynamics was negative in all EU Member States. But in 2010, positive investment dynamics was restored in numerous EU Member States, while investment volumes in Latvia reached 80% of the level of the previous year.

The decrease of private investments in Latvia was intensified also by the decrease of public investment volumes due to the necessity to implement budget consolidation measures. In 2008 and 2009, public investments decreased by 15.4% and 24% respectively. In 2010, public investments constituted 85% of the level of 2009. Overall they shrunk by almost a half in three years. Despite the fact that the decrease in public investment volumes to a certain extent intensified recession of overall investments, the state plays an important role in the process of investing as the state provides significant support to private investments through the EU Structural Funds co-funding. Moreover, the share of public investments in overall investments in the Latvian national economy reached 19% in 2010, i.e. almost 3 percentage points more than in 2007. In the three quarters of 2011, public investments increased by 16.4% and constituted 19% of GDP.

Table 3.2

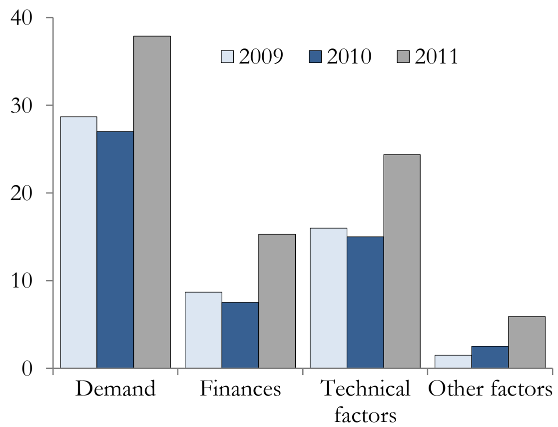
**Gross Capital Formation**

| | 2004-2007 average annually | 2008 | 2009 | 2010 | 2011 I-IX |
|---|---|---|---|---|---|
| | growth in per cent | | | | |
| GDP | 9.9 | -3.3 | -17.7 | -0.3 | 5.4 |
| Gross Capital Formation | 14.9 | -19.7 | -47.1 | 7.2 | 31.3 |
| – gross fixed capital formation | 17.7 | -13.8 | -37.4 | -12.2 | 24.6 |
| | % of GDP | | | | |
| Gross Capital Formation | 37.1 | 31.2 | 20.5 | 20.9 | 24.6 |
| – gross fixed capital formation | 32.0 | 29.7 | 21.6 | 19.5 | 20.9 |
| – changes in inventories | 5.1 | 1.6 | -1.1 | 1.4 | 3.7 |

Polling 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 if compared with the previous years. Also, improving funding conditions are considered as an important factor limiting investments and relating to slow restoration of private sector crediting channels.

Figure 3.9

**Factors limiting investments**




On the other hand, the capacity load level in manufacturing has been gradually increasing since the beginning of 2010. In October 2011, it reached 69%, which is just 3 percentage points below the level of the end of 2007. It indicates that the current manufacturing volume is approaching its potential. Increase of demand, as well as entrepreneurs' positive future vision 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 consolidate positions in foreign and domestic markets including by technologically renewing the existing capacity loads.

**Structure of the investment sectors**[1]**.** Though the overall investment volumes decreased more in 2008 than in 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. Yet, 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 the production of goods decreased by 18%, but in the services sector increased by 6 per cent.

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

In general, the investment process in 2010 has been weak especially in the service sectors. If compared with 2009, investments in service sectors decreased by 31%. However, investments in goods production sector were by just 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

[1] Investments in sectors are presented according to the non-financial investment statistics that do not include all investments in fixed assets

be noted that investments in manufacturing sector increased by 5.5 per cent.

Stabilizing economic situation positively affected the investing process in Latvia. It is recovering quite rapidly. According to provisional data, investment dynamics of goods production sectors is almost 3 times faster than the dynamics of service sectors. In the three quarters of 2011, investments in service sectors increased by 17.6% and constituted almost 60% of total investments in the national economy of Latvia. Investments in goods production sectors in three quarters of 2011 were almost one and a half times more than a year ago. It was mainly due to the extensive investments in the energy sector and manufacturing.

Table 3.3

**Dynamics and Structure of Investment Sectors**

| | Growth rates | | | | Structure | | | |
|---|---|---|---|---|---|---|---|---|
| | 2004-2007 average annually | 2009 | 2010 | 2011 I-IX* | 2004-2007 average annually | 2009 | 2010 | 2011 I-IX* |
| Primary sectors | 7.6 | -41.0 | -16.3 | 54.0 | 4.4 | 3.8 | 5.9 | 6.1 |
| Manufacturing | 17.9 | -53.1 | 5.5 | 39.5 | 16.2 | 9.3 | 13.0 | 18.7 |
| Electricity, gas, and water supply | 13.2 | -35.3 | -9.8 | 52.9 | 7.8 | 8.2 | 9.7 | 16.4 |
| Construction | 26.1 | -46.1 | -33.3 | 51.6 | 7.2 | 9.1 | 8.0 | 1.6 |
| Trade | 5.0 | -50.6 | -24.2 | 19.0 | 13.2 | 8.0 | 8.0 | 6.9 |
| Transport and communications | 3.0 | -40.1 | 8.1 | 22.8 | 13.2 | 11.5 | 19.4 | 19.3 |
| Other commercial services | 22.8 | -30.9 | -37.7 | -12.5 | 23.4 | 25.0 | 20.6 | 6.3 |
| Public services | 19.5 | 0.0 | -44.3 | 23.8 | 14.7 | 25.1 | 18.5 | 24.8 |
| **Total** | **15.6** | **-34.4** | **-24.2** | **28.5** | **100** | **100** | **100** | **100** |

* estimated by using quarterly data

Investments in manufacturing have been gradually increasing since the end of 2010, though the investment level in the sector still is rather low. From 2007 until 2009, investments in the 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%).

Table 3.4

**Dynamics and Structure of Investments in Manufacturing**

(per cent)

| | Growth rates | | | | Structure | | | |
|---|---|---|---|---|---|---|---|---|
| | 2004-2007 average annually | 2009 | 2010 | 2011 I-IX* | 2004-2007 average annually | 2009 | 2010 | 2011 I-IX* |
| Food industry | -1.8 | -52.0 | -6.1 | 57.2 | 21.8 | 15.1 | 13.4 | 14.7 |
| Light industry | -13.3 | -32.8 | -30.0 | 19.3 | 2.7 | 2.5 | 1.7 | 1.0 |
| Wood processing | 18.2 | -88.3 | 139.6 | 174.0 | 26.4 | 8.4 | 19.1 | 30.4 |
| Paper industry and publishing | 20.2 | -71.5 | 152.6 | 144.5 | 7.2 | 2.5 | 5.9 | 3.0 |
| Chemical industry and related industries | 24.3 | -11.4 | 16.3 | 6.4 | 7.6 | 12.2 | 13.5 | 10.0 |
| Production of other non-metallic mineral products ** | 79.0 | -19.7 | -51.9 | -75.4 | 14.4 | 39.3 | 17.9 | 7.7 |
| Production of metals and metal articles** | 20.5 | -59.4 | 130.1 | 420.1 | 7.1 | 7.0 | 15.2 | 23.1 |
| Production of machinery and equipment | 9.0 | -43.7 | 90.1 | 117.4 | 2.1 | 2.0 | 3.6 | 1.1 |
| Production of electrical and optical equipment | 7.1 | -53.7 | 15.8 | 130.7 | 2.5 | 1.1 | 1.9 | 1.5 |
| Production of vehicles | 25.0 | 0.4 | 43.2 | 183.3 | 2.3 | 4.5 | 3.5 | 4.8 |
| Other production industries | 20.9 | -27.0 | -23.7 | 168.0 | 5.8 | 5.4 | 4.3 | 2.7 |

* estimated by using quarterly data

** evaluation of the Ministry of Economics

In the first half of 2010, investments in the manufacturing remained at the level of the previous year, and the amount of investments started already growing at the end of the year. Overall in 2010, investments in the manufacturing were by 5.5% higher than in the previous year. It should be noted that investments in production sectors of non-durable consumer goods and investment goods are increasing the 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 tendencies in 2010 were observed also in metal processing and production of vehicles. Also in the 1st quarter of 2011, investments in these sectors exceeded the level of corresponding period of the previous year.

Since 2004, extensive investments have been made in production of construction materials. Though investment volumes in production of construction materials have decreased (annually by almost 20%) since 2008 due to deterioration of situation in real estate market, in nine months of 2011, investments in this sector constituted almost a half of total investments in manufacturing industry.

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 near future, investment volumes in the national economy of Latvia are likely to increase gradually. However, the dynamics of the investing process to a 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

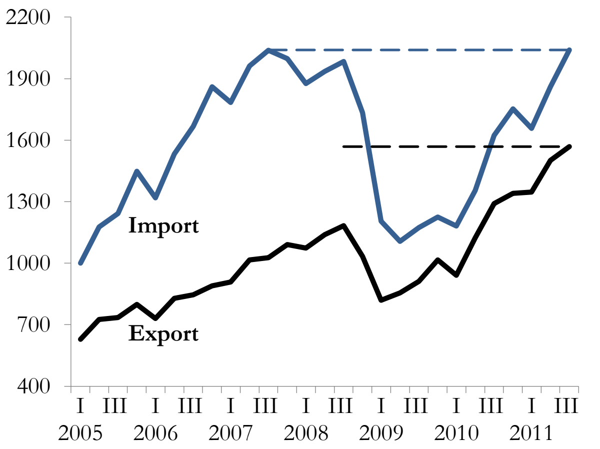
<u>**Export and import of goods**</u>

After the global financial crisis, export of Latvian goods has resumed stable growth which is slightly faster than before the crisis thus allowing to reach the pre-crisis level of export of goods. Overall, in 2010 it increased by 30% in actual prices in comparison with 2009 and by 6% in comparison with the pre-crisis level in 2008 (respectively by 20% and 9% at comparable prices). Export of goods continued increasing rapidly also in 2011 (in January-November 2011, increase was by 30% in actual prices if compared to January-November, 2010).

Import of goods is also growing similarly to export in the post-crisis period. Yet, considering the rapid decrease in import of goods at the end of 2008 and at the beginning of 2009 which was much more significant than the decrease of export, it still is slightly behind the pre-crisis level. In January-November 2011, volumes of import of goods in actual prices have increased by 31% in comparison with January-November, 2010.

Figure 3.10

**Export and Import of Goods by Quarters**
(million LVL)

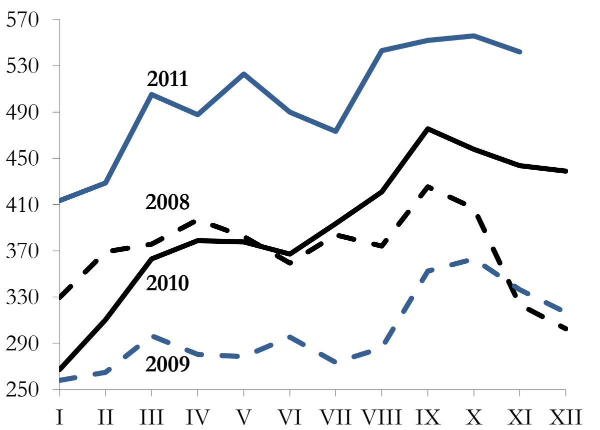



It should be noted that the negative balance of export and import of goods has significantly shrunk due to the global financial crisis. At the end of 2006, import of goods was double the export, while in the 3rd quarter of 2011, import exceeded exports by approximately 30 per cent.

In 2010, changes in the trading conditions positively influenced **export of goods**. The export unit value index increased by 14 % and the import unit value index – by 7% in comparison with the three quarters of 2010. In the three quarters of 2011, the most significant increase of the export unit value was for metal and metal articles, agricultural and food products, as well as wood and timber products. Yet, it has slightly decreased for machine engineering products.

Figure 3.11

**Export of Goods by Months**
(million LVL)



In 2010, export volumes of goods increased in all product groups; and this increase was mostly due to wood and wood products, metal processing products, as well as agricultural and food product export. All together, these groups ensured almost 2/3 of the total export increase in 2010.

From January until November 2011, growth was observed in all goods export groups, if compared to the corresponding period of 2010. The total increase in export was mostly due to the increase in export of mineral products (19%), metal and metal articles (18%), and chemical industry group products (13%).

Table 3.5

**Main Commodity Groups for Export**

(%, in actual FOB prices)

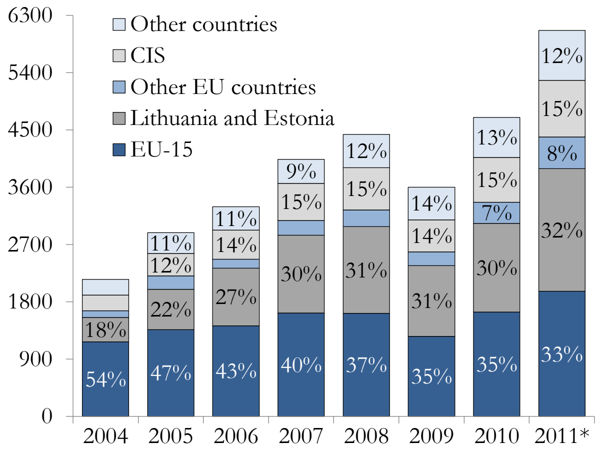
| | 2010 | | 2011 I-XI | |
|---|---|---|---|---|
| | structure | increase compared to the previous year | increase compared to the corresponding period of the previous year | contribution in changes of volume |
| **Total** including: | **100** | **30.3** | **29.6** | **29.6** |
| wood and wood products | 19.0 | 49.5 | 15.9 | 3.1 |
| agriculture and food products | 17.9 | 25.3 | 18.4 | 3.2 |
| metal and metal articles | 13.8 | 45.2 | 39.0 | 5.4 |
| machinery products | 13.0 | 19.6 | 20.3 | 2.6 |
| products of chemical industry and related industries, plastics | 10.7 | 22.7 | 35.3 | 3.8 |
| minerals | 6.0 | 41.8 | 91.4 | 5.6 |
| vehicles | 6.0 | 11.2 | 39.1 | 2.4 |
| light industry products | 5.0 | 14.8 | 20.9 | 1.0 |
| other goods | 8.6 | 29.4 | 29.4 | 2.5 |

Export to the EU Member States increased by 30% in 2010, but from January until November 2011 – by 31%, in comparison with the corresponding period of 2010. The growth in export of metal product group traditionally contributed the most to this increase (23% of total increase in export to the EU countries). Considering the large share of the EU countries in the Latvian export (75% of the total increase of export), this group was the main influencing factor on the overall tendencies in Latvian export.

Figure 3.12

**Structure of Latvian Export by Groups of Countries**

(million LVL)



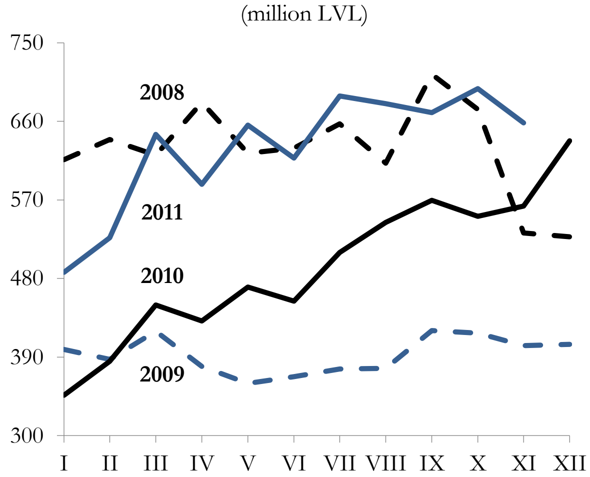

* evaluation by the Ministry of Economics

In 2010, export to the CIS countries increased by 40%, but from January until November 2011 increased slightly slower – by 26%, in comparison with the same period a year ago. The largest contribution to the export increase from January until November 2011 to the CIS countries was on the account of agricultural and food products group, as well as machinery industry group, altogether constituting more than a half of all export increase to the CIS countries.

Figure 3.13

**Import Dynamics of Goods by Months**

(million LVL)




Also the **import of goods** rapidly increased in 2010 (by 26%). The increase was observed in all product groups, especially in metal and metal articles, machinery and chemical industry product groups. From January until November 2011, import of goods has increased even more rapidly – by 31% in comparison with the corresponding period of the previous year, due to growing demand for intermediate consumer goods in manufacturing, demand for investment goods, as well as the increase in private consumption. Minerals, machine engineering production, metal processing products, as well as vehicle import groups contributed to import the most in this period, altogether constituting more than 70% of the total import increase.

Import from the EU and CIS countries has increased equally rapidly.

Table 3.6

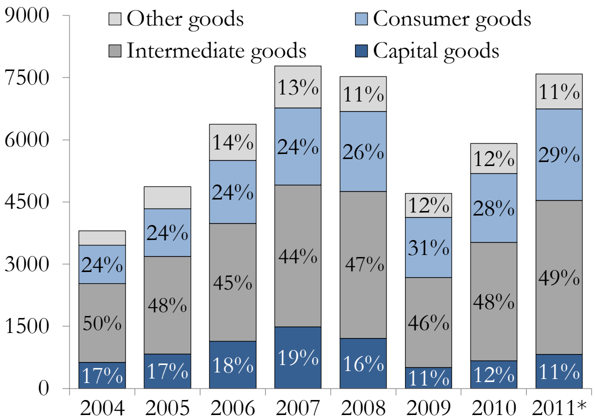
**Main Commodity Groups of Import**
(%, in current CIF prices)

| | 2010 | | 2011 I-XI | |
|---|---|---|---|---|
| | structure | increase compared to the previous year | increase compared to the corresponding period of the previous year | contribution in changes of volume |
| **Total** including: | **100** | **25.5** | **31.1** | **31.1** |
| minerals | 15.4 | 12.2 | 53.1 | 8.1 |
| machinery products | 16.4 | 31.3 | 33.2 | 5.5 |
| products of chemical industry and related industries, plastics | 16.9 | 25.3 | 15.0 | 2.6 |
| agriculture and food products | 16.3 | 11.6 | 17.7 | 2.9 |
| metal and metal articles | 11.6 | 79.9 | 42.0 | 4.4 |
| vehicles | 7.2 | 39.2 | 58.2 | 4.2 |
| light industry products | 5.7 | 13.6 | 17.7 | 1.1 |
| wood and wood products | 1.6 | 45.7 | 18.9 | 0.3 |
| other goods | 9.0 | 16.9 | 21.9 | 2.0 |

The share of import 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 import of capital goods and intermediate goods is increasing more rapidly. Nevertheless, it should be noted that import volumes of these goods are considerably lower than in the pre-crisis period. The share of import of consumer goods is accordingly reducing as import volumes of these import groups remain at the level of 2009.

Figure 3.14

**Import by Classification of the Broad Economic Categories**
(relating to the basic sections of national accounts, in actual CIF prices, million LVL)

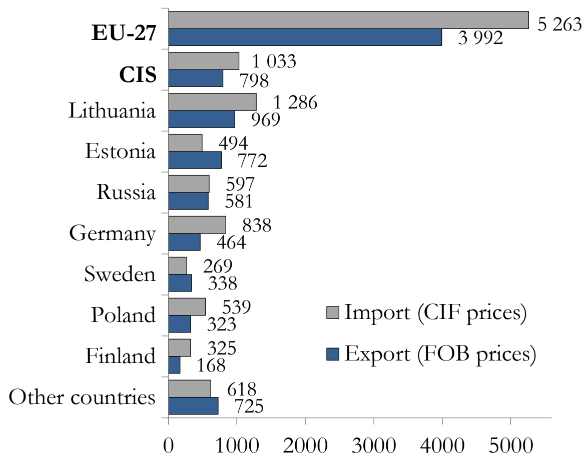



* evaluation by the Ministry of Economics

The biggest **trade partners** of Latvia from January until November, 2011 were Lithuania – 18% of the total foreign trade turnover, Germany and Estonia – 10%, Russia – 9%, Poland –7%, Sweden – 5%, and Finland – 4 per cent.

Figure 3.15

**Foreign Trade Turnover of Latvia in January-November 2011**
(million LVL)

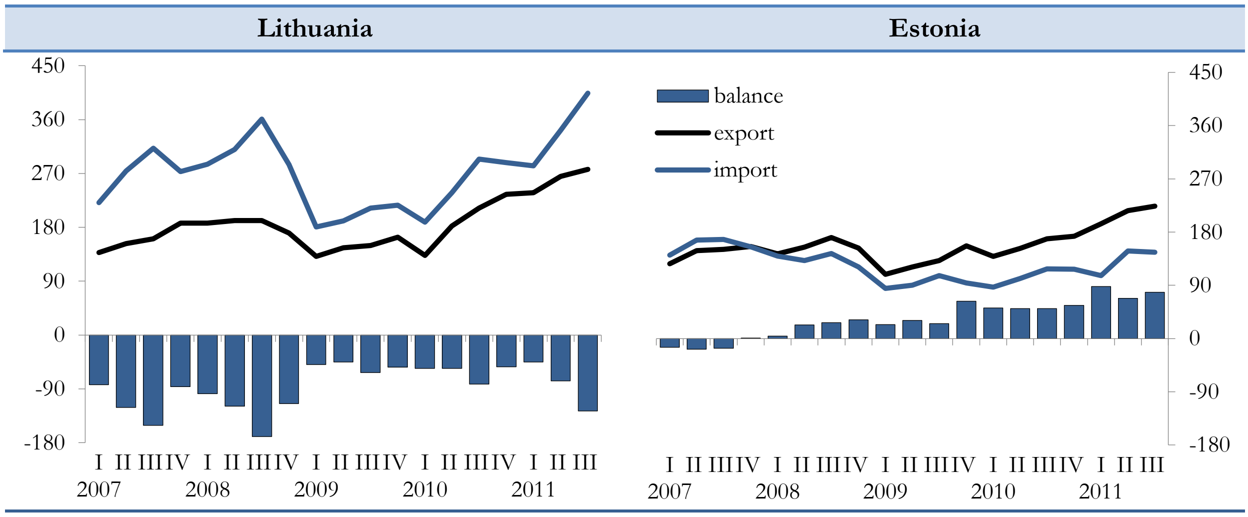



The most important foreign trade partner countries of Latvia traditionally are **Lithuania** and **Estonia**. Significant deterioration of the Latvian trade balance with both countries was observed during the rapid growth of the Baltic States. Yet, starting with the second half of 2008, when the total import volumes reduced, the foreign trade balance with Lithuania and Estonia started to improve gradually.

Since 2008, the foreign trade balance with Estonia has been positive and has a tendency of increasing, while with Lithuania it is still negative. The import from Lithuania from January until November 2011, exceeded the export by 33% (in 2010 – by 32%), while the export to Estonia exceeded the import by 56% (in 2010 – by 50%). Overall, the trade balance with both countries is almost neutral – import exceeds export by 2%. The main groups of products exported to Estonia and Lithuania are agricultural and food products, machinery products, as well as chemical industry products. Mineral products, agricultural and food products constitute the largest share of import from Lithuania. But agricultural and food products and chemical industry products constitute the largest share of import from Estonia.

Figure 3.16

**Foreign Trade Turnover of Latvia with Lithuania and Estonia by Quarters**
(million LVL)




__Export and import of services__

The decrease in export of services during the crisis was considerably smaller than export of goods. Therefore the export of services is growing slower than the export of goods.

The positive balance of services in 2010 almost completely covered the negative goods trade balance. If compared to 2009, volumes of export and import services slightly increased, thus maintaining a marked positive balance of services. Also from January–September 2011, the export and import grew at the same pace.

The revenues from transit transport still constitute half of the services export. Although the revenues from sea and air transport have slightly decreased, the overall transport export is growing on the account of rapid increase of revenues from land transport, in general the transport export continues to grow.

Table 3.7

**Export and Import of Services**
(per cent)

| | **2010** | | | | **2011 I-IX** | | | |
|---|---|---|---|---|---|---|---|---|
| | **structure** | | **changes compared with the previous year** | | **structure** | | **changes compared with the corresponding period of the previous year** | |
| | **export** | **import** | **export** | **import** | **export** | **import** | **export** | **import** |
| **Services – total** | **100** | **100** | **1.4** | **2.7** | **100** | **100** | **13.6** | **15.4** |
| including: | | | | | | | | |
| Transport services | 49.2 | 29.5 | -1.5 | 19.6 | 50.6 | 30.7 | 14.0 | 18.4 |
| – sea transport | 14.8 | 7.7 | -16.3 | 5.2 | 12.9 | 7.6 | -3.7 | 13.5 |
| – air transport | 9.3 | 10.6 | 13.9 | 32.4 | 8.6 | 10.3 | -3.0 | 8.1 |
| – other transport | 25.1 | 11.2 | 4.0 | 19.9 | 29.1 | 12.7 | 31.6 | 31.7 |
| Travel | 17.3 | 29.2 | -6.4 | -14.6 | 17.7 | 29.1 | 13.3 | 11.3 |
| Commercial services | 32.2 | 39.9 | 10.6 | 8.3 | 30.3 | 39.0 | 12.4 | 16.9 |
| Other services | 1.3 | 1.4 | 22.5 | -18.6 | 1.4 | 1.2 | 35.2 | -3.3 |

The revenues from tourists coming to Latvia and export of commercial services have increased in 2011.

Export of services to the EU countries constitutes about a half of the total export of services of Latvia. From January until September 2011, export of services volumes increased by 9%. In the three quarters of 2011, the increase in transport export as well as commercial service export to the EU countries contributed the most to export or services.

As the volumes of service export to the CIS countries rapidly increased during the last years, its share in the total export of services increased. From January until September 2011, export of services to the CIS countries increased by 14%. The largest contribution to this increase was on the account of the increase of transport export, as well as of revenues from tourists coming from the CIS countries. Meanwhile, the export of commercial services decreased.

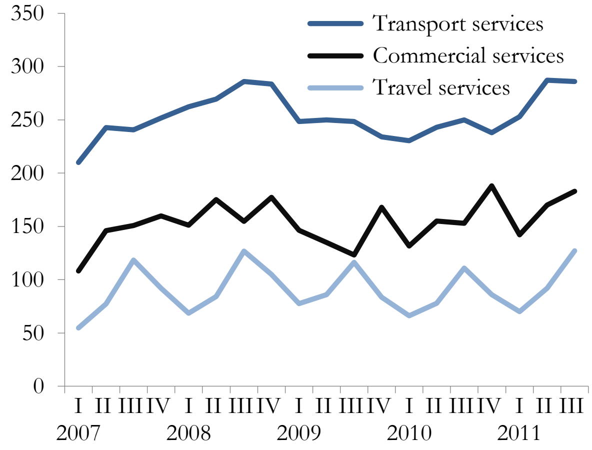
Export of services decreased to both Lithuania and Estonia from January until September 2011 (by 5% and 4%).

The main service export groups to both countries are commercial services and services related to transport.

Figure 3.17

**Export of Services by Quarters**

(million LVL)




## 3.2. Contribution of Sectors

### 3.2.1. Structure of Economy

The global financial crisis in 2008 and 2009 severely affected all key sectors of the national economy of Latvia. Sectors oriented to domestic demand – trade and construction – experienced the deepest decrease during the economic crisis. The decrease of external demand during the crisis resulted in significant decrease of the manufacturing volumes. At the end of 2009, along with resuming gradual growth in foreign trade partner countries, as well as restoring competitiveness due to reduced expenses, situation in tradable sectors and especially in the main export sector – manufacturing industry – started improving. The negative influence of the crisis was less intense in such export-oriented sectors as agriculture and forestry, as well as transport and storage.

During the crisis, the paradigm of economic growth has been changed in Latvia – the national economy has reoriented from domestic demand-based growth to export. Increase in revenues from export and growth of tradable sectors in post-crisis period fosters the growth of other sectors of the national economy. The increasing role of tradable sectors in the national economy is proven by the structure of sectors according to the value added. Before the crisis in 2007, agricultural, forestry, manufacturing and transport service sectors constituted 26% of the total value added, but in 2011, the share of these sectors already reached nearly 37 per cent.

Table 3.8

**Structure of the National Economy**

(per cent)

| | By value added | | | | By number of employed | | | |
|---|---|---|---|---|---|---|---|---|
| | **2008** | **2009** | **2010** | **2011e** | **2008** | **2009** | **2010** | **2011e** |
| Agriculture and forestry | 3.0 | 3.8 | 4.5 | 4.5 | 7.9 | 8.8 | 8.8 | 9.7 |
| Manufacturing | 10.8 | 10.9 | 13.4 | 14.2 | 14.8 | 13.2 | 13.7 | 13.7 |
| Other industry | 4.3 | 4.9 | 5.3 | 5.2 | 2.9 | 3.0 | 3.2 | 2.7 |
| Construction | 10.1 | 8.0 | 5.9 | 6.0 | 11.4 | 7.8 | 7.1 | 7.3 |
| Trade | 18.8 | 16.9 | 18.2 | 18.8 | 18.9 | 19.1 | 19.0 | 18.8 |
| Transport and storage | 8.1 | 11.1 | 12.1 | 12.8 | 8.6 | 8.9 | 8.7 | 8.7 |
| Other commercial services | 28.4 | 27.5 | 25.8 | 24.5 | 14.9 | 16.9 | 17.7 | 17.5 |
| Public services | 16.5 | 17.0 | 14.8 | 13.9 | 20.7 | 22.3 | 21.9 | 21.6 |
| **Total** | **100** | **100** | **100** | **100** | **100** | **100** | **100** | **100** |

e – evaluation by the Ministry of Economics

The structure of the national economy by the number of employed has also changed due to the crisis. The number of people employed in construction sector has decreased by over 4 percentage points. Despite the increase in production volumes in tradable sectors, the share of the employed in these sectors has not significantly changed. The share of people employed in the public sector has remained rather high because within budget consolidation measures expenses were reduced mainly on the account of the decrease in wages and to a lesser extent on the account of the decrease in the number of employed.

Growth in 2010 was observed in all sectors of trade. In 2010, manufacturing increased by 16.5%, other industries (mining industry, pit management, electric energy, gas and heat supply, air-conditioning, water supply, sewage and waste management) by 6.2%, transport and storage sector – by 5.6%, but agriculture and forestry – by 2%. Overall, growth of these sectors ensured contribution of 2 percentage points to the growth of GDP. After the huge downturn during the crisis, also the trade, hotel and restaurant sector resumed growing in 2010 – the total annual growth by 3.1%. That ensured contribution of 0.4 percentage points to the growth of GDP.

The construction sector is experiencing the deepest decline in production volumes. Construction production volumes in 2010, if compared with 2009, still continued decreasing (by 23.9%) along with the decrease of investments. Tendencies in construction in 2010 influenced the decrease of GDP by 1.3 percentage points.

Although volumes or services resumed growing in the second half of 2010 along with the growing domestic demand, the total volumes of both public and commercial services were lower than a year ago. Tendencies in services sector in 2010 influenced the decrease of GDP by 1.4 percentage points.

Table 3.9

**Dynamics of GDP**

(in % compared to the corresponding period of the previous year, not seasonally adjusted data)

| | 2005-2007* average annually | 2008 | 2009 | 2010 | 2010 I | 2010 II | 2010 III | 2010 IV | 2011 I | 2011 II | 2011 III |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *changes in volumes* | | | | | | | | | | | |
| Agriculture, forestry | 3.9 | -2.2 | 9.1 | 2.0 | 3.8 | 1.1 | 0.5 | 4.1 | 7.4 | 4.3 | 0.6 |
| Manufacturing | 4.1 | -8.6 | -17.8 | 16.5 | 4.0 | 15.4 | 23.4 | 21.7 | 14.7 | 14.6 | 9.3 |
| Other industry | 3.4 | 6.0 | -3.9 | 6.2 | 8.5 | 5.8 | 3.6 | 6.0 | -1.1 | 3.8 | 6.2 |
| Construction | 20.3 | -3.5 | -32.0 | -23.9 | -43.4 | -35.3 | -13.1 | -9.6 | -11.8 | -0.9 | 19.6 |
| Trade | 15.7 | -7.0 | -25.2 | 3.1 | -8.9 | 0.0 | 10.6 | 9.8 | 10.4 | 8.4 | 10.4 |
| Transport and storage | 10.1 | -0.3 | 1.1 | 5.6 | 5.3 | 5.5 | 6.7 | 5.1 | 7.6 | 8.1 | 9.0 |
| Other commercial services | 9.8 | 5.4 | -14.7 | -4.7 | -5.5 | -7.1 | -4.0 | -2.1 | -1.5 | 2.4 | -0.9 |
| Public services | 3.5 | -0.1 | -9.3 | -6.4 | -10.9 | -11.4 | -2.6 | -1.3 | 0.6 | 1.0 | 1.6 |
| **GDP** | **10.3** | **-3.3** | **-17.7** | **-0.3** | **-5.5** | **-3.5** | **3.5** | **3.6** | **3.5** | **5.6** | **6.6** |
| *contribution to changes in volumes* | | | | | | | | | | | |
| Agriculture, forestry | 0.3 | -0.1 | 0.3 | 0.1 | 0.1 | 0.0 | 0.0 | 0.1 | 0.2 | 0.2 | 0.0 |
| Manufacturing | 1.2 | -2.1 | -2.3 | 1.3 | 0.4 | 1.5 | 2.8 | 2.2 | 1.4 | 1.8 | 1.3 |
| Other industry | 0.3 | 0.4 | -0.2 | 0.2 | 0.4 | 0.2 | 0.1 | 0.2 | -0.1 | 0.1 | 0.2 |
| Construction | 3.8 | -0.7 | -3.6 | -1.3 | -2.7 | -2.7 | -1.2 | -0.7 | -0.4 | 0.0 | 1.6 |
| Trade | 7.5 | -3.4 | -6.5 | 0.4 | -1.8 | 0.0 | 2.3 | 1.8 | 1.7 | 1.7 | 2.4 |
| Transport and storage | 2.4 | -0.1 | 0.1 | 0.5 | 0.7 | 0.7 | 0.9 | 0.6 | 0.9 | 1.1 | 1.2 |
| Other commercial services | 5.4 | 2.7 | -4.5 | -0.9 | -1.6 | -1.7 | -1.1 | -0.5 | -0.4 | 0.6 | -0.2 |
| Public services | 1.0 | 0.0 | -1.3 | -0.6 | -1.2 | -1.4 | -0.3 | -0.2 | 0.1 | 0.1 | 0.2 |
| **GDP** | **10.3** | **-3.3** | **-17.7** | **-0.3** | **-5.5** | **-3.5** | **3.5** | **3.6** | **3.5** | **5.6** | **6.6** |

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

In the three quarters of 2011, manufacturing industry exceeded the level of the three quarters of 2010 by 12.6%. At the same time, other industry sectors increased by 2.4%, but agriculture and forestry sector – by 3.4%. Overall, these sectors constituted 1/3 of the total growth in 2011.

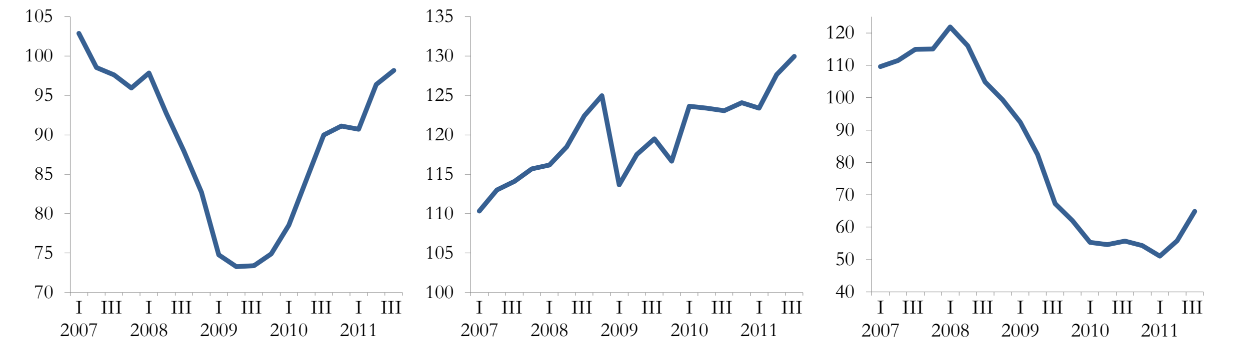
It should be noted that the construction sector experienced a decrease in construction volumes in the first half of 2011, and overall construction volumes shrank by almost 60% during crisis. However, in the 3rd quarter of 2011, construction production volumes (according to seasonally adjusted data) increased by 16.2% in comparison with the 2nd quarter and exceeded the level of the 3rd quarter of 2010 by 19.6%. Recovery of construction sector is mainly due to the active absorption of the EU funds. It should be noted that the construction sector has been quite successful in reorienting to external markets during the crisis. In the 3rd quarter of 2011, the volume of construction works performed by Latvian builders outside Latvia exceeded the level of the 3rd quarter of 2010 by nearly 50%. But in comparison with the 3rd quarter of 2008, the volume of construction works performed by Latvian builders outside Latvia has increased more than 6 times.

Figure 3.18

**Manufacturing**
Value added changes, seasonally adjusted data, 4th quarter of 2006 = 100

**Other industry**
Value added changes, seasonally adjusted data, 4th quarter of 2006 = 100

**Construction**
Value added changes, seasonally adjusted data, 4th quarter of 2006 = 100



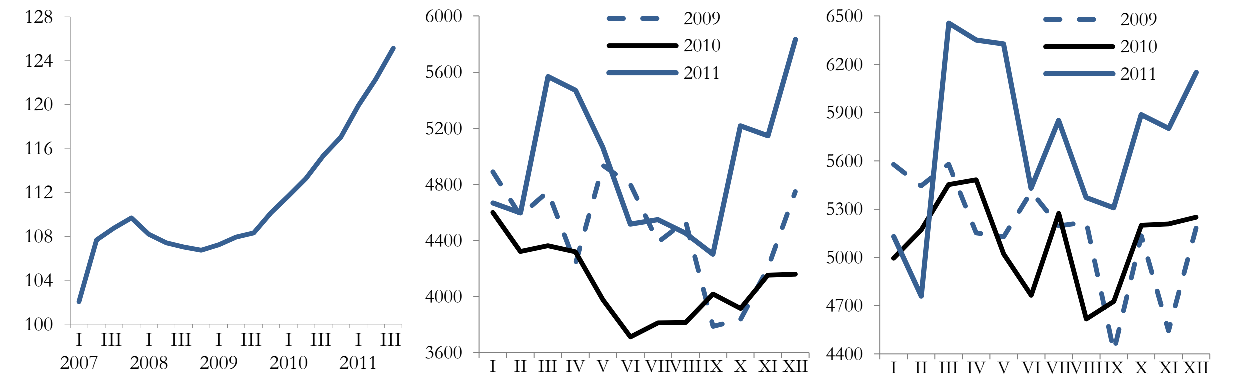

Transport and storage constituted approximately 1/5 of the total growth of sectors in 2011. In the three quarters of 2011, this sector exceeded the level of the three quarters of 2010 by 8.2%. The growth of the sector is based on extensive rise in volumes of freight. In January-December 2011, freight in railway exceeded the level of the corresponding period of 2010 by 20.8%. But the volume of delivered and received freight in ports increased by 12.5% in this period. The volume of freight by transport vehicles also increased in 2011.

Figure 3.19

**Transport and storage**
Value added changes, 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



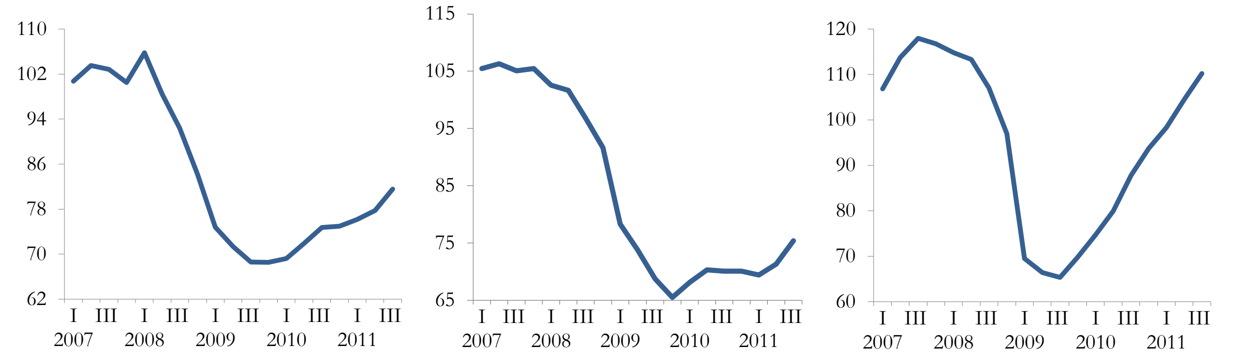

The volumes of services provided in trade, hotels and restaurant sectors continued growing in 2011 due to the increasing private consumption – the volumes of services provided in the sector during the three quarters exceeded the level of the corresponding period of 2010 by 9.7%. Considering the large share of the sector in national economy, the increase had an impact on the growth of GDP by 2 percentage points.

The retail trade turnover continued growing steadily in 2011, during the eleven months of 2011 exceeding the level of the corresponding period of 2010 by 4.3%. It should be noted that the turnover growth tendencies differed among various type of retail companies. In the eleven months of 2011, the volumes of vehicle fuel retail turnover lagged behind the level of the corresponding period of 2010 by 8.5%. At the same time, the volumes of food retail turnover were by just 0.9% higher than in January-November 2010, while the volumes of non-food retail trade (excluding vehicle fuel retail trade) increased by 11.8% and practically constituted the entire increase in the retail turnover.

Since the 1st quarter of 2010, increase in wholesale volumes was observed throughout the year, and growth rates remained stable also in 2011. In the 3rd quarter of 2011, the volumes of wholesale enterprises' turnover were by 24.1% higher than in the 3rd quarter of 2010.

Figure 3.20

| **Trade** | **Retail trade** | **Wholesale turnover** |
|---|---|---|
| Value added changes, seasonally adjusted data, 4th quarter of 2006 = 100 | deflated turnover, seasonally adjusted data, 4th quarter of 2006 = 100 | at current prices, seasonally adjusted data, 4th quarter of 2006 = 100 |




Output volumes of other commercial service sectors in 2011 practically remained at the level of 2010. But the consolidation measures of the government expenditures affected the volume of services provided in public service sector which in the three quarters of 2011 were by just 1.1% higher than in the three quarters of 2010.

Further growth of sectors will be closely related to export possibilities and development of tradable sectors. But the increase in revenues from export will foster domestic consumption which in its turn will spur domestic market-oriented sectors.

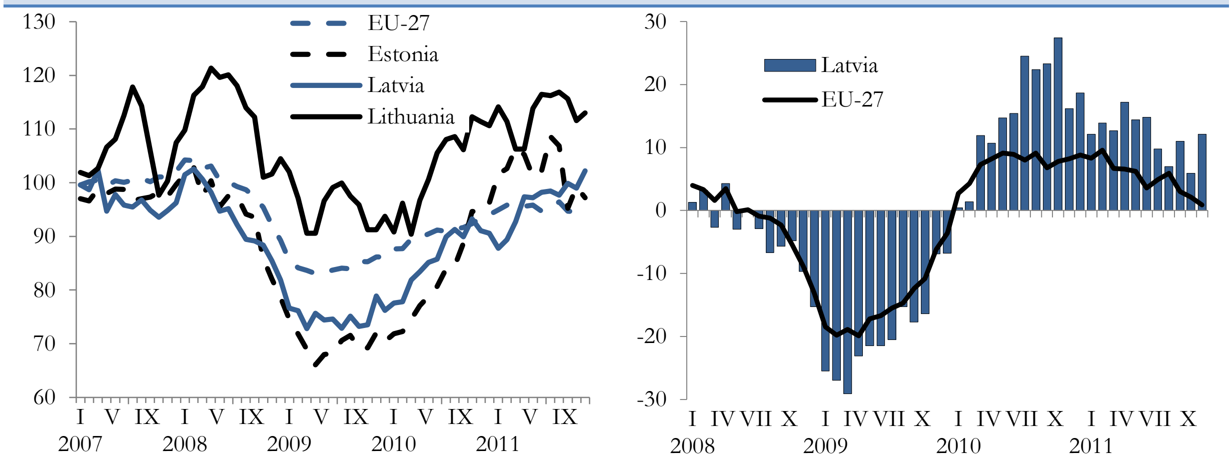
### 3.2.2. Manufacturing

From 2005 until 2007, the manufacturing grew by only 4% per year. During these years, manufacturing lost both its relative competitiveness in relation to other sectors of national economy and competitiveness in foreign markets due to the rapid increase in production costs. Already in 2007, production volumes of the sector had practically stopped growing. As the domestic and external demand significantly shrank due to the crisis, production volumes of manufacturing also experienced rapid decrease – in the 2nd quarter of 2009, production volumes of the manufacturing sector constituted only 70% of the level of the 1st quarter of 2007. In the second half of 2009, the growth resumed in the majority of trade partner countries of Latvia, and the increase in external demand provided positive growth stimuli to Latvian producers – production volumes have been increasing since the second half of 2009.

Figure 3.21

**Manufacturing Production Volume Index**

| Seasonally adjusted data, December 2006 = 100 | Data adjusted by number of business days, % compared to the corresponding period of the previous year |
|---|---|




Recovery from crisis consequences in the sector was rather rapid, and at the end of 2009, production volumes in separate sectors of manufacturing already exceeded the level of respective period of the previous year. Not only increase of demand in trade partner countries, but also increase of competitiveness achieved by significant cuts in expenses during the crisis plays an important role in growth of the manufacturing.

Table 3.10

**Structure of Manufacturing in 2011***

per cent

| | By turnover | By number of employed | Share of export in the sales of sector |
|---|---|---|---|
| **Manufacturing – total** | **100** | **100** | **61.4** |
| Food industry | 25.1 | 23.1 | 30.4 |
| Light industry | 4.4 | 12.0 | 83.3 |
| Wood processing | 23.5 | 19.6 | 73.2 |
| Paper industry and publishing | 4.1 | 3.7 | 56.8 |
| Chemical industry and related industries | 7.6 | 6.5 | 78.0 |
| Production of other non-metallic minerals | 5.3 | 4.1 | 47.1 |
| Production of metals and metal articles | 14.6 | 10.5 | 72.7 |
| Production of electrical and optical equipment | 4.6 | 3.3 | 85.3 |
| Production of machinery and equipment | 2.3 | 2.9 | 86.8 |
| Production of vehicles | 3.3 | 3.1 | 87.2 |
| Other production industries | 5.2 | 11.3 | 51.8 |

* evaluation of the Ministry of Economics

The expansion of export opportunities determines the rapid growth of the manufacturing – production volumes in 2010 were by 16.5% higher than in 2009. Turnover of exported production in 2010 increased by 28%, while due to the remaining weak domestic demand, turnover volumes in the domestic market increased only by 3.2 per cent.

Table 3.11

**Changes of Production Volumes in Manufacturing**

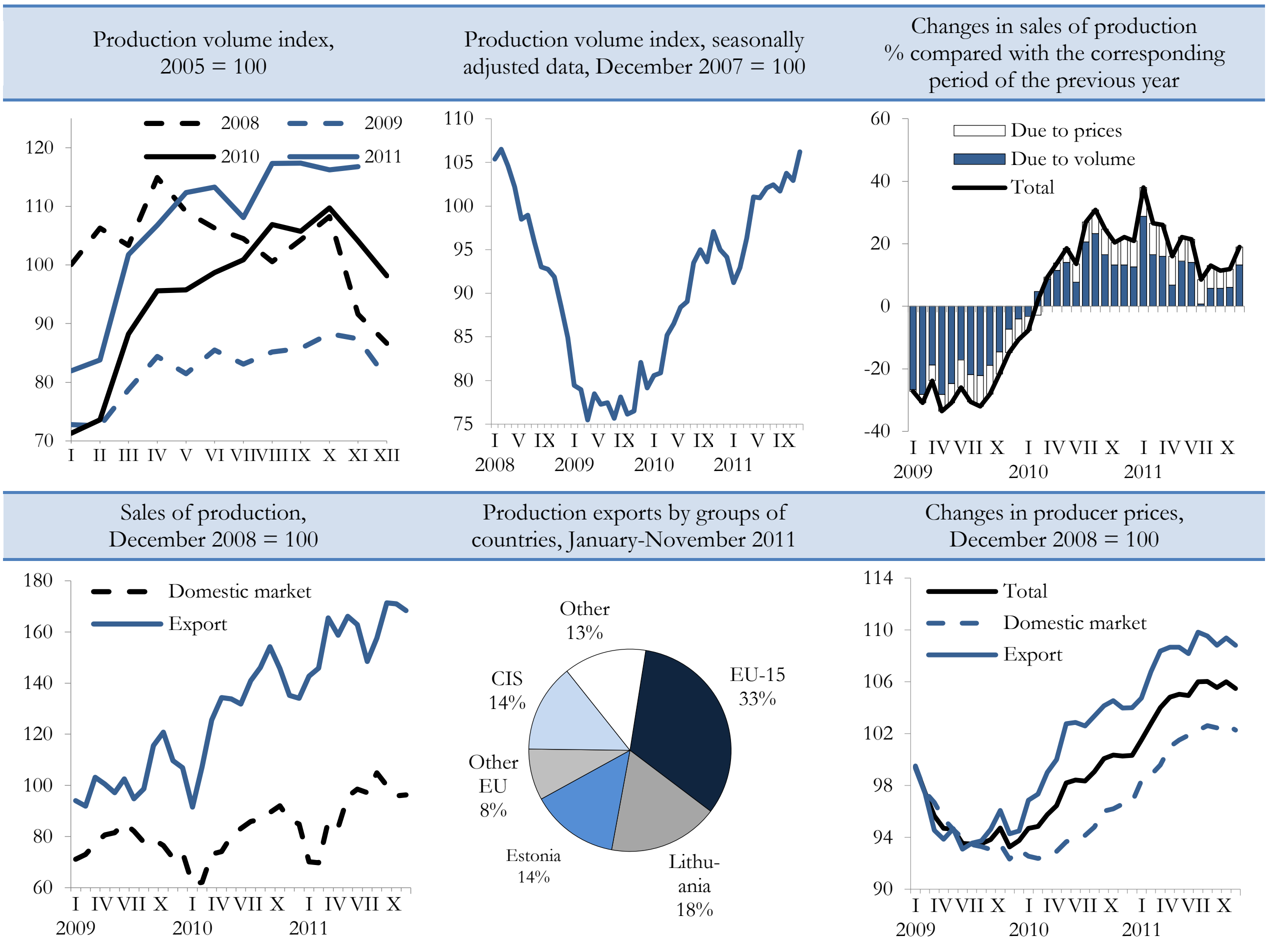
(per cent, compared to the corresponding period of the previous year)

| | 2007 | 2008 | 2009 | 2010 | 2011 I-XI |
|---|---|---|---|---|---|
| **Manufacturing – total** | **0.3** | **-3.4** | **-20.2** | **16.5** | **11.9** |
| Food industry | 1.3 | -2.0 | -16.1 | -0.1 | 0.1 |
| Light industry | 0.3 | -12.2 | -38.6 | 19.4 | 22.3 |
| Wood processing | -6.0 | -12.1 | 1.6 | 33.0 | 12.3 |
| Paper industry and publishing | 0.2 | -3.9 | -17.1 | 19.8 | 0.0 |
| Chemical industry and related industries | 3.1 | -2.0 | -18.5 | 5.2 | 4.8 |
| Production of other non-metallic minerals | -17.1 | -14.4 | -40.1 | 17.6 | 23.8 |
| Production of metals and metal articles | 11.5 | 1.4 | -27.1 | 24.2 | 29.7 |
| Production of electrical and optical equipment | 3.8 | 14.1 | -34.8 | 33.2 | 28.1 |
| Production of machinery and equipment | 5.0 | 10.4 | -35.5 | 17.8 | 40.4 |
| Production of vehicles | 10.7 | 5.8 | -49.7 | 59.0 | 39.8 |
| Other production industries | 3.0 | -5.5 | -20.1 | -4.9 | 7.8 |

In the eleven months of 2011, manufacturing production volumes have increased by 11.9%. Wood processing and metal and finished metal articles producing subsectors have contributed the most to the growth of manufacturing industry as the increase in manufacturing production volumes of these sectors practically constituted a half of the total growth of the manufacturing sector. In 2011, significant growth pace was observed in production of electric and optical equipment, as well as vehicles manufacturing and machine engineering sectors. At the same time it should be noted that one of the largest manufacturing subsectors – food industry – is recovering from the crisis consequences slower than other sectors. In the eleven months of 2011, production volumes of this sector have increased by just 0.1% in comparison with the corresponding period of 2010.

Figure 3.22

**Indicators Characterising Manufacturing**




The increase in turnover of manufacturing production in 2011 was based not only on an increase in the production volumes but also on the considerable rise of producer prices. For instance, the turnover of food industry in November 2011 was by 8.4% higher than a year ago mainly due to the rise in producer prices worldwide.

Wood processing, metal processing, production of electrical and optical equipment, as well as production of machine engineering contribute the most to the increase in turnover of manufacturing industry.

In November 2011, volume of production sold for export was by 24.5% higher than a year before. At the same time it should be noted that the demand for Latvian industry products has gradually increased also in domestic market (by 14% in comparison with the eleven months of 2010).

The share of export in sales of the manufacturing industry has rapidly increased after the crisis; however it stabilised in the second half of 2011. In 2011, 60% of the total production of the sector was exported. The share of export in sales of the manufacturing industry has increased by 10 percentage points if compared to 2008. A little more than 72% of total exports are sold in the markets of EU Member States. Yet, 34% of the total exported production is sold in the euro zone countries; moreover, 40% of all production sold in the euro zone countries is exported to Estonia (15% of the total export). Almost 16% of the total exported production is sold in Lithuania, while 16% of the total export is sold in the CIS countries.

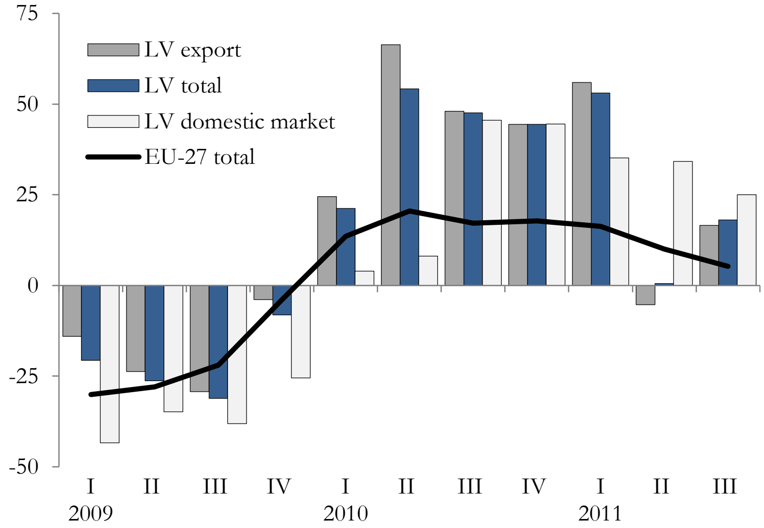
The manufacturing producer prices kept growing rapidly at the beginning of 2011. The manufacturing producer prices increased for both exported production and production sold in the domestic market. Since the mid-2011, producer prices have stabilised.

The overall dynamics of producer prices is influenced to a great extent by fluctuations in producer prices for exported production. The prices for exported production are mainly determined by price tendencies in the world. For example, the rapid rise in manufacturing producer prices in the first half of 2011 was mainly based on the rise in the world prices for the key export products – metal articles and food products.

Figure 3.23

**New Orders in Manufacturing**

(total in manufacturing industry sectors mainly oriented towards orders,
% compared to the corresponding quarter of the previous year, seasonally unadjusted data)



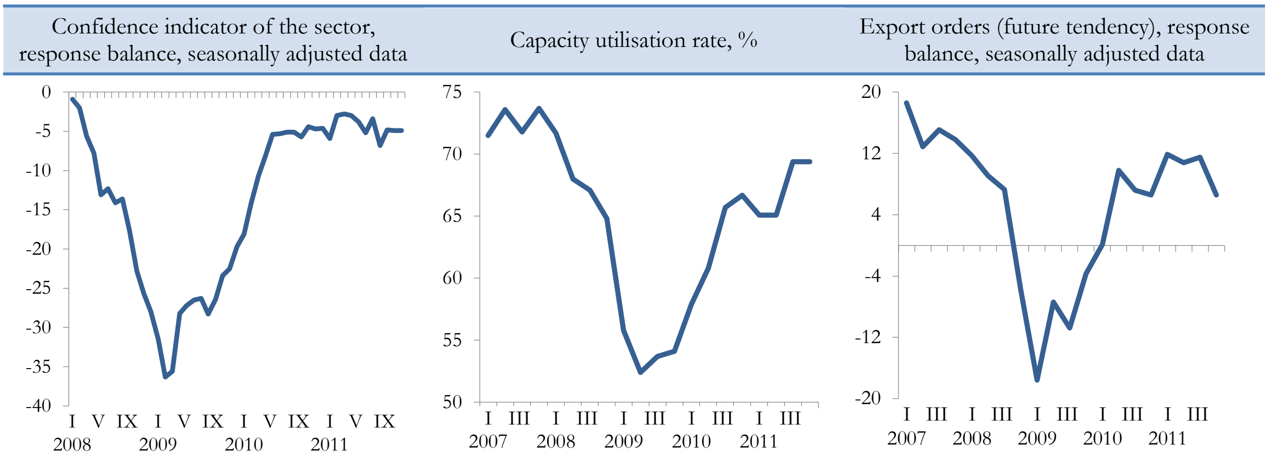

In the 3rd quarter of 2011, new orders kept increasing steadily in such sectors as light industry, production of vehicles and machine engineering. It should be noted that the volumes of new orders are increasing not only in export markets but also in the domestic market.

The production capacity keeps increasing in line with the increase of production volumes. In the 4th quarter of 2011, the level of production capacity was 69.4% exceeding the level of the 4th quarter of 2010 by 2.7 percentage points.

The results of conjuncture surveys of Latvian manufacturing enterprises show that evaluation of entrepreneurs regarding further growth possibilities is not improving; however at the same time entrepreneurs are more optimistic about export development possibilities. The overall confidence indicator of manufacturing in December 2011 was 5.7 points, yet, it is by 1 point worse than the indicator in December 2010. Still it should be noted that the confidence of entrepreneurs in December 2011 exceeded the level of February 2009 by 30.7 points when the indicator reached the lowest level. Overall, manufacturing confidence is affected by uncertainty about development perspectives of the main trade partner countries.

Figure 3.24

**Development Tendencies of Manufacturing**



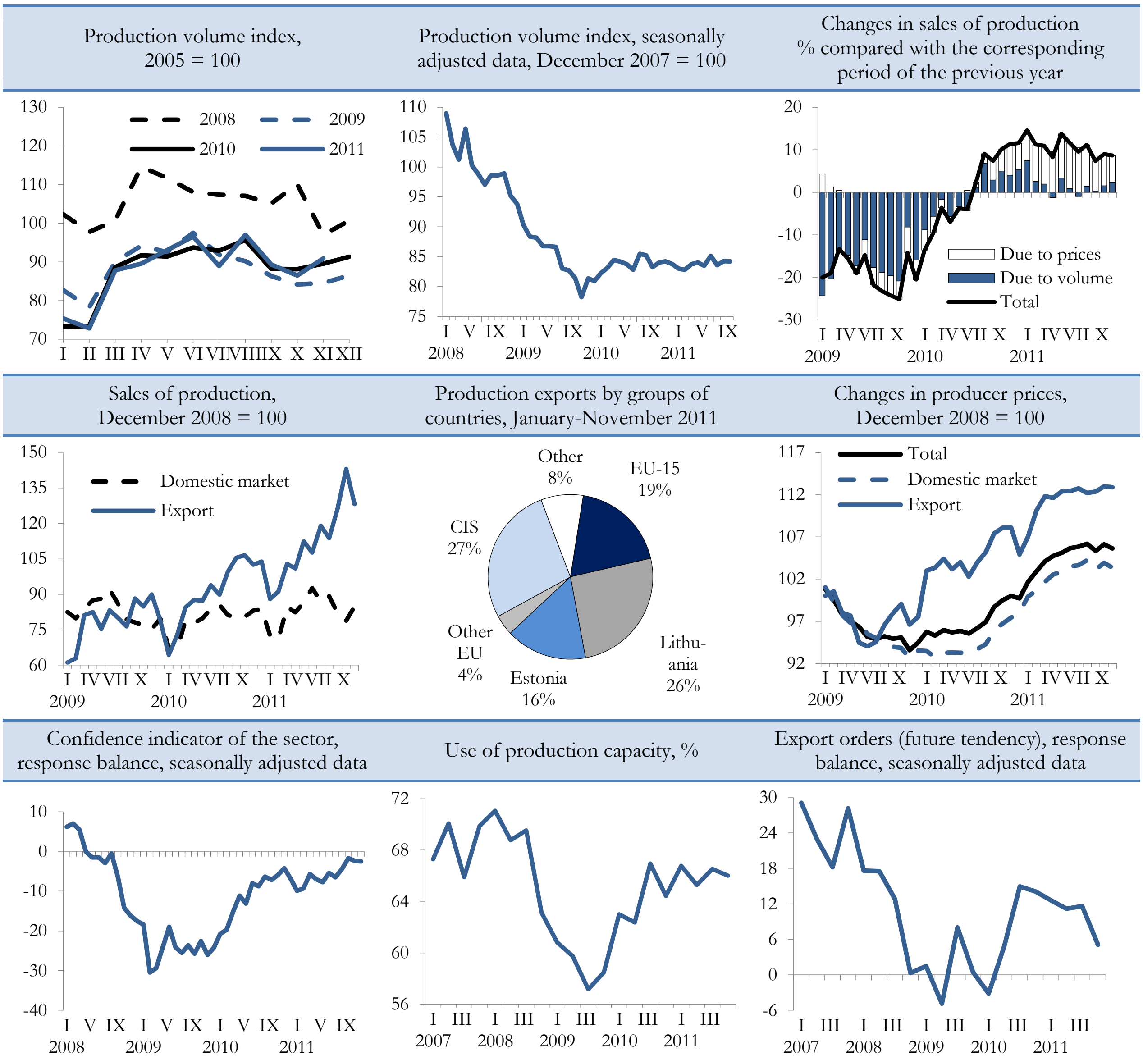
***Food industry*** is the largest manufacturing industry by both turnover and the number of employed. The sector is mainly oriented towards the domestic market therefore along with the decreasing domestic demand during the crisis, production volumes of the sector decreased rapidly.

In 2009, production volumes of the food and beverages decreased by 17.8% in comparison with 2007 and that was slower than in the manufacturing overall. However the recovery of food industry is slow. Growth resumed at the end of 2009, yet it was very moderate and was mainly related to the expanding export possibilities. Overall, the production volumes of the food industry in 2010 still remained at the level of 2009. In the eleven months of 2011, production volumes have practically remained at the level of the corresponding period of the previous year. The increase in production volumes in the eleven months of 2011 can be observed in fruit and vegetable processing, as well as in fish and meat processing. Meanwhile, the production volumes of pastry and flour products, dairy products, as well as production of beverages lag behind the level of 2010.

The sale of production in export markets increased quite rapidly in 2010 (by 16.2%) due to the remaining weak demand in domestic market. In the eleven months of 2011, sales of production in export markets increased by 24%, but in the domestic market – by 5.3%. Increase of turnover in sector is related to the rise in producer prices, because rise in price for food products in the world was reflected also in the changes in Latvian food producer prices. In November 2011, producer prices were by 5.6% higher than in November 2010. Despite the rather weak domestic demand, producer prices for production sold in the domestic market have increased by 6.1% during a year. However, producer prices for exported production have been increasing since the mid-2009, and in November 2011, they exceeded the level of June 2009 by 20 per cent.

Figure 3.25

**Indicators Characterising Food Industry**



The sector of ***light industry*** already before the economic crisis was mainly oriented to export. During the economic crisis, production volumes of the sector significantly reduced 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 during these years production volumes of the sector decreased by 46.2 per cent.

The light industry was recovering quite rapidly in 2010 by being able to enter new market niches (increase by almost 20%). In the eleven months of 2011, production volumes of the sector exceeded the level of the corresponding period of the previous year by 22.3%. Although production volumes still lag behind the pre-crisis level, the level of production capacity in the sector reached 75% at the end of 2011 thus only slightly lagging behind the highest level in the history of the sector.

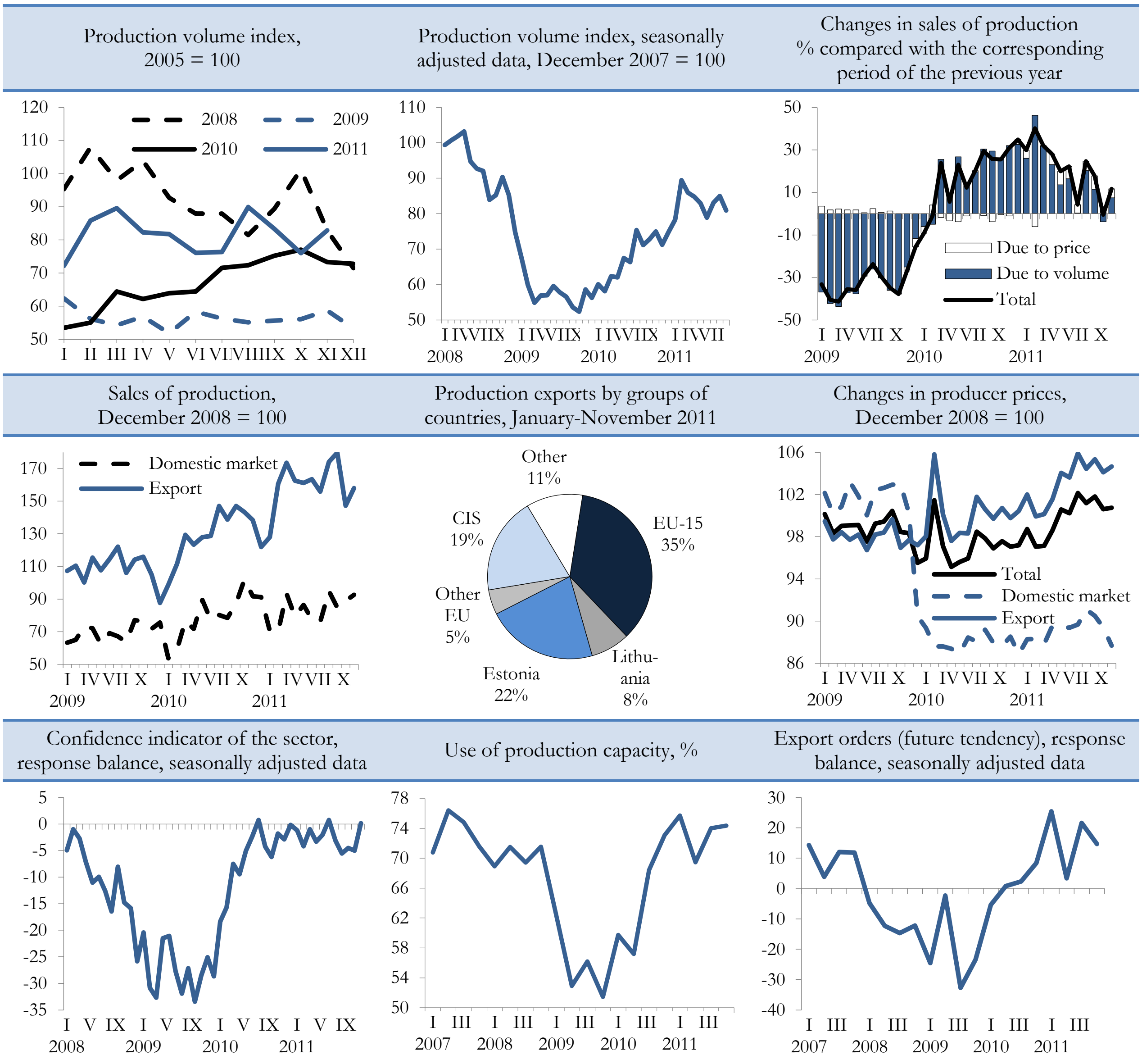
The growth of light industry is mainly based on export increase – in 2010 sales revenue from exported production grew by 19%, but from January until November 2011 – by 23%. 84% of production is sold in external markets. The key commodity markets of light industry are the old EU Member States, however, if compared to 2008 – the share of EU-15 states has decreased.

The turnover of the sector is gradually increasing also in the domestic market after the huge decline in 2009 – in the eleven months of 2011, the volumes of production sold in domestic market exceeds the level of the corresponding period of the previous year by 5.5 per cent.

Revenues of the light industry are mainly based on the increase in production volumes, and to a lesser extent on prices. Producer prices in November 2011 have increased by 3.8% in comparison with November 2010. It was mainly based on the rise in producer prices for exported production (by 4.9%), while prices for production sold in the domestic market have shrunk by 1 per cent.

Figure 3.26

**Indicators Characterising Light Industry**



***Wood processing*** is one of the largest manufacturing sectors, and it plays an important role in the national economy of Latvia. Already in the rapid growth years, the sector experienced downturn. From 2006 to 2008, the production volumes of the sector shrank by one third. It was mainly due to the lost competitiveness in external markets and to the decreasing demand for wood processing products in Europe. However, since 2009, wood processing is one of the most rapidly growing manufacturing sectors, and production volumes are already significantly exceeding the pre-crisis level. In 2010, production volumes of the sector increased by 33%, but in the eleven months of 2011 – by 12.3%. The growth of wood processing is mainly based on the expanding export opportunities – volumes of exported production in 2010 increased by 45%, while in the eleven months of 2011 by 13% if compared to the corresponding period of 2010.

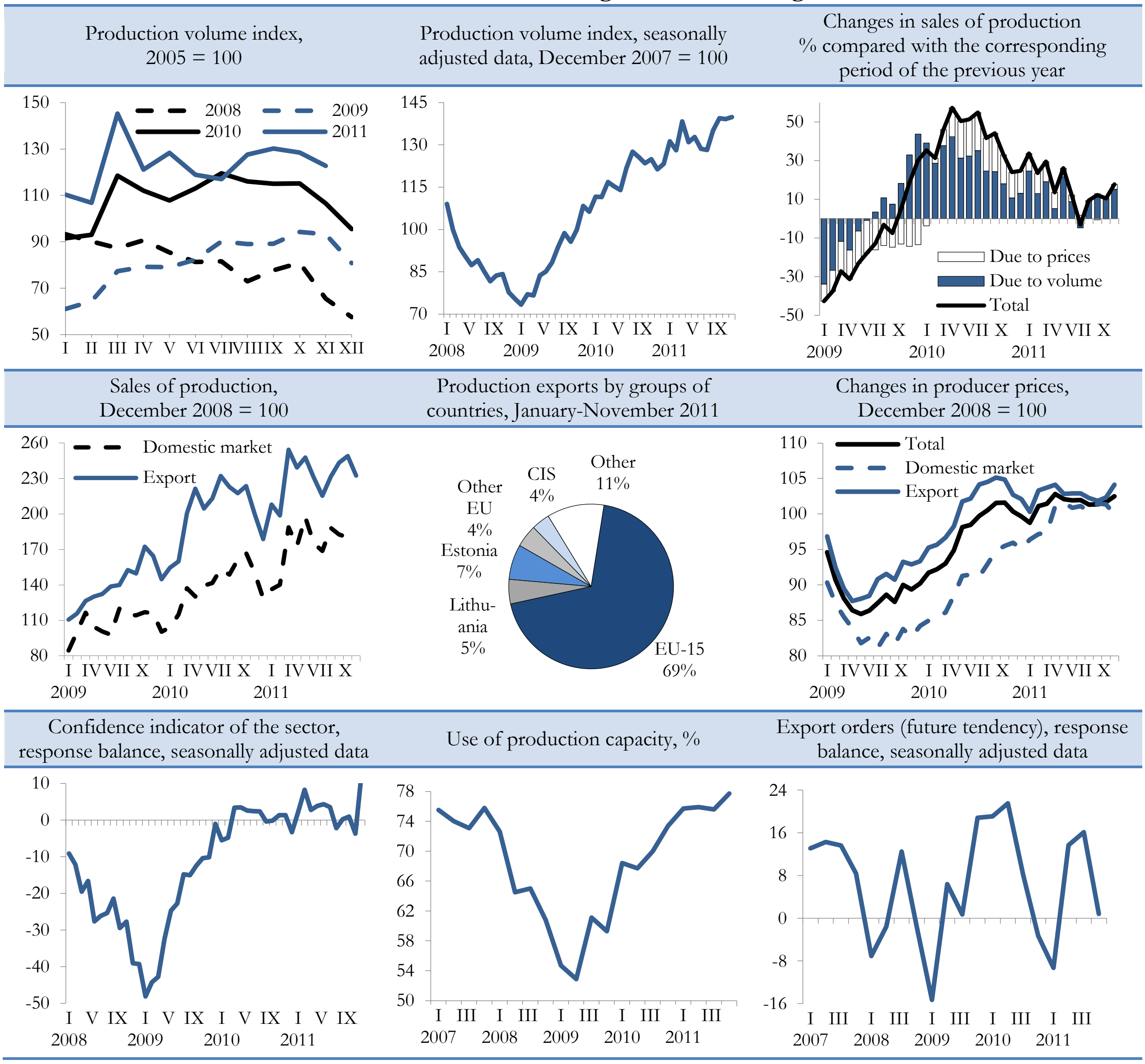
Almost 1/4 of wood and timber product export is considered to be the export of high or medium high value added goods – veneer and plywood, cellular wood panels, etc. The wood processing sector exports slightly more than 70% of produced production. The main export markets are the EU-15 Member States. The demand for wood processing production is growing also in the domestic market – it has increased by 24% in the eleven months of 2011 if compared with the same period of 2010.

In 2010, the increase of turnover of the sector was greatly influenced also by the rise in producer prices. However, the dynamics of producer prices was moderate in 2011. In November, the producer prices had increased by 2.1% within a year. Prices for the production sold in the domestic market have increased faster (by 4.1%), while prices for exported production – by 1.4 per cent.

Further sector development depends on the ability to increase production capacity. At the end of 2011, the level of production capacity load exceeded 78% thus being the highest indicator in comparison with other sectors of manufacturing.

Figure 3.27

**Indicators Characterising Wood Processing**



***Paper industry and publishing*** constitute on average 4% of the total turnover of manufacturing industry and of the number of the employed.

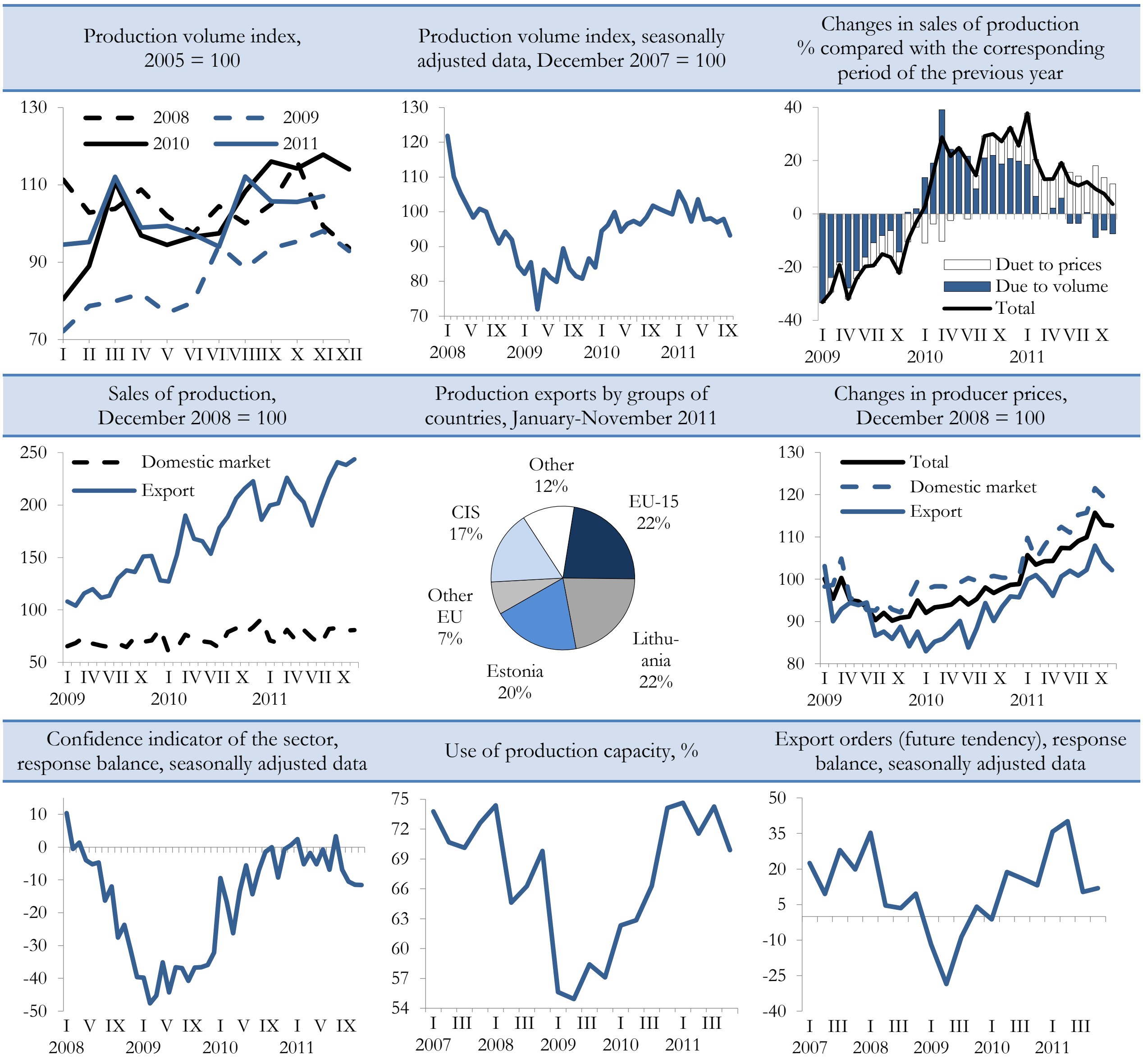
In the pre-crisis period, the sector was mainly oriented towards the domestic market. Approximately 40% of the total production was exported. Export possibilities were mainly related to Lithuania and Estonia where 60% of all exported production was sold in 2008. During the economic crisis, when both domestic and external demand significantly shrank, the production volumes of the sector decreased by over 20 per cent.

In 2010, the production volumes increased by 19.8% and the turnover increased by 23% due to the increase in export volumes (revenues from production sold in export increased by 43%, while revenues from production sold in the domestic market – by 6.4%). In January-November 2011, the turnover of the sector has increased by 13.5% in comparison with January-November 2010. The turnover of production exported during this period increased by over 20%, while revenues from production sold in the domestic market increased by 5.3%. In 2011, export constituted almost 57% of the total turnover of the sector. The share of the EU and the CIS countries in the export has significantly increased in comparison with 2008.

The increase in the turnover of paper industry and publishing in 2011 was mainly based on the rise in producer prices, while production volumes in 2011 remained at the level of 2010. Producer prices in November 2011 were by 14.2% higher than in November 2010. Despite the weak domestic demand, prices for the production sold in the domestic market increased faster than those for exported production. In November 2011, the producer price level for production sold in the domestic market was by 20.5% higher than a year ago, while prices for exported production increased by 6.5% in a year.

Figure 3.28

**Indicators Characterising Paper and Publishing Industry**



Production volumes of ***the chemical industry*** in 2008 and 2009 in total reduced by one fifth. Yet, recovery after the crisis is very uneven. It should be noted that development tendencies of chemical subsectors differed both during the economic downturn and in the post-crisis period. Production volumes of the pharmaceutical base stock and preparations shrank by 16.8% and production volumes of rubber and plastic articles – by almost 40%. At the same time, production volumes of chemical substances and products increased by 15 per cent.

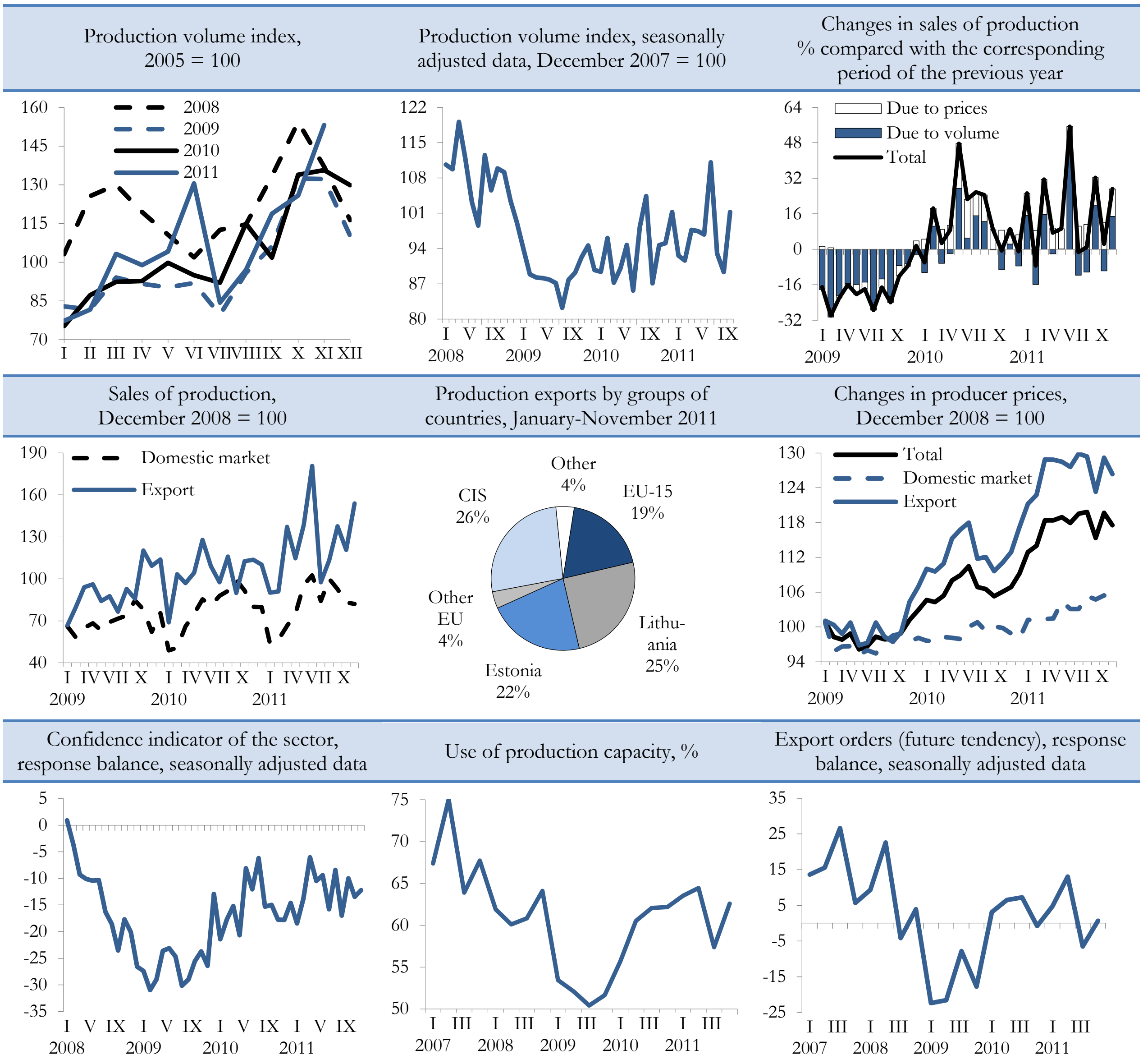
In 2010, due to the increasing demand both in domestic and foreign markets, the output of chemical industry increased by 5.2%. Production volumes increased for both chemical products and rubber and plastic articles, but in 2010, production volumes in the pharmaceutical industry reduced by 3.3 per cent.

In eleven months of 2011, production volumes of the chemical industry increased by 4.8%, in comparison with the corresponding period of the previous year, but the turnover in this period increased by 16.2%. The increase in volumes of sales of exported production (by 20.6%) contributed the most to the growth of turnover, while volumes sold in the domestic market increased at a moderate pace (by 4%). During the economic recession, the decline in producer prices of the chemical industry was very moderate; yet, since the end of 2009, producer prices have been growing rapidly, especially for the exported production. Just like in the majority of manufacturing sectors, the increase in producer prices slowed down in the second half of 2011. In November 2011, producer prices exceeded the level of November 2010 by 10.6%. Prices for production exported in this period have increased by 12.8%, while prices for the production sold in the domestic market – by 6.1 per cent.

The level of production capacity reached 62.3% at the end of 2011 being one of the lowest indicators among other manufacturing sectors.

Figure 3.29

**Indicators Characterising Chemical Industry and Related Industries**



***Other non-metallic minerals production*** sectors during the pre-crisis period were mainly oriented towards domestic demand – only less than 20% from the production were exported. The development of the sector greatly depended on demand fluctuations, mainly in relation to the demand for construction, therefore, during the economic crisis, when construction volumes significantly decreased, the production of non-metallic minerals considerably decreased. In 2009, the production output of the sector decreased by almost a half in comparison with 2007.

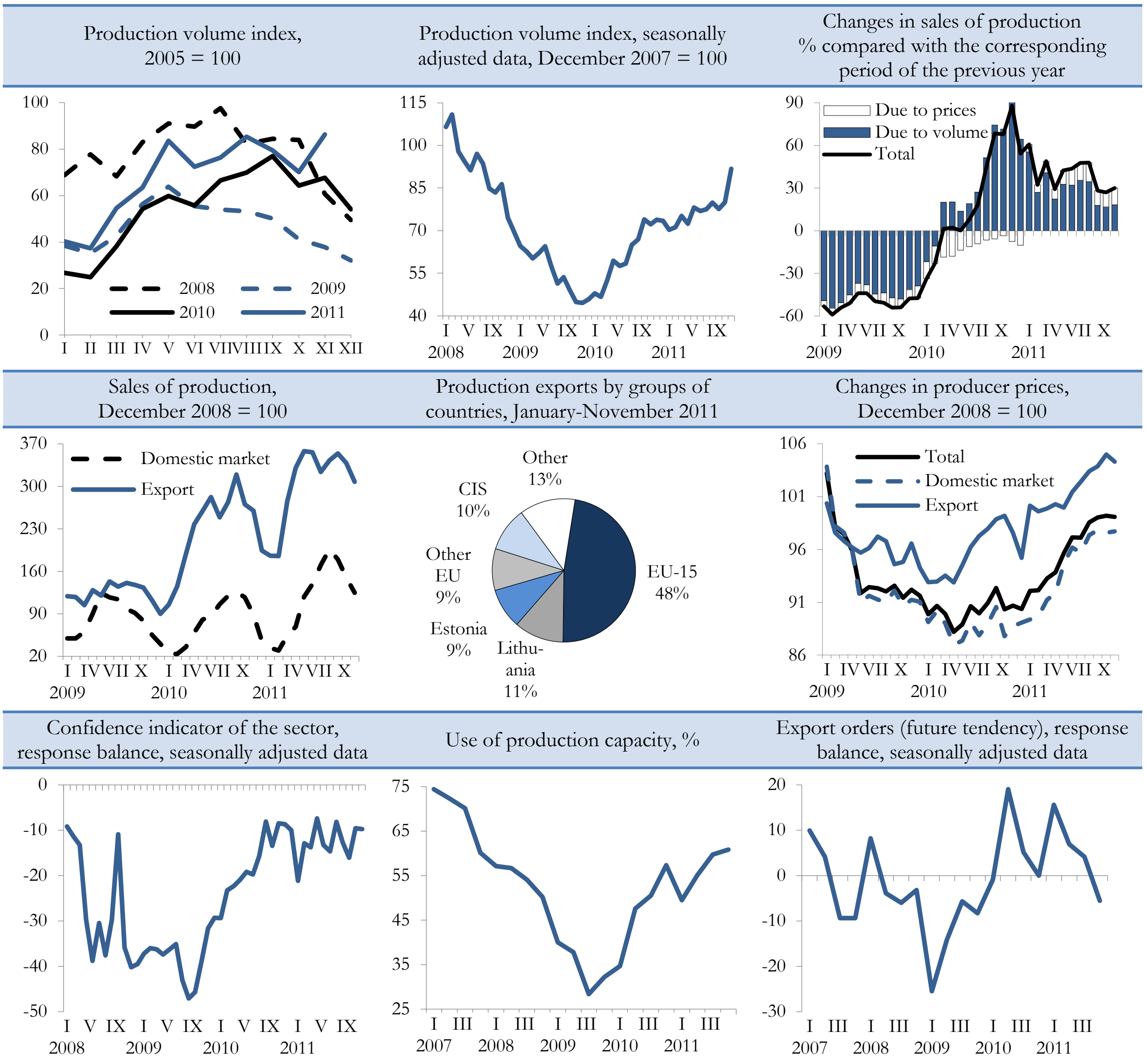
The successful recovery of the sector after the crisis is mainly related to the ability to focus on foreign markets – mainly to the old EU Member States. In 2010, production volumes of the sector increased by 17.6% and the turnover – by 24.4% due to external demand. Sales volumes of production exported during this period increased by almost 90%. At the same time, due to the remaining low domestic demand, the sales of production in the domestic market reduced by 6% in 2010. In 2010, the share of exported production was almost a half of the total turnover.

Production volumes of the sector continued increasing in 2011 – in the eleven months, an increase by 23.8% was observed in comparison with the corresponding period of 2010. Also the turnover of the sector increased significantly in the eleven months of 2011 (by 38.3%). As the economic situation gradually improved, the turnover in domestic market has significantly increased (by 46%), but in January-November 2011, sales revenues from exported production exceeded the level of the corresponding period of the previous year by 30 per cent.

After the huge drop in producer prices during the crisis, they resumed increasing in the middle of 2010. In November 2011, producer prices have increased by 9.3% in a year, including prices for production sold in the domestic market – by 10.1%, but for exported production – by 6.9 per cent.

Figure 3.30

**Indicators Characterising Production of Other Non-metallic Minerals**



***Production of metals and metal articles*** is the third largest manufacturing industry by turnover which is mainly export-oriented – average 70% of production is sold in external markets. Taking into account the comparatively large export share in the product sales, the global economic development tendencies considerably influenced development of the sector. During the economic crisis – in 2008 and 2009, production volumes of the sector shrank by ¼. In 2009, the output of the sector shrank by 27% but the sales volumes shrank by a third.

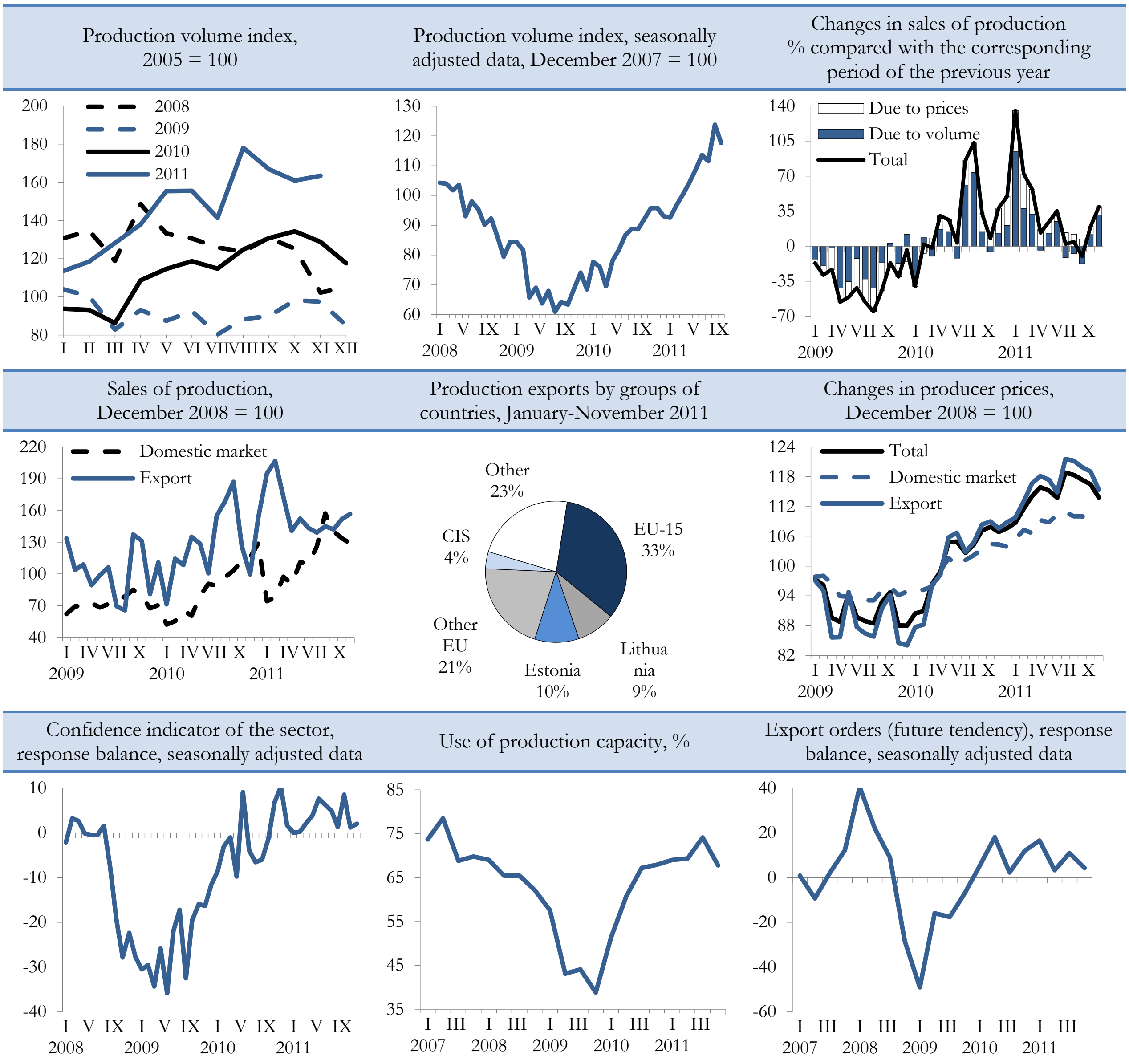
As the economic situation in the main trade partner countries stabilised, production volumes of the metal processing sector have been increasing since the middle of 2009. In 2010, production volumes increased by 24%. It should be noted that in 2010, not only the turnover of exported production (by 25%), but also the production volumes sold in the domestic market (by 20%) experienced a significant increase.

Rapid growth of the sector remained also in 2011. Production volumes in the eleven months have increased by nearly 30% in comparison with January-November 2010. The turnover of production sold for export in the same period increased by 25%, while the turnover in the domestic market – by 35%. 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 global economic crisis resulted in shrinking world prices for metal; however, world prices for metal began increasing again at the beginning of 2010 and slowed down only at the end of 2011. It reflects in both the increase in producer prices for production both sold in the domestic market and for production exported. In November 2011, producer prices were by 6.5% higher than a year ago.

Figure 3.31

**Indicators Characterising Production of Metals and Metal Articles**



***Electrical and optical equipment production*** sector developed rather successfully during the rapid growth period. During the economic crisis, when the demand reduced significantly, production volumes of the sector shrank by ¼, but since the middle of 2009, the situation in the sector has been improving. It is mainly determined by the increase in external demand.

In 2010, output of the sector exceeded the level of 2009 by more than 33%. Increase in production volumes of electronic equipment has contributed the most to the growth (by 37%) of the sector, but the production volumes of computer, electronic and optical equipment have increased by 27% in 2010.

Sales revenues of exported production in 2010 increased by 32%, but those of production sold in the domestic market – by 9%. Overall, the sector exports nearly 85% of the production.

In 2011, growth rates of electronic and optical equipment production sector remained among the highest in the sector. In the eleven months, production volumes have increased by 28.1% in comparison with the corresponding period of 2010.

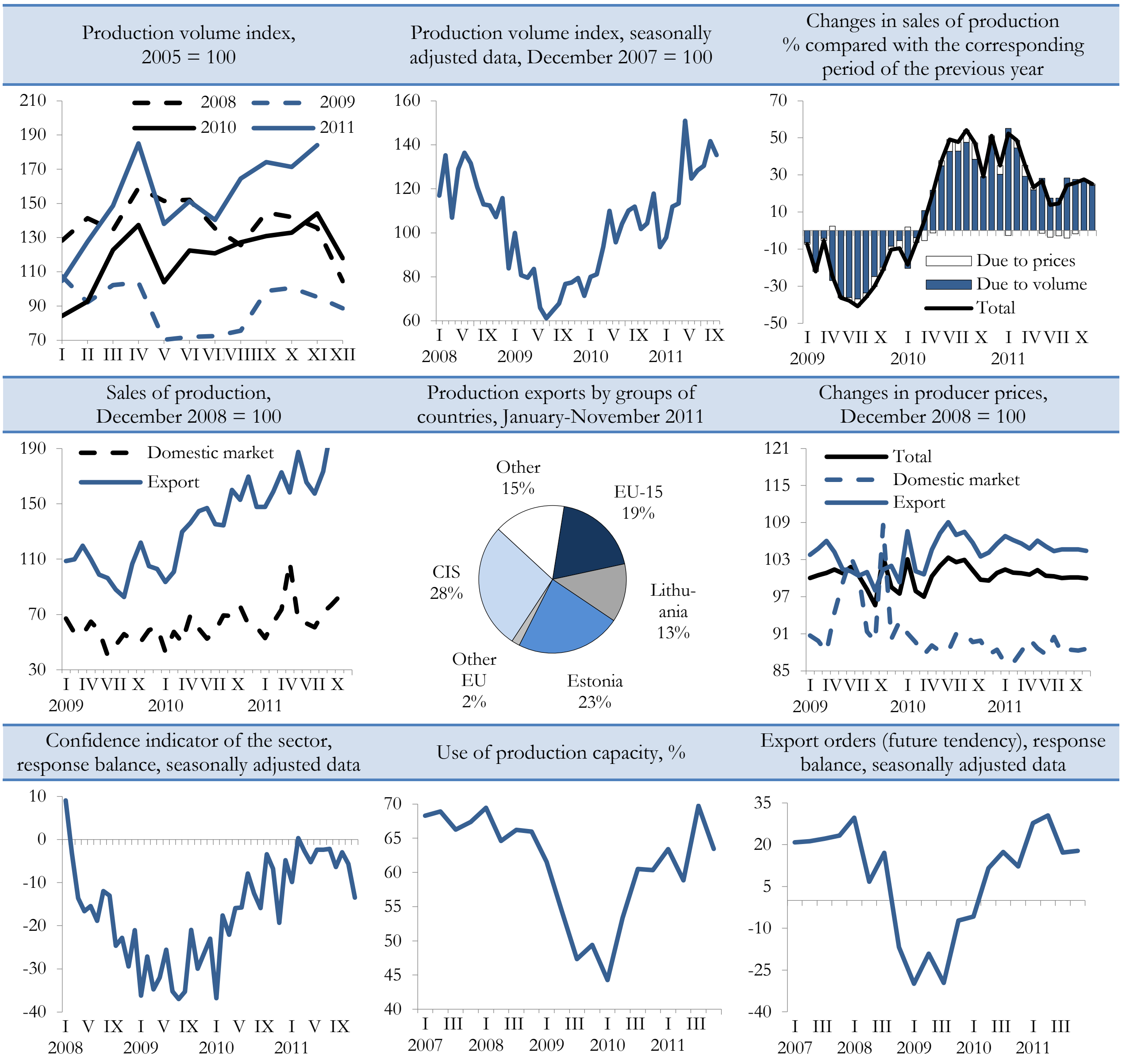
Despite the significant increase in production volumes in 2011, the turnover of the sector has increased at a more moderate rate in – by 27% (on average similar for both the exported production and that sold in the domestic market).

The dynamics of the sales revenues of the sector is mainly influenced by changes in producer prices. After experiencing marked fluctuations during the crisis, producer prices have stabilised and have remained practically unchanged since the beginning of 2010. In November 2011, producer prices have increased only by 0.4% in a year, including in domestic market – by 1 per cent.

Future development opportunities of the sector are mainly related to export. It is proven by the optimistic evaluation of sector entrepreneurs regarding export orders.

Figure 3.32

**Indicators Characterising Production of Electrical and Optical Equipment**



***The sector of machinery and equipment production*** is the supplier of production means and technologies to other sectors. Over 85% of all production of the sector is sold in foreign markets. Production volumes significantly shrank along with the shrinking economic activities during the crisis. 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. At the end of 2009, the situation in the sector stabilised; however, the overall production level during the crisis reduced by a half.

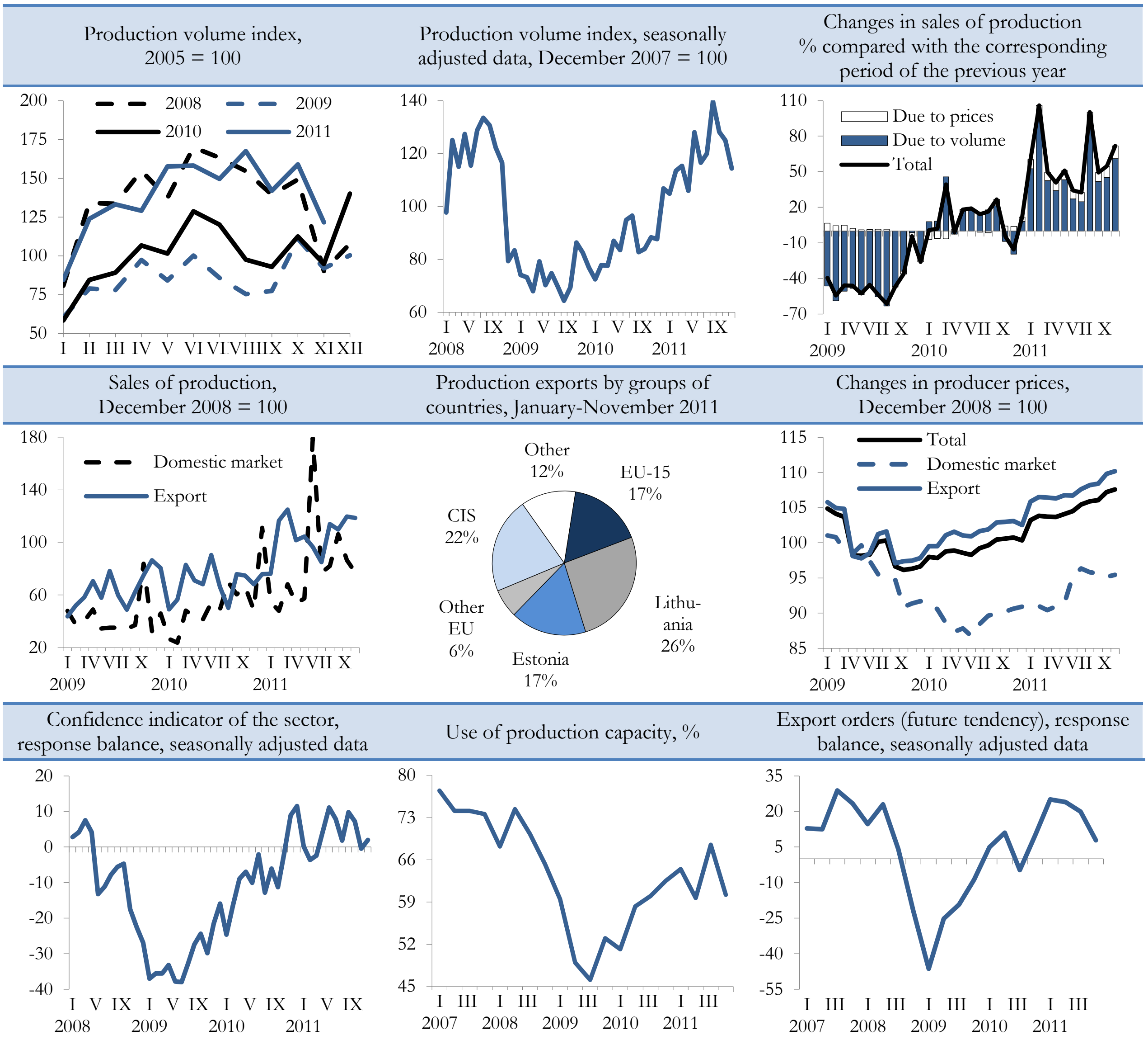
Recovery from the crisis in production of machinery and equipment is closely related not only to the changes in external demand but also to the increase in domestic demand. In 2010, volumes of manufactured production in the sector increased by 17.8%, while the increase in turnover was more moderate – by 9.6%. In 2010, sales volumes in domestic market increased significantly faster (by 25%) while volumes of production sold for export increased by just 7%. In 2011, production volumes in the sector have reached the pre-crisis level. Overall, production outputs in the eleven months of 2011 have increased by over 40% in comparison with January-November 2010. Meanwhile, the turnover in this period has increased by almost 60% (including in the domestic market by 67%, but exported production – by 55%).

Since the end of 2009, when the demand in global market increased, producer prices for exported production have been growing, yet the increase is comparatively moderate. In November 2011, the producer prices for exported production were by 6.9% higher than a year ago. Producer prices for the production sold in the domestic market continued decreasing until the mid-2010 due to the weak demand in the domestic market followed by a moderate rise in prices. In November 2011, the producer prices have increased by 5.3% in a year.

Positive future development tendencies of the sector are proven by the increase in new orders, including in the domestic market.

Figure 3.33

**Indicators Characterising Production of Machinery and Equipment**



***The sector of vehicle production*** is characterised by marked fluctuations of production volumes closely related to changes in new orders. As almost 90% of production is exported, fluctuations of external demand have a significant impact on development of the sector. 80% of all exported production is sold in the EU market, more than a half of it – in Lithuania and Estonia.

During 2008 and 2009, production volumes of the sector decreased by almost a half. Since 2010, along with the improving situation in external markets, the volumes of production in the sector resumed increasing and in 2010 exceeded the level of 2009 by 59 per cent.

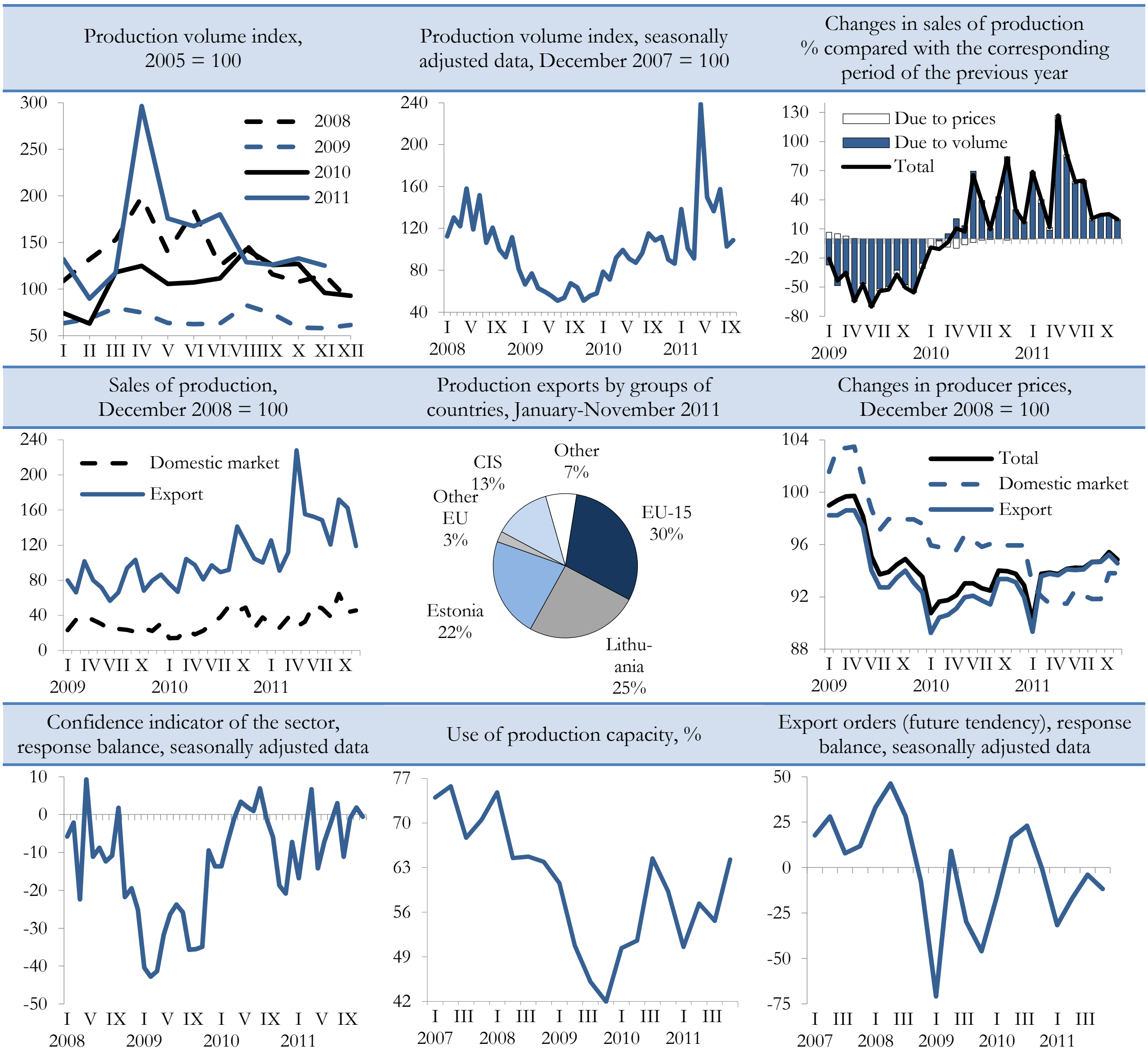
The volumes of new orders in both domestic and external markets increased rapidly in the second half of 2010 and in 2011. Despite the decrease in production volumes in the second half of 2011, overall in January-November 2011, production volumes of vehicles production sector have increased by almost 40% in comparison with the eleven months of 2010.

The increase in production sold for export has contributed more to the growth of the turnover of the sector in 2011 – by 48% in the eleven months of 2011. At the same time, revenues from production sold in the domestic market increased by 34.7%. Despite the rapid increase in volumes, the level of production capacity load at the end of 2011 was 64%, and that is by approximately 10 percentage points less than at the end of 2008.

During the crisis, the decrease of demand resulted in a decline in producer prices, but despite the gradual increase of demand over the course of last years, producer prices practically are not growing. Producer prices in the domestic market even decreased in 2011 – in November 2011, they were by 2.2% lower than a year ago. The small rise in prices for the exported production resulted in the increase of producer prices overall by 1.2% in the sector in total.

Figure 3.34

**Indicators Characterising Production of Vehicles**



## 3.3. Forecasts

The Ministry of Economics has developed medium-term forecasts of more rapid and slower economic development (until 2016). The basic assumptions of the developed forecasts are based on different global economic recovery scenarios and on the ability of Latvian producers to maintain competitiveness restored during the crisis. Forecasts of the European Commission, as well as of the International Monetary Fund as of December 2011, 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**

Economic growth of Latvian economy remained stable in the 4th quarter of 2011. According to the estimation of the Ministry of Economics, GDP in 2011 may exceed the level of 2010 by 5.5 per cent.

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. The exacerbating debt crisis in the euro zone, as well as uncertainty about the expected fiscal consolidation in most developed countries have forced international institutions to reduce the forecasted global economic growth rates for 2012, including the main trade partner countries of Latvia.

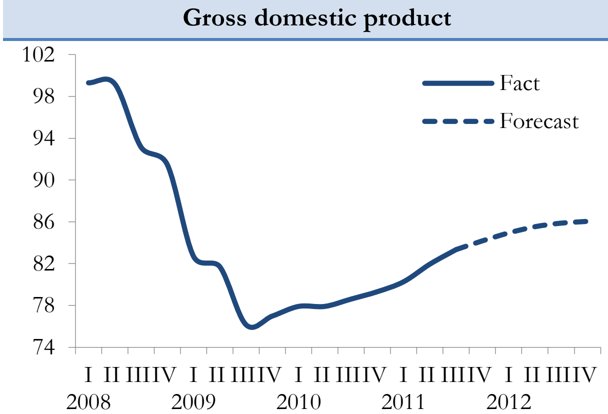
Exports of Latvia will grow at a more moderate rate. In 2012, the decreased economic growth may lead to reduced positive effect on the overall national economy. Therefore no significant increase in domestic demand is expected in 2012. The increase in consumption will be still limited also by high indebtedness of households and a relatively high unemployment rate despite the gradually improving situation in the labour market.

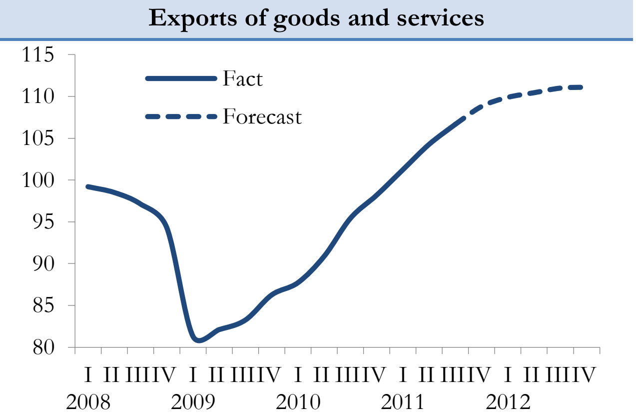
The dynamics of investments will be affected by cautious crediting policy of commercial banks, whereas private sector investments will be influenced by the awaiting behaviour of entrepreneurs regarding future perspectives.

Thus, the growth of the economy of Latvia will not exceed 3% in 2012. Yet, considering many uncertainties about possibilities of solving several big debt problems in the euro zone and their potential impact on the real sector of these countries, the Ministry of Economics has prepared also the more pessimistic forecast of 1.5% growth of GDP in 2012.

Figure 3.35

**Forecast of GDP and Exports**
(4th quarter of 2007 = 100)



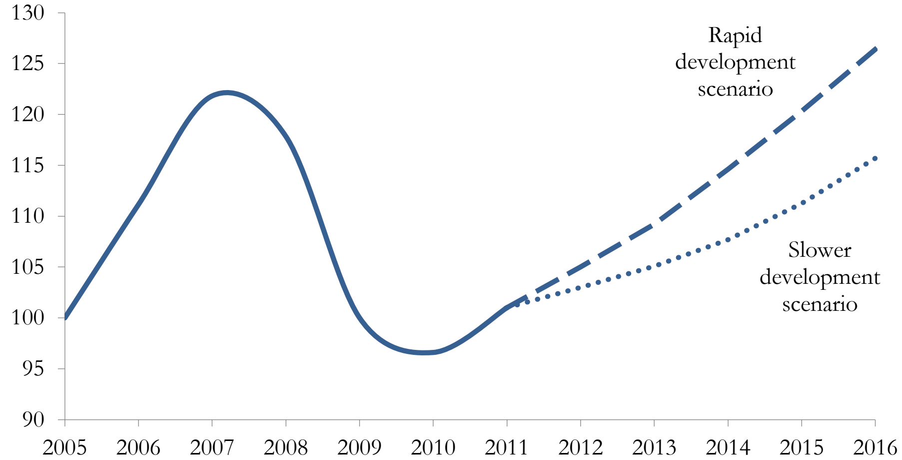

In 2012, most of the sectors of the national economy will grow, though at a slower growth rate than in 2011. Despite the slowdown of the growth rates, still export-oriented sectors (manufacturing, agriculture and forestry, transport services) will greatly contribute to the growth. Yet, the decrease in the government budget expenditures will affect public services sectors where output in 2012 will remain at the level of 2010.

**Development Perspectives in 2013-2016**

The medium-term growth of the national economy will depend to a great extent on two factors. Firstly, on the solutions the euro zone countries will be able to adopt to exit the tension in financial sector in order to avoid possible economic stagnation. Secondly, it will depend on how efficient will be the structural policy implemented by the Latvian government for improvement of competitiveness under limited access to financing, including state budget. It is particularly important to keep improving competitiveness of Latvian producers also in the main export sector – manufacturing.

Figure 3.36

**Forecast of Latvian GDP**
(2005 = 100)




The more rapid development scenario foresees that growth rates of manufacturing (and respectively also exports) will remain comparatively fast also after 2012, based mainly on both the increased competitiveness of Latvian producers and on the growth of external demand. The slower development scenario assumes that the growth in Europe will be weak and competitiveness in tradable sectors will not improve in the medium-term.

Table 3.12

**Forecast of Latvian GDP by Expenditure Items**

| | 2011 | 2012 | 2013-2016 average annually* |
|---|---|---|---|
| *in % over the previous year* | | | |
| **Gross domestic product** | **5.5** | **1.5..3.0** | **3.0..4.7** |
| Private consumption | 4.7 | 3.7..4.0 | 2.4..4.6 |
| Public consumption | 1.9 | -0.9..1.0 | 0.2..0.5 |
| Gross fixed capital formation | 23.7 | 1.8..7.0 | 4.0..8.4 |
| Exports | 12.5 | 1.9..5.0 | 3.4..6.0 |
| Imports | 19.2 | 4.3..8.3 | 2.6..6.2 |
| *structure, %* | | | |
| **Gross domestic product** | **100** | **100** | **100** |
| Private consumption | 62.9 | 64.5..63.8 | 63.0..63.5 |
| Public consumption | 15.5 | 14.5..14.5 | 12.2..11.6 |
| Gross fixed capital formation | 22.9 | 23.4..24.3 | 25.1..28.8 |
| Changes in inventories | 1.4 | 2.9..3.1 | 3.3..2.6 |
| Exports | 60.1 | 59.6..60.7 | 59.3..62.5 |
| Imports | 62.9 | 64.8..66.4 | 62.8..69.0 |
| Export-import balance | -2.8 | -5.3..-5.7 | -3.6..-6.4 |

* structure at the end of the period

Competitiveness of Latvian manufacturing is based mainly on relatively cheap labour and low total costs. Due to the rise of labour costs and prices in 2006 and 2007, these advantages to a great extent were lost. In 2008–2010, the significant decrease of overall demand and the strict budget limitations, when wages in the public sector were considerably reduced, decreased the overall level of wages and prices in the domestic market, thus partly improving the competitiveness of Latvian producers. Currently, this impact has decreased and wages have started to increase again. It should be taken into consideration that under the conditions of free movement of labour force it will be not possible to maintain continuously low wages in the Latvian economy in the long-term, therefore a corresponding productivity increase and increased diversity of export products will play a crucial role, allowing to compete in the international markets more successfully.

Table 3.13

**Forecast of Latvian GDP by Sectors**
(in % over the previous year)

| | 2011 | 2012 | 2013-2016 average annually |
|---|---|---|---|
| **Gross domestic product** | **5.5** | **1.5..3.0** | **3.0..4.7** |
| Agriculture, forestry | 2.9 | 1.5..1.6 | 2.8..3.8 |
| Manufacturing | 11.8 | 0.2..3.7 | 4.9..6.2 |
| Other industry | 1.8 | 0.3..0.8 | 1.7..1.7 |
| Construction | 9.2 | 2.1..7.7 | 4.9..6.3 |
| Trade, accommodation | 10.0 | 3.9..5.3 | 2.9..5.4 |
| Transport and storage | 7.9 | 2.5..2.8 | 3.0..5.9 |
| Other commercial services | 0.1 | 0.8..1.5 | 2.7..4.5 |
| Public services | 0.7 | -1.0..-0.3 | 0.6..0.8 |

According to the rapid growth scenario, in order to ensure the average annual growth of 4.7% in 2013-2016, the production volumes of manufacturing should increase by more than 6% annually.

The growth in the medium-term will be not as rapid as it has been in 2005–2007, because its driving force will be not related with the large financial inflows that have stimulated domestic demand and fostered mainly 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 Latvia, which was affected by the global financial crisis, has a significant impact on the Latvian fiscal position. The general government sector budget deficit in Latvia was LVL 1256.6 million or 9.6% of GDP, and in 2010 it slightly decreased by LVL 1050.6 million or 8.2% of GDP (see Table 4.1).

Table 4.1

**General Government Budget**

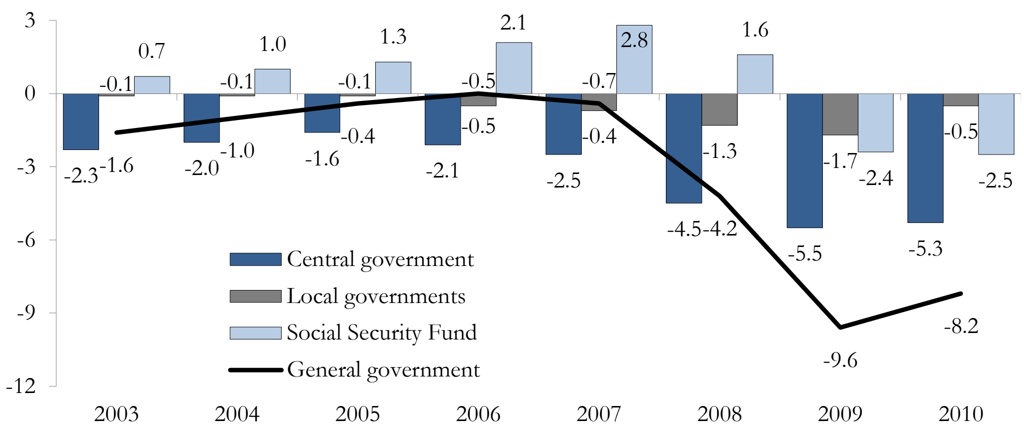
| | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|
| Revenues (million LVL) | 4208.0 | 5235.5 | 5605.8 | 4519.2 | 4601.8 |
| (% of GDP) | 37.8 | 35.6 | 34.9 | 34.6 | 36.1 |
| Expenditures (million LVL) | 4263.2 | 5287.9 | 6287.0 | 5775.8 | 5652.5 |
| (% of GDP) | 38.3 | 35.9 | 39.1 | 44.2 | 44.4 |
| Balance (million LVL) | -55.1 | -52.4 | -681.2 | -1256.6 | -1050.6 |
| (% of GDP) | -0.5 | -0.4 | -4.2 | -9.6 | -8.2 |

In 2009 and 2010, the general government budget deficit was constituted 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). The social insurance budget had a surplus in the previous years, however, the deficit has appeared over the last two years.

Figure 4.1

**General Government Budget Balance by Sub-Sectors**

(% of GDP)

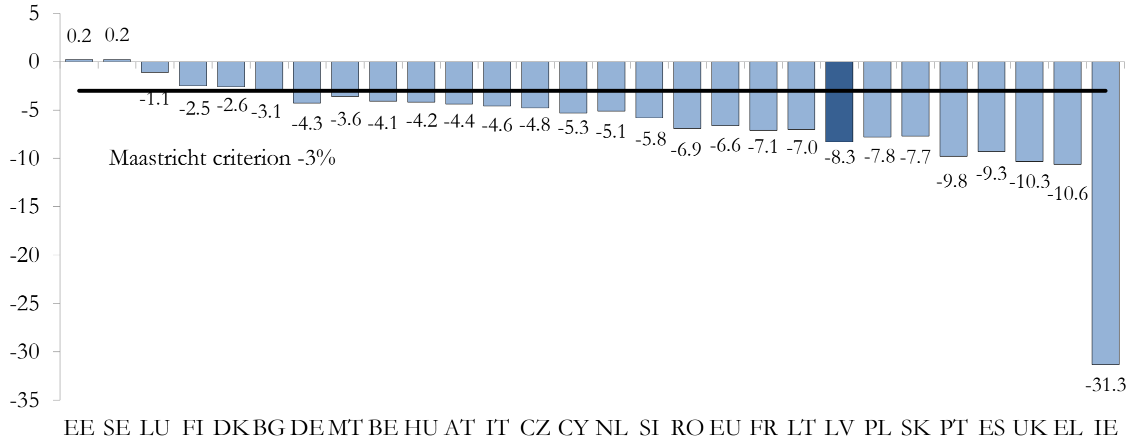



The budget deficit was observed in 2010 almost in all 27 EU Member States. The average budget deficit level of the EU Member States in 2010 was 6.6% of GDP (in 2009 – 6.9% of GDP, in 2008 – 2.4% of GDP). The budget condition of 21 EU Member States was improved in 2010. However, only Estonia and Sweden had a slight budget surplus (0.2% of GDP). Ireland, Greece, the United Kingdom, Portugal, and Spain had the highest general government budget deficit to GDP in 2010. The budget deficit in these countries exceeded 9% of GDP.

According to the forecasts of the European Commission published in autumn 2011, the budget situation in the EU Member States is expected to continue improving both in 2011 and 2012. In 2011, the average budget deficit level of the EU states is forecasted to be in the amount of 4.7% of GDP, but in 2012 – 3.9% of GDP. In 2011, the highest budget deficit that could exceed 8% of GDP is expected in Ireland, Greece, and the United Kingdom.

Figure 4.2

**General Government Budget Deficit/Surplus in the EU Member States in 2010**
(% of GDP)



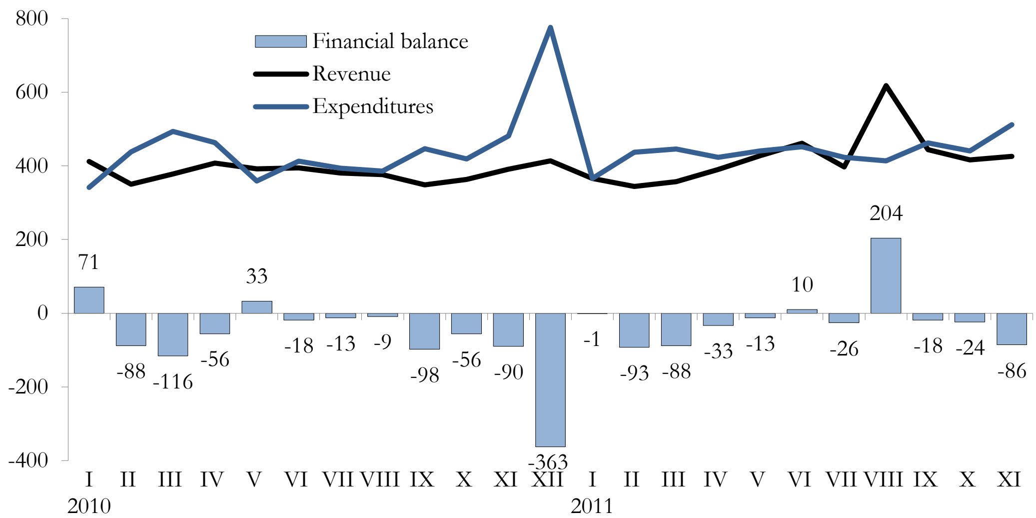

On December 21, 2010, the Saeima adopted the budget for 2011 envisaging the general government budget deficit in the amount of 5.4% of GDP, which is considerably below the set budget deficit target of 6% of GDP (commitments of Latvia expressed upon concluding the Memorandum of Understanding with the EU and signing the Letter of Intent with the IMF). On April 14, 2011, the Saeima adopted the amended budget for 2011, thus reducing the general government budget deficit to 4.2% of GDP. However, taking into consideration the provisions stipulated in the Law on Budget concerning the possibility to increase additionally the appropriation for unforeseen cases if necessary, the estimated budget deficit for 2011 is 4.5% of GDP. In total, consolidation measures in the amount of LVL 350 million have been included in the budget for 2011, thus allowing fulfilment of the budget deficit target.

The consolidation in 2011 was carried out by raising certain tax rates (VAT, real estate tax, excise duty, personal vehicle tax), cancelling tax reliefs/reduced rates (VAT, excise duty), raising social insurance contributions of employees, introducing financial stability fee, increasing proportions of public enterprise dividend payments, etc. Also, a range of measures to reduce budget expenditures were carried out – reduced expenditure for personnel and wages in public administration, reduced expenditures in health, social, and defence sectors, as well as reduced subsidies for education and certain public transport passenger carriers.

Overall, consolidation measures of fiscal impact in the amount of 16.6% of GDP have been carried out from 2008 until 2011, out of which 6.7% of GDP are measures on the revenue side, while measures on the expenditure side constitute total 9.9% of GDP.

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. According to the provisional estimation of the Ministry of Finance, general government budget deficit was 4% of GDP.

The fiscal policy target of Latvia for 2012 was to prepare a budget that would ensure the general government deficit below 3% of GDP (according to the ESA'95 methodology), at the same time striving to achieve the deficit target in the amount of 2.5% of GDP.

On December 15, 2011, the Saeima approved the budget for 2012 envisaging the general government budget deficit below 2.5% of GDP pursuant to the European Commission's ESA '95 methodology. The fiscal consolidation measures for 2012 approved by the government constitute a total of LVL 156.1 million including both reducing the general government budget expenditures in the amount of about LVL 89.7 million and increasing revenue in the amount of about LVL 66.4 million. In comparison with the plan for 2011 (with amendments), the draft law expects an increase in the revenues for the amount of LVL 255.1 million or 6% and a decrease in expenditures for the amount of LVL 113.5 million or 2.4%. In 2012, funding in the amount of LVL 993.9 million or 30.6% of the total general government budget expenditures are allocated for implementation of projects and measures financed and co-financed by the European Union policy instruments and other foreign financial support.

The general government deficit is expected to be below 1.9% of GDP in 2013 and 1.1% of GDP in 2014. By achieving these objectives, excessive budget deficit will be prevented, and the Maastricht criterion for the budget deficit will be fulfilled in a sustainable way.

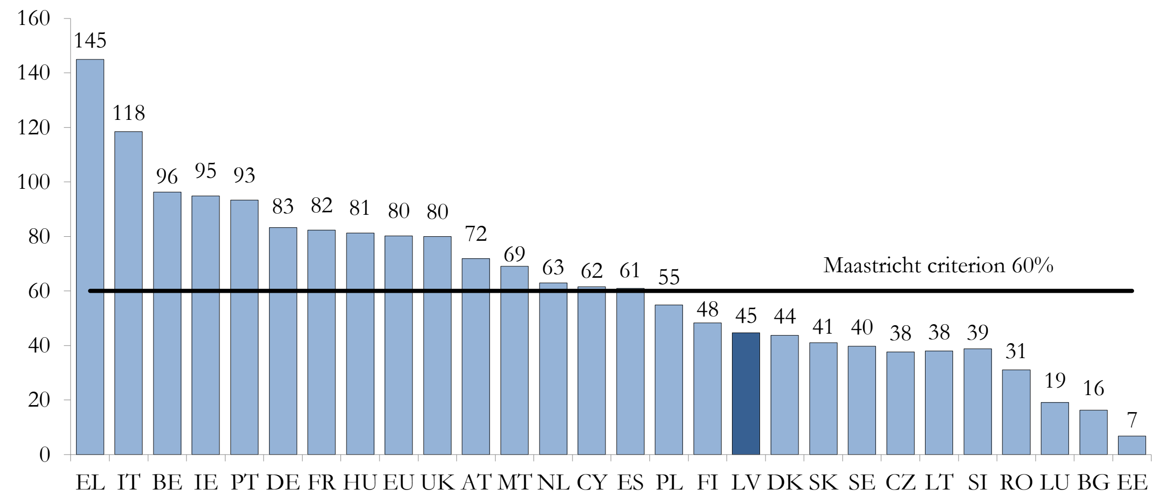
In order to ensure development of sustainable and counter-cyclical fiscal policy, the *Draft Law on Fiscal Discipline* has been developed stipulating binding fiscal conditions for both the annual state budget and medium-term budget. In order for these systemic new approaches towards development of fiscal policy and observing discipline to be sustainable without being constantly amended or even cancelled, amendments to the Constitution (*Satversme*) have been prepared. In addition to these legislative proposals, also amendments to the *Law on Budget and Financial Management* have been prepared in order to improve the budget quality and its link to planning documents.

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

In 2010, the EU average level of the public debt was 80.2% of GDP (74.7% of GDP in 2009, 62.5% of GDP in 2008). The public debt exceeded the Maastricht criterion that is 60% of GDP in 14 EU Member States in 2010. In 2010, the highest public debt to GDP was observed in Greece, Italy, Belgium, Ireland, and Portugal, while the lowest general government debt to GDP was registered in Estonia, Bulgaria, and Luxembourg. According to the European Commission forecasts for autumn 2011, the average level of the general government debt in the EU will reach 82.5% of GDP in 2011 and will continue increasing also in 2012 and 2013.

Figure 4.4

**General Government Debt in the EU Member States in 2010**
(% of GDP)



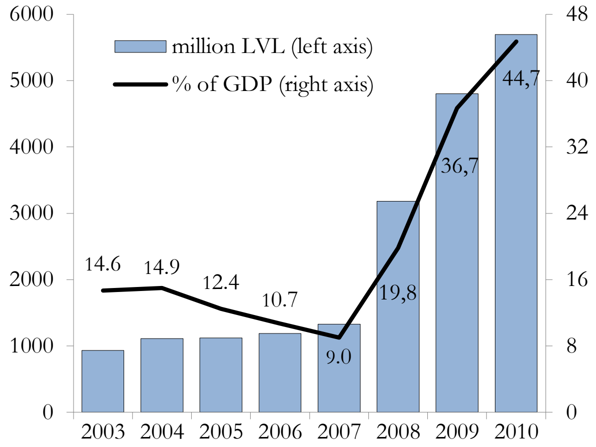

The general government debt in Latvia has gradually increased until 2007. Since 2008, it has been growing rapidly to ensure the financial obligations of the government and reached LVL 5694.6 million or 44.7% of GDP at the end of 2010 (see Figure 4.5), but at the end of September 2011 – LVL 6109.8 million. The level of the general government debt is mainly influenced by the central government debt.

At the end of 2008, on the basis of the *Economic Stabilization and Growth Revival Programme of Latvia,* the

IMF, the European Commission, the World Bank, the European Bank for Reconstruction and Development, and several EU Member States have agreed on providing financial support to Latvia from 2008 until 2011 in the amount of LVL 5.3 billion (EUR 7.5 billion). According to the concluded agreements, the funding of the international loan programme is envisaged for covering the financial obligations of the government budget (including financing the government budget deficit and loans, refinancing of public debts) and ensuring stability of the financial sector.

Figure 4.5

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




In the framework of the international assistance programme, the total financing in the amount of LVL 3.1 billion (EUR 4.4 billion) has been received from 2008 until the end of 2010) – slightly more than a half of the total initial amount of the programme.

Considering the improved economic and financial situation in the country, Latvia has no need to receive the funding in full amount available within the loan. Latvia plans to pay the received funding by refinancing the government debt to the international financial market. This June, Latvia has successfully returned to international financial markets by issuing 10-year euro bonds worth USD 500 million. Latvia plans to further issue public annual state debt securities and ensure priority diversifying of the investor base (Europe, USA, and Asia).

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

### 4.1.2. Budget Revenues

Revenues of the general government consolidated budget in 2010 decreased by 2.6% in comparison with 2009, while in January-November 2011, the revenues of the general government consolidated budget were LVL 4647.9 million, which is by LVL 454.3 million or 10.8% more than in the corresponding period of the last year. The share of tax revenues in total revenues has increased in 2011.

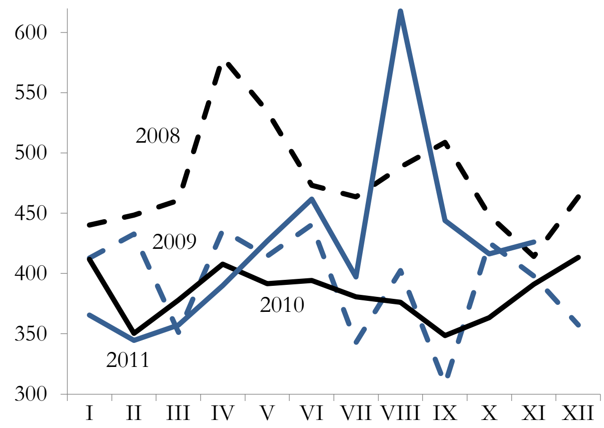
Increase in revenues of the general government budget is mainly related to increase in tax revenues (by nearly 14%).

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

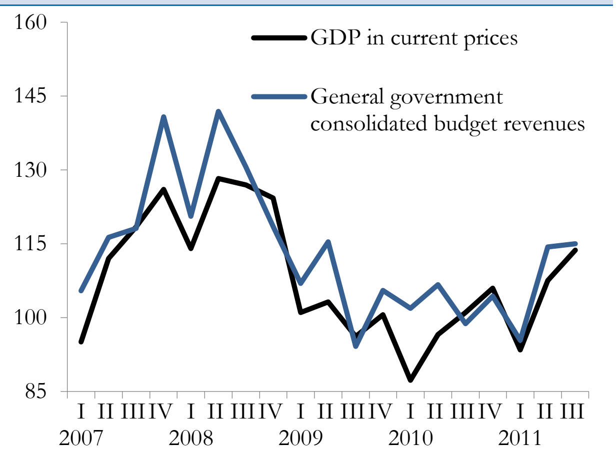
Taxes collected in the January-November 2011 constituted 76% of all budget revenues. Total tax revenues increased by 13.6% and constituted LVL 3533.9 million in comparison with the previous year slightly exceeding the expected tax revenues in 2011.

Figure 4.6

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




**GDP and General Government Consolidated Budget Revenues by Quarters**
(4th quarter of 2006, = 100)




* According to the official data of monthly reports of the Treasury

Table 4.2

**Budget Revenues***
(% of GDP)

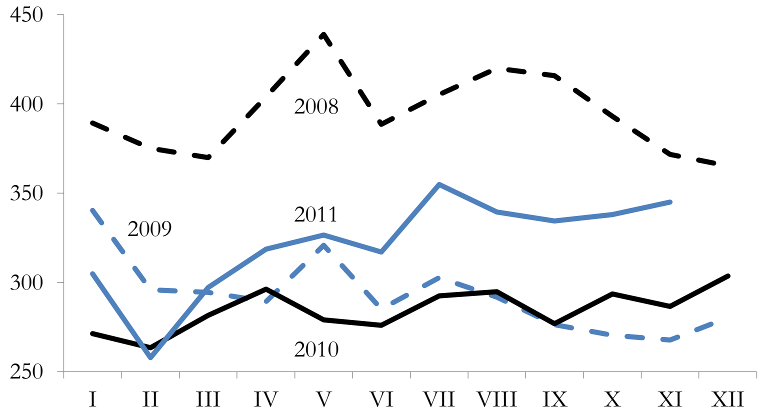
| | 2007 | 2008 | 2009 | 2010 | 2011 I-IX |
|---|---|---|---|---|---|
| **General government consolidated budget revenues** | **36.3** | **35.6** | **36.2** | **36.2** | **37.1** |
| **I Tax revenues** | **29.6** | **29.4** | **26.9** | **26.8** | **27.8** |
| *1. Indirect taxes* | 11.4 | 10.5 | 10.1 | 10.2 | 10.6 |
| – value added tax | 8.2 | 6.9 | 6.1 | 6.5 | 7.0 |
| – 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 | 7.9 |
| – corporate income tax | 2.7 | 3.1 | 1.5 | 0.9 | 1.3 |
| – personal income tax | 6.0 | 6.4 | 5.6 | 6.2 | 5.7 |
| – real estate tax | 0.5 | 0.4 | 0.6 | 0.7 | 0.9 |
| *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 | 9.3 |

* Data of the Treasury

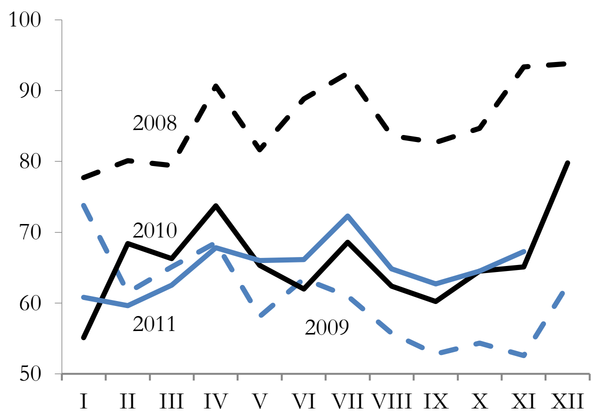
Increase in taxes in January-November 2011, mainly relied on the increase in revenues from mandatory state social insurance contributions, value added tax, and corporate income tax.

Figure 4.7

**Tax Revenues by Months***
(million LVL)




**Personal Income Tax**




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

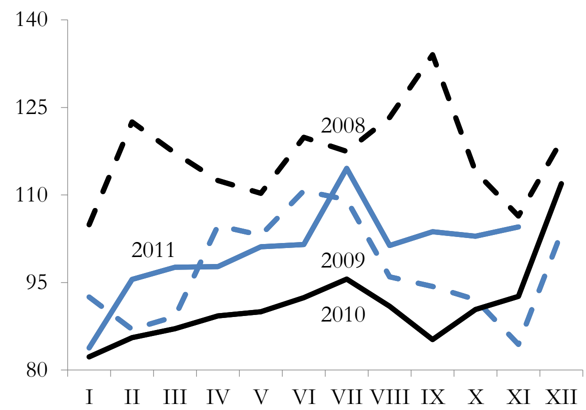
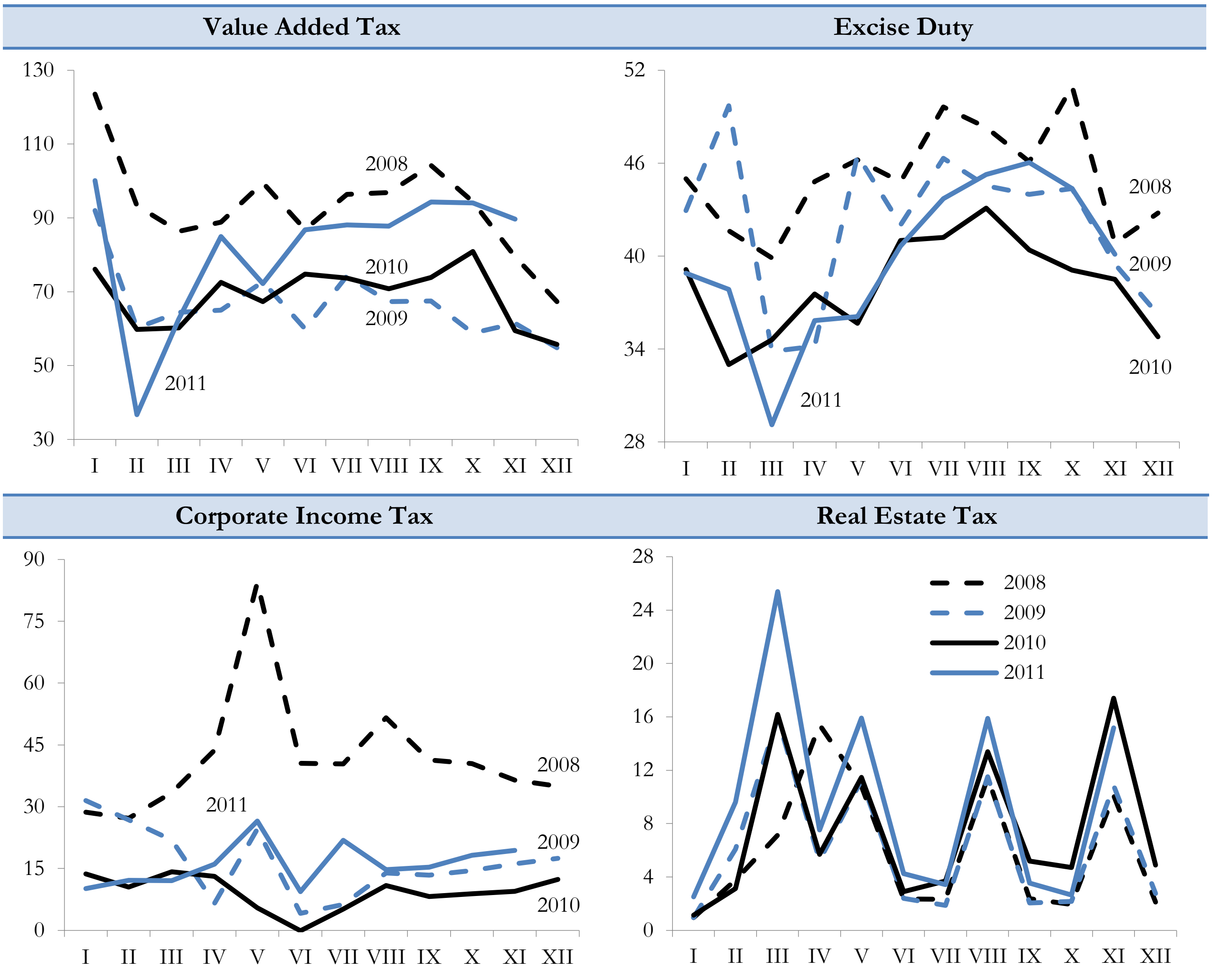


Figure 4.7 continued




* According to the official data of monthly reports of the Treasury

The share of **employment tax** in January-November 2011, constituted almost 51.5% of all tax revenues which is by 3.7% less than in 2010. In this period, the share of employment tax in the overall tax revenues has shrunk by 2.9 percentage points in comparison with the previous year.

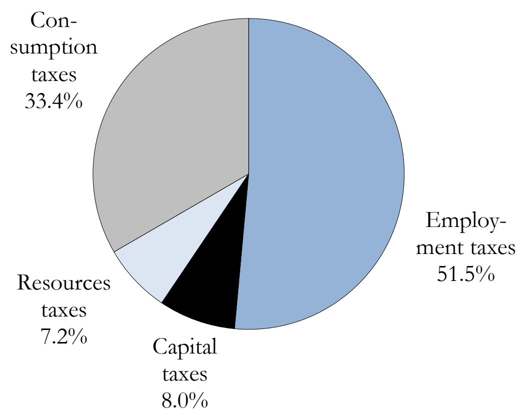
The personal income tax standard rate has been reduced from 26% to 25% as of January 1, 2011. At the same time, the monthly non-taxable minimum of the personal income tax payer has been raised from LVL 35 to LVL 45, as well as the tax credit for the care of dependent persons of personal income tax from LVL 63 to LVL 70 per month. 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.

In January-November 2011, the collected personal income tax amounted to LVL 714.5 million, and it has been slightly increased in comparison with the corresponding period of 2010 (by 0.4%). It is mainly related to the raised minimum monthly wage from LVL 180 to LVL 200 (since January 1, 2011) and to an increase in the number of the employed.

Figure 4.8

**General Government Consolidated Budget Tax Revenues by Tax Groups in 2011**

(%)




The standard rate of the state mandatory social insurance contributions was increased from 33.09% to 35.09% as of January 1, 2011 according to the increase in the employee rate from the current 9% to 11 per cent.

The revenues from mandatory state social insurance contributions in January-November 2011 were LVL 1104.3 million, which is by 12.5% higher than in the respective period of 2010. The increase in revenues is related to the increase in the standard rate of state mandatory social insurance contributions and of the minimum monthly wage, as well as to the increase in the number of the employed.

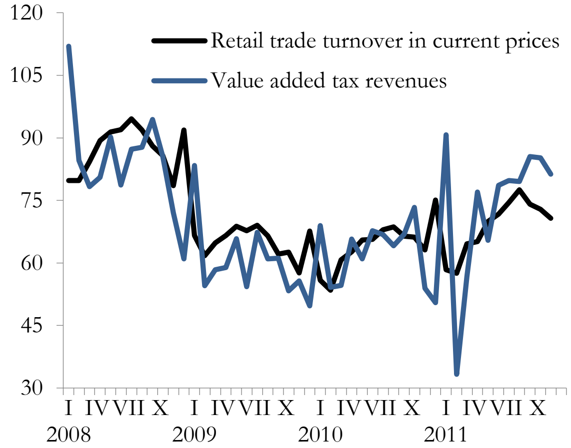
The share of **the consumption taxes** in the tax structure has reduced from 31% in 2010 to 33.4% in 2011.

On January 1, 2011, the standard rate of the value added tax was increased from 21% to 22%, but the reduced tax rate applicable to particular goods and services was increased by 2% (from 10% to 12%). Since January 1, 2011, the standard rate in the amount of 22% is applied to electricity supply for inhabitants. 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 provided construction services into the state budget, thus limiting fraud in the construction sector.

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 to decrease. Due to the increase in import volumes and changes in the retail trade turnover amount, the value added tax increased in 2010. In January-November 2011, the revenue of value added tax increased significantly and was LVL 356.5 million which is by 16.6% more than in the corresponding period of the previous year.

A standard tax rate was applied to fuel containing 5% of biofuel, and excise duty was raised for non-alcoholic beverages in 2011. The new rates for certain tobacco products came into force on January 1, 2011. Furthermore, a common procedure regarding the application of the excise duty to food supplements containing alcohol was established in 2011. The excise duty rate for alcoholic beverages and fuel was raised, as well as gradual increase of the excise duty for tobacco products was set. As of January 1, 2012, the new amendments to the *Excise Duties Law* are in force. Changes will apply to the criterion for regular movement of goods to be imported from third countries by natural persons by replacing the existing definition "not more than once a day" with "not more than once every seven days". Thus, the risk of malicious use of exemption from the excise duty under the law will be reduced.

In 2010, the revenues from the excise duty were by 9.1% less than in 2009. In January-November 2011, the revenues from the excise duty were LVL 437.9 million which is by LVL 14.7 million or 3.5% more than in the respective period of the previous year. The increase in the excise duty was influenced by an increase in the amount of legal sales of alcohol and cigarettes.

The share of **the capital taxes** in the total tax revenues increased from 5.9% in 2010 to 8% in 2011.

The reducing business activities and the increasing number of insolvent enterprises in 2010 caused a significant decrease of the enterprise income tax levy (by 43.1%); however in January-November 2011, the situation considerably improved, and the enterprise income tax levy amounted to LVL 175.8 million which is by 76.3% more than in the corresponding period of 2010. An increase in the enterprise income tax levy is mainly related to the reduction in the amount paid.

In 2010, the real estate tax levy has significantly increased (by 22.9%). A significant increase in the real estate tax revenues was observed also in January-November 2011, reaching LVL 105.9 million and being by 24.8% higher than in the corresponding period of the previous year. It is mainly related to doubling of the real estate tax for residential space. Since 2012, the amendments to the law on real estate tax provide the local municipalities with more rights to define tax objects (for example, applying tax to auxiliary buildings of residential buildings. The amendments also entitle local municipalities to decide on the application of limitation for an increase in the amount of the real estate tax in 2012.

The share of **resource tax** group has been reduced from 7.9% in 2010 to 7.2% in 2011.

Changes in resource tax group are mainly related to the excise duty for oil products. In 2010, the excise duty for oil products was collected in the amount of LVL 260.9 million which is by 8.2% less than in 2009, but in 2011, it decreased by LVL 2.4 million or 9.4% in comparison with the previous year which is due to the changes in the structure of oil products for consumption as the amount of oil products with a lower excise tax rate were consumed more.

Annual revenues from the natural resources tax (including special budget of local municipalities) in 2010 have increased by 18.3% exceeding the plan by 26.9%. Similarly, in 2011, revenues from the natural resources tax increased by 18.5%, in comparison with the previous year thus exceeding the plan by 0.4 per cent.

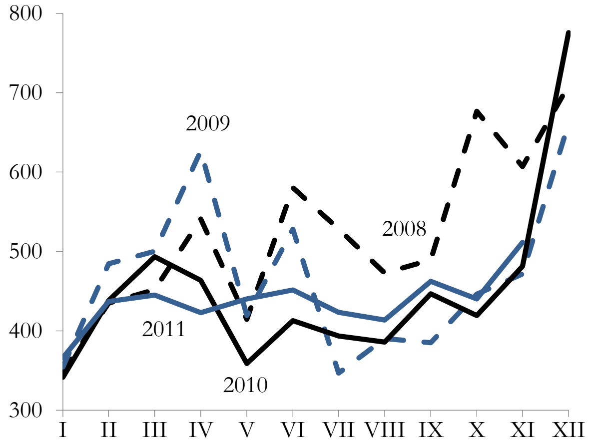
## 4.1.3. Budget Expenditures

In 2010, the government consolidated budget expenditures were reduced (by 6.4%) in comparison with the previous year, but in January-November 2011, the total government consolidated budget expenditures increased reaching LVL 4814.9 million which is by 3.9% more than in the corresponding period of 2010.

Figure 4.10

**General Government Consolidated Budget Expenditures by Months***

(million LVL)




* according to official monthly report data of the Treasury

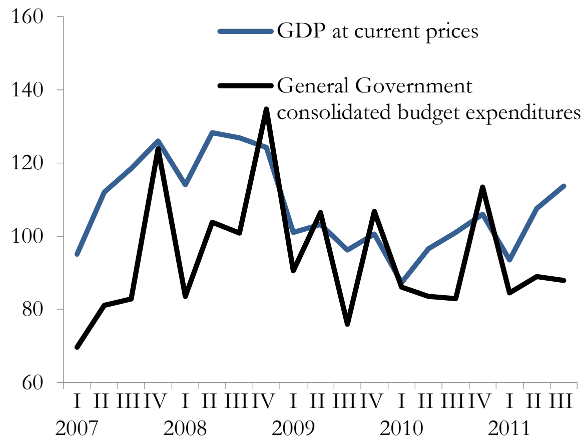
In January-November 2011, the expenditures for subsidies and grants decreased by 6.6%, but current expenditures – by 0.2% in comparison with the same period of 2010. Just like a year ago, the capital expenditures increased significantly in January-November 2011.

Current expenditures and subsidies and grants kept a high share in expenditures.

Figure 4.11

**GDP and General Government Consolidated Budget Expenditures by Quarters**

(4th quarter of 2006, = 100)

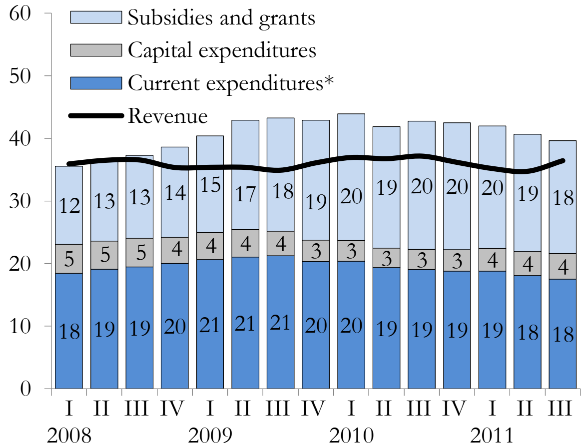



According to expenditures by functional categories, the highest share at the end of 3rd quarter of 2011 was for social security (30.6% of all expenditures) followed by economic affairs (17.4%), education (16.9%), and expenditures for general government services (12.5%), but the lowest share of all expenditures 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)




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

Table 4.3

**Expenditures of the General Government Consolidated Budget by Functions***

(per cent)

| | 2008 | | 2009 | | 2010 | | 2011 I-IX | |
|---|---|---|---|---|---|---|---|---|
| | structure | to GDP | structure | to GDP | structure | to GDP | structure | to GDP |
| **Expenditures – total** | **100** | **38.9** | **100** | **43.0** | **100** | **42.5** | **100** | **37.7** |
| General public services | 13.6 | 5.3 | 14.8 | 6.4 | 13.4 | 5.7 | 12.5 | 4.7 |
| Defence | 3.5 | 1.4 | 2.4 | 1.0 | 2.0 | 0.9 | 1.8 | 0.7 |
| Public order and safety | 5.0 | 1.9 | 4.5 | 1.9 | 4.4 | 1.9 | 4.5 | 1.7 |
| Economic affairs | 18.1 | 7.0 | 15.7 | 6.7 | 16.0 | 6.8 | 17.4 | 6.5 |
| Environmental protection | 2.4 | 0.9 | 2.2 | 0.9 | 1.1 | 0.5 | 2.2 | 0.8 |
| Housing and community amenities | 3.6 | 1.4 | 2.1 | 0.9 | 2.5 | 1.1 | 2.7 | 1.0 |
| Health | 8.1 | 3.1 | 7.5 | 3.2 | 7.2 | 3.1 | 8.3 | 3.1 |
| Recreation, culture, and religion | 4.0 | 1.6 | 3.4 | 1.5 | 2.9 | 1.2 | 3.2 | 1.2 |
| Education | 20.2 | 7.9 | 19.6 | 8.4 | 16.7 | 7.1 | 16.9 | 6.4 |
| Social security | 21.5 | 8.4 | 27.9 | 12.0 | 33.8 | 14.4 | 30.6 | 11.5 |

* according to the official data of the Treasury

**The public demand** is made 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 outlay using the budget resources.

Table 4.4

**Public Demand**

| | % to GDP | | | | Changes in comparison with the previous year, % | | | |
|---|---|---|---|---|---|---|---|---|
| | 2007 | 2008 | 2009 | 2010 | 2007 | 2008 | 2009 | 2010 |
| **Public Demand** | **23.5** | **24.9** | **23.9** | **21.2** | **10.9** | **-3.5** | **-13.3** | **-11.0** |
| *Public consumption* | 17.8 | 20.0 | 19.6 | 17.5 | 4.9 | 1.6 | -9.4 | -9.7 |
| – central government* | 9.8 | 10.9 | 10.7 | 10.0 | 2.1 | 0.7 | -8.7 | -6.1 |
| – local government | 8.0 | 9.1 | 8.8 | 7.5 | 8.6 | 2.5 | -10.3 | -14.0 |
| *Gross fixed capital formation* | 5.7 | 4.9 | 4.3 | 3.7 | 28.2 | -15.4 | -24.1 | -15.5 |
| – central government* | 2.9 | 1.8 | 1.5 | 1.2 | -3.6 | -38.1 | -25.4 | -25.9 |
| – local government | 2.8 | 3.1 | 2.7 | 2.6 | 92.1 | 7.5 | -23.3 | -9.7 |

* together with the Social Security Fund

The public demand decreased most rapidly in 2009 (by 13.3%). A significant decrease was observed also in 2010 when the public demand reduced by 11% in comparison with the previous year. Just like the previous years, the decrease in demand was mainly due to cutting down central government expenditures for the total fixed capital development (by 25.9%).

Municipal expenditures for investments were significantly reduced in both 2009 and 2010.

# 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 can reduce the total price level. However, price level was more significantly affected by external factors.

In 2010, the consumer prices already increased by 2.5% (12-month inflation), but, considering the deflation in 2009, the average price level in 2010 was by 1.1% lower than a year ago. The price rise in 2010 was mainly affected by the rise in the world prices for food and oil products. Changes of other product and services groups generally slightly reduced the consumer price index in 2010.

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. It should be noted that during summer the rise in prices in Latvia slightly slowed down due to the influence of seasonal factors and decline in prices worldwide.

Figure 4.13

**Private Consumption and Consumer Price Index**

(4th quarter of 2005 = 100)

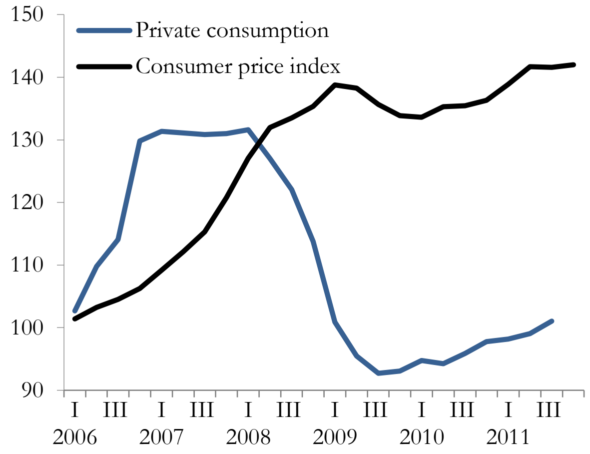



Table 4.5

**Consumer Price Changes by Months**

(per cent)

| | Compared to the previous month | | Compared to the respective month of the previous year | | Average during the year | |
|---|---|---|---|---|---|---|
| | 2010 | 2011 | 2010 | 2011 | 2010 | 2011 |
| January | 0.2 | 1.3 | -3.1 | 3.7 | 2.5 | -0.5 |
| February | 0.0 | 0.3 | -4.2 | 4.0 | 1.3 | 0.2 |
| March | 0.5 | 0.7 | -3.9 | 4.2 | 0.3 | 0.8 |
| April | 0.9 | 1.1 | -2.7 | 4.5 | -0.4 | 1.5 |
| May | -0.1 | 0.4 | -2.3 | 5.0 | -1.0 | 2.1 |
| June | 0.4 | 0.3 | -1.4 | 4.8 | -1.4 | 2.6 |
| July | 0.2 | -0.3 | -0.6 | 4.3 | -1.6 | 3.0 |
| August | -0.7 | -0.3 | -0.3 | 4.7 | -1.8 | 3.4 |
| September | 0.4 | 0.4 | 0.4 | 4.6 | -1.8 | 3.8 |
| October | 0.4 | 0.2 | 1.0 | 4.4 | -1.6 | 4.1 |
| November | 0.2 | 0.0 | 1.9 | 4.2 | -1.4 | 4.2 |
| December | 0.1 | 0.0 | 2.5 | 4.0 | -1.1 | 4.4 |

Factors influencing prices in 2011:

– A significant rise in prices in the first half-year exceeding seasonal fluctuations by 1 percentage point. Changes in prices for food products mainly depend on world price fluctuations. Considering the stop of rise in food prices worldwide, the rise in food products in Latvia is more moderate since July 2011. It should be noted that in December 2011 if compared to December of the previous year, the rise in prices for food products (by 4.7%) was the lowest one since 2003, except for 2009 when food prices were declining;
– The rise in fuel prices was significantly affected by the rise in world prices for oil products. The rise in fuel prices by 12.5% in 2011 was one of the factors that mostly influenced changes in the average price level (by 0.7 percentage points);
– The expected inflation in relation to the increase in price for energy resources and retail trade turnover. The increase of electricity tariffs reached 26.7% in a year, thus having the most significant impact on changes in the average price level (by 0.8 percentage points), prices for natural gas also increased. For the very first time in a year, the total retail trade turnover started increasing in August 2010 and kept a very slow increase throughout fall of 2010 and the first quarter of 2011; however, in April 2011 the retail trade turnover stopped increasing due to the decrease in the volume of sales of vehicle fuel in retail trade. Since May 2011, the retail trade turnover resumed slow growth and, despite the continuing decrease in vehicle fuel

retail trade turnover, it has increased by 4.3% (at constant prices) in 11 months of 2011, compared to the corresponding period of 2010;

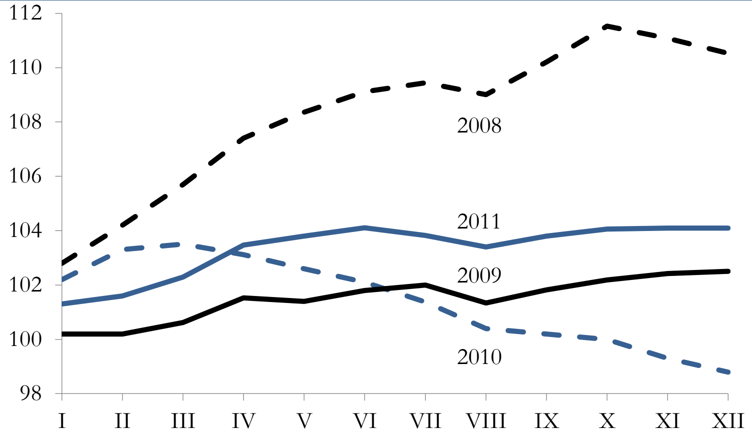
– The rise in prices for alcoholic beverages and tobacco products increased by 6.9% in 2011. The rise in prices for spirits and tobacco products was influenced by the increase in excise duty in the middle of the year;

– The rise in prices for clothes and footwear, which exceeded seasonal fluctuations by nearly 5 percentage points in the first half of the year, was mainly based on the rise in prices for cotton due to floods, as well as growing private consumption. Due to a significant decline in prices during the summer months, overall the prices increased by 1.6% in 2011;

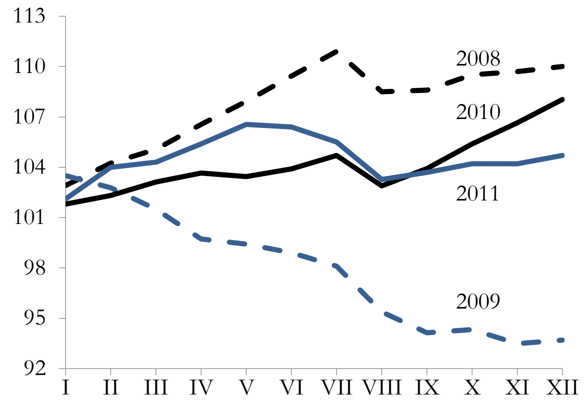
– Tax increase. Increase in the value added tax rate in January 2011 caused the rise in consumer prices by 0.9 per cent.

Figure 4.14

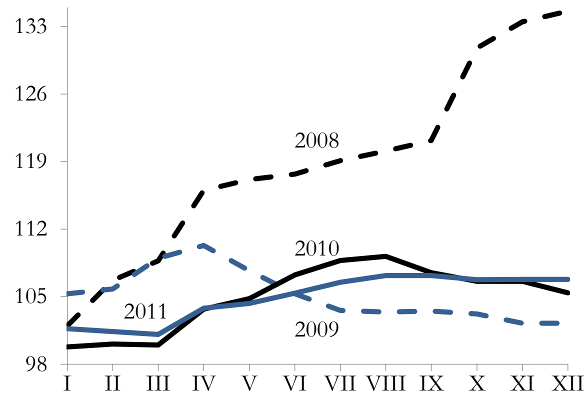
**Consumer Price Index by Groups and Sub-groups**
(December of the previous year = 100)



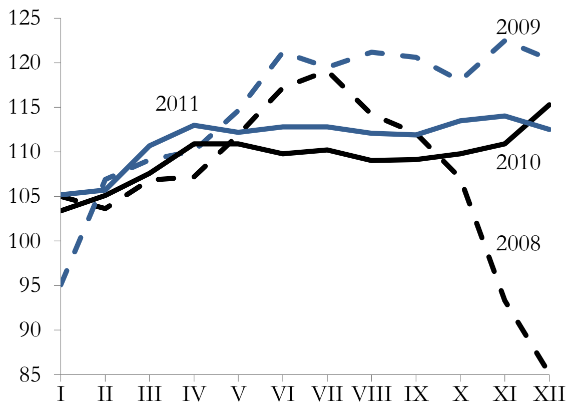

**Food and non-alcoholic beverages**




**Administratively regulated prices**




**Fuel**




**Alcoholic beverages and tobacco**

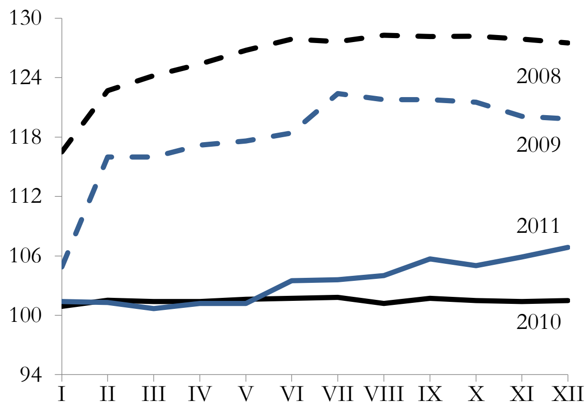
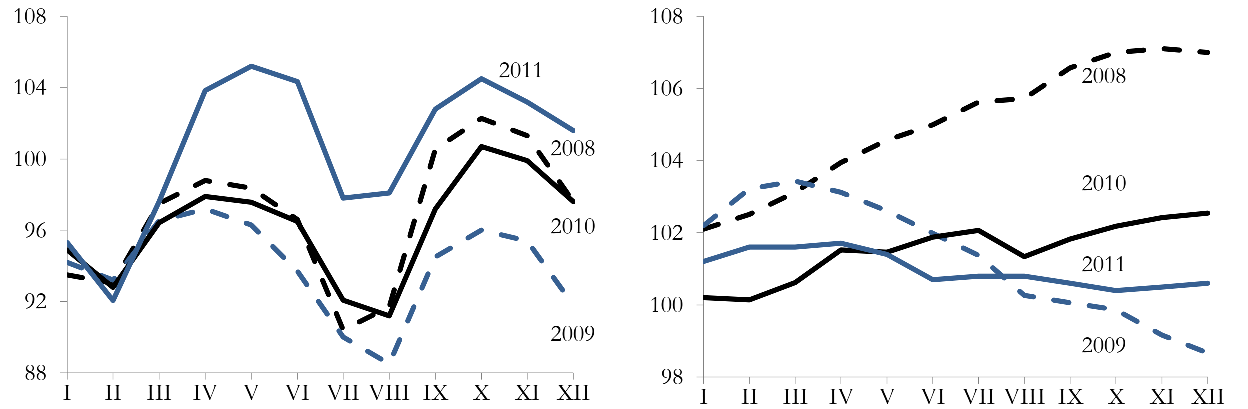


Figure 4.14 continued

**Clothing and footwear** | **Other product and services groups**



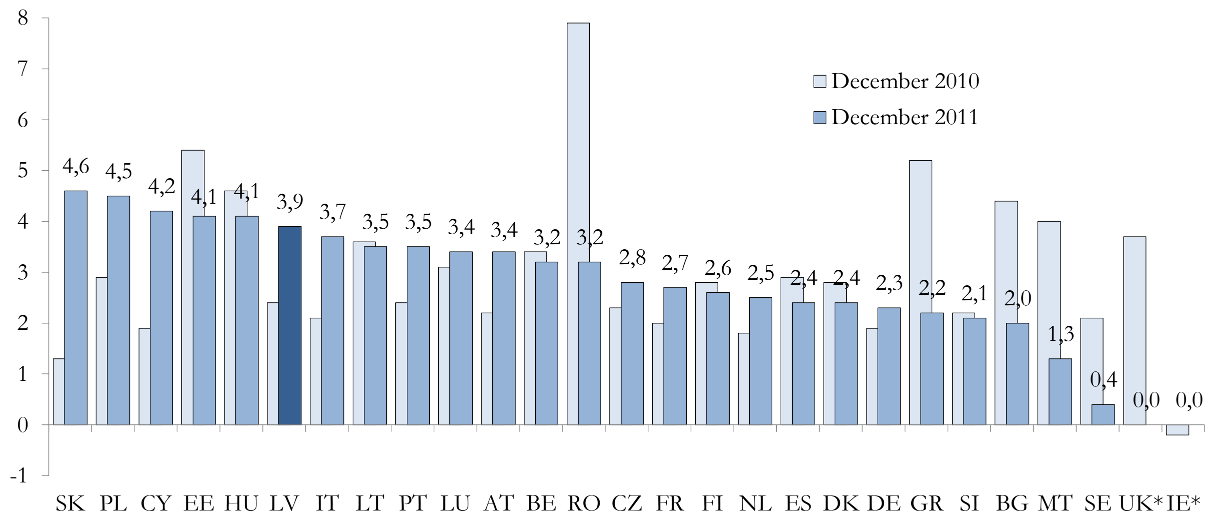

In 2012, the influence of several factors, which determine the rise in price in 2011 (consumer taxes, electricity tariffs, food prices in the world), on consumer prices will be reduced. Yet, the increase in natural gas tariffs and rise in prices for heating energy will have a certain impact on consumer prices at the beginning of 2012.

Fuel prices are rather uncertain as they are also influenced by EUR and USD exchange rate fluctuations. 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 2–2.5 per cent.

Figure 4.15

**Changes of the Harmonised Index of Consumer Prices in the EU Member States in December 2010 and December 2011**

(12-month inflation, %)




Source : *Eurostat*

* no data on December, 2011

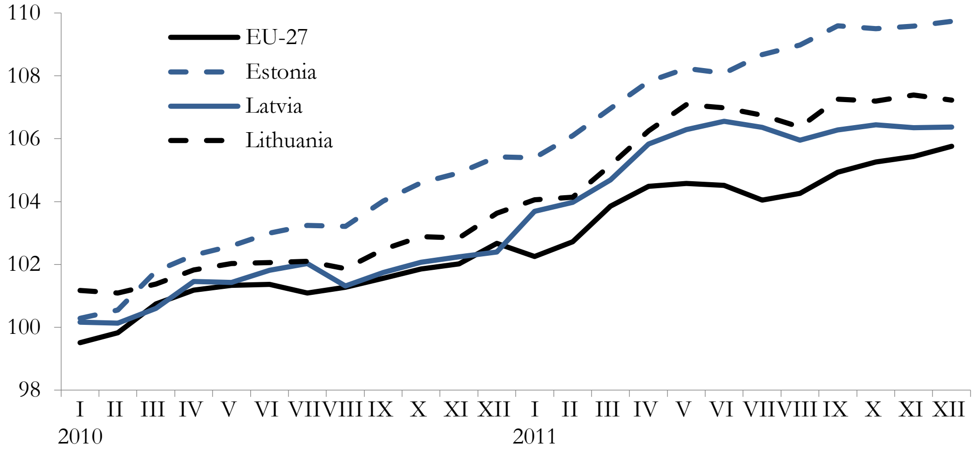
In 2010, in comparison with 2009, the average price level in the European Union has increased faster than in Latvia – by 2.6 per cent.

In December 2011, the price level in all European Union countries has increased (on average by 3%) in comparison with December 2010. Just like in Latvia, it was due to 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.

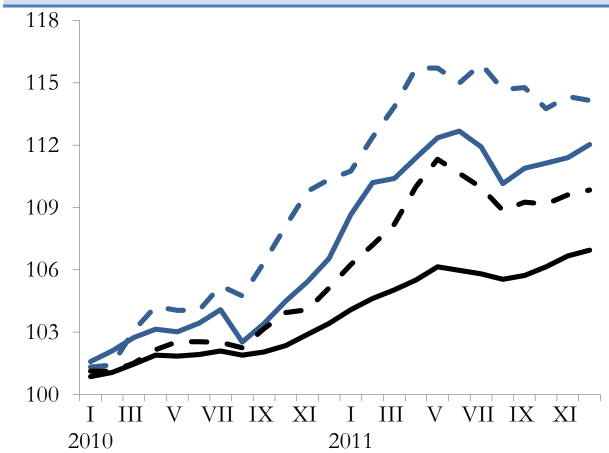
In December 2011, as compared to December 2010, the price inflation rose most rapidly in Slovakia, Poland, and Cyprus thus becoming the countries with the highest inflation rate in the European Union. But the price inflation decreased most rapidly in Romania, Greece, and Malta.

Figure 4.16

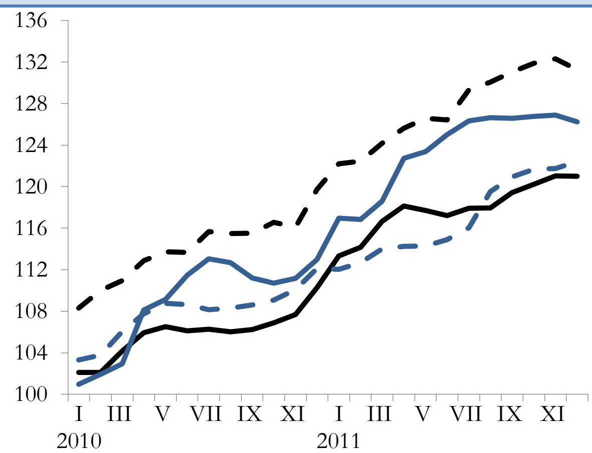
**Harmonised Consumer Price Index**
(December 2009 = 100)



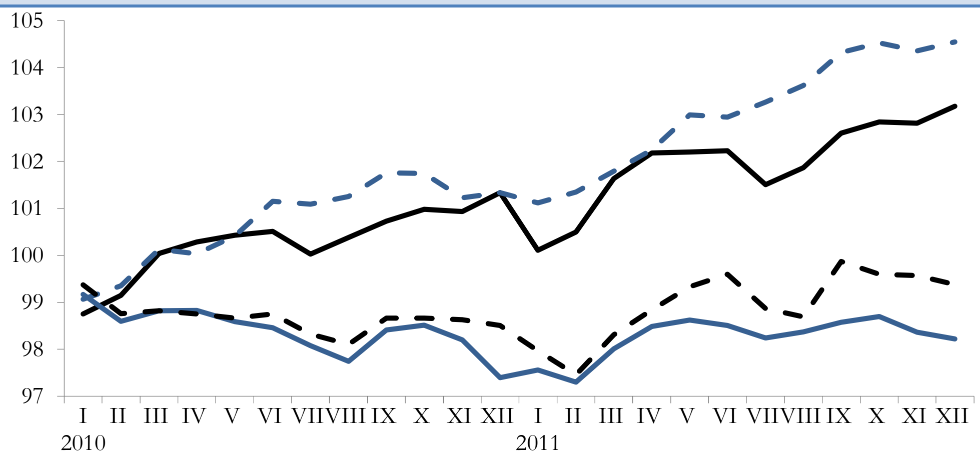

**Food products**
(including alcohol and tobacco)




**Energy**




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




In December 2011, if compared to December 2010, the consumer prices in the Baltic States continued increasing significantly for the food product group and energy. However, in the second half of the year, the rise in food prices became more moderate due to the stop of rise in food prices worldwide.

The highest increase in prices for the food product group and energy among the Baltic States was observed in Latvia – correspondingly by 5.1% and 11.7%, prices for these groups in Lithuania increased correspondingly by 4.5% and 9.6%, while the lowest increase in prices was experienced in Estonia – correspondingly by 3.5% and 9.2 per cent.

In should be noted that in December 2011, if compared to last December, prices in Estonia for the service group increased twice as fast as in the other two Baltic states – by 4.1% (in Lithuania – by 2.1%, in Latvia – by 1.6%).

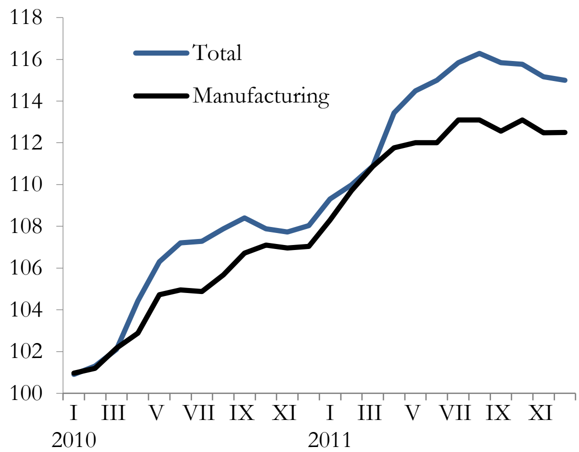
### 4.2.2. Producer Prices

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

In early 2011, the producer prices continued increasing but began declining slowly in the second half of the year and reached 6.5% in December in comparison with December 2010, including the manufacturing industry – to 5.4%. In 2011, if compared to the average level of 2010, the producer prices have increased by 7.7%. Prices for products sold on the domestic market rose by 8.7%, but for exported products – by 6.2%. The price changes in 2011 were most significantly influenced by the production of chemicals and chemical products – by 25.7%, production of metal articles – by 20%, printing and reproduction of recorded media – by 15.6%, waste collection, management and disposal, material processing – by 12.7 per cent.

Figure 4.17

**Producer Price Changes**
(December 2009= 100)

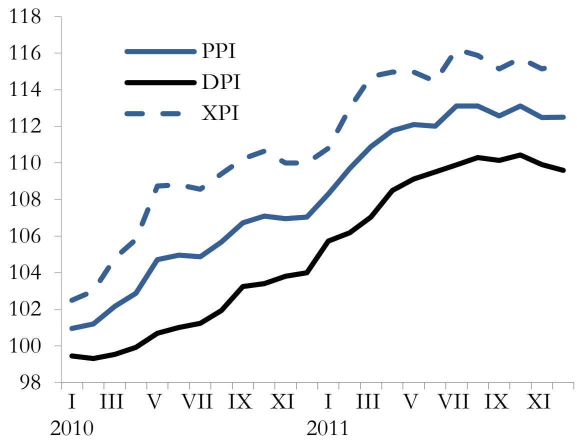



The rise in prices for products sold in the domestic market was affected by stabilizing domestic demand, whereas the price for exported products mainly depended on the halt in price increase for key export products of Latvia, including wood and timber products, metal articles and food products in world's markets.

Overall, the producer prices in the European Union stabilised in 2010 and continued rising in the first half of 2011, yet the producer prices began declining in mid-2011 also in 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.

Figure 4.18

**Producer Price Changes in Manufacturing**
(December 2009 = 100)



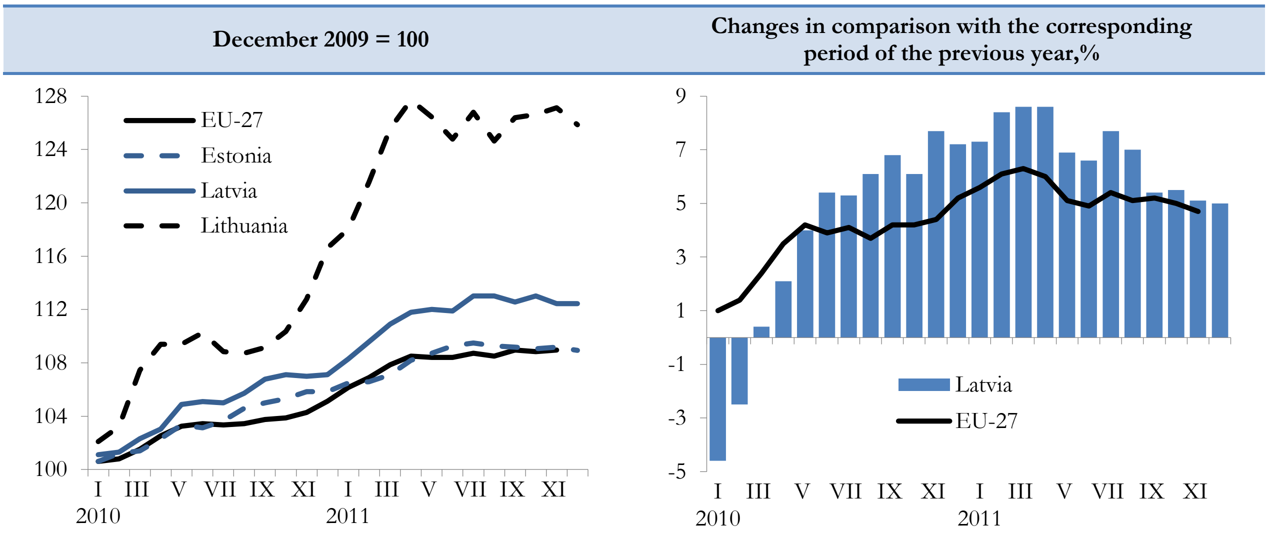

PPI – producer price index;
DPI – producer price index for products sold in the domestic market
XPI – producer price index for exported products

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

At the beginning of 2011, in comparison with the beginning of the previous year, the trade conditions improved considerably as import prices increased at almost half the speed as those of export. In the 3rd quarter of 2011, the unit value for exported goods increased by 11.2% and that of imported goods – by 4.9%, if compared to the corresponding period in 2010.

Figure 4.19

**Producer Price Index by Months in Manufacturing**



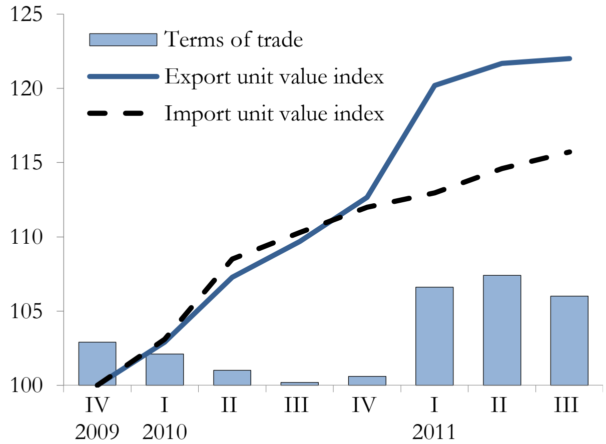

## 4.2.3. Foreign Trade Unit Value Indices

The average export unit value level in the 3rd quarter of 2011 was mainly raised by the increase in the unit value for miscellaneous manufactured articles, mineral products, and textiles and textile articles, if compared to the 2nd quarter of 2011. The unit value increase for mineral products, textiles and textile articles, as well as for products of the chemical and allied industries had the greatest 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)



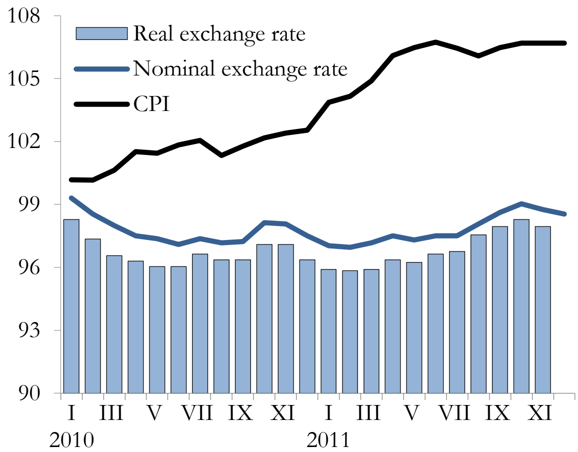

As competitiveness of Latvian entrepreneurs improved, the real effective exchange rate of the Latvian lat continued decreasing in 2010 and at the beginning of 2011. Despite the slight increase at the end of 2010 and in April 2011, generally it is at a low level.

At the beginning of 2011, the decrease of the real effective exchange rate of the lat has been determined by the low nominal effective exchange rate of the lat, but at the end of the year, the increase of the real effective exchange rate of the lat is determined by the rise in consumer prices (see also Chapter 4.4.1).

Figure 4.21

**Effective Exchange Rate of the Lats***

(December 2009 = 100)




* Effective exchange rate of the lat has been calculated in proportion 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

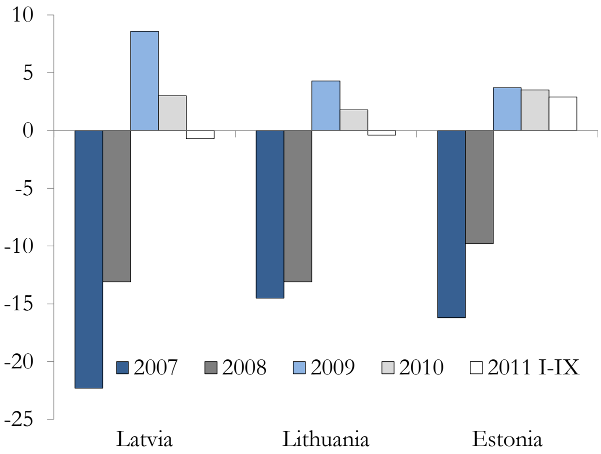
Latvia experienced an adjustment in the current account in a relatively short time due to the rapid decrease of the foreign investment flow due to the influence of the global financial crisis. The current account deficit has been rapidly decreasing since the beginning of 2008, and the balance was positive already at the beginning of 2009. Yet, the stabilizing economic situation in 2010 lead to a rather rapid decrease in the surplus of current account, and the balance of current account was negative in the second half of the year. In general, the surplus of current account was 3% of GDP in 2010. The quarterly dynamics of the current account in 2010 shows another redirection, i.e. a decrease in the positive balance and approaching the state of deficit, which was typical in Latvia for several years.

Also in the first half of 2011, there was a slight surplus of the balance of the current account (1.1% of GDP in the 1st quarter and 0.9% of GDP in the 2nd quarter), indicating balanced investments and savings. However, in the 3rd quarter of 2011, deficit was observed in the current account (3.7% of GDP) mainly due to the increase in foreign trade deficit. Overall, there was a slight deficit to the balance of the current account (0.7% of GDP) in the nine months of 2011.

Similar to Latvia, rapid correction of external imbalance due to financial crisis took place also in our neighbouring countries.

Figure 4.22

**Current Account Balance in the Baltic States**
(% of GDP)



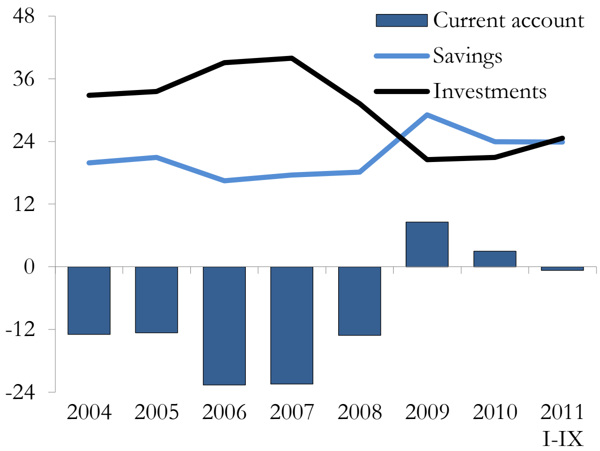

In Estonia, the current account surplus in 2009 reached 3.7% of GDP compared to the 9.8% deficit in 2008. However, in Lithuania the positive balance of the current account was 4.3% of GDP in 2009 (deficit in 2008 – 13.1% of GDP). In 2010, the current account surplus in Estonia and Lithuania was correspondingly 3.5% and 1.8%. In the three quarters of 2011, the positive balance of current account remained positive in Estonia (2.9% of GDP), but slight deficit has been observed in Lithuania (0.4% of GDP).

Changes in the current account balance of Latvia in 2010 are 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 are mainly related to the dynamics of goods export and import.

Along with increasing economic activities, the dynamics of import are accelerating. In the nine months of 2011, import in actual prices increased by 30.2% if compared to the nine months of the previous year, but export increased by 29.1% in the same period, while foreign trade deficit reached 8.7% of GDP (in the 1st quarter – 7.9%, in the 2nd quarter – 7.4% and in the 3rd quarter – 10.7%), which was by 1.6% percentage points higher than a year ago.

Figure 4.23

**Current Account Deficit, Investments and Savings**
(%of GDP)




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 the nine months of 2011, the income balance deficit was 1.5% of GDP (in the 1st quarter – 0.4%, in the 2nd quarter – 2.5%, and in the 3rd quarter – 1.6% 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.

Table 4.6

**Balance of Payments of Latvia**
(% of GDP)

| | 2007 | 2008 | 2009 | 2010 | 2010 I-IX | 2011 I-IX |
|---|---|---|---|---|---|---|
| **A. Current account** | **-22.4** | **-13.1** | **8.6** | **3.0** | **4.4** | **-0.7** |
| Trade balance | -24.0 | -17.8 | -7.1 | -7.1 | -7.1 | -8.7 |
| *Export* | *28.6* | *28.5* | *28.4* | *37.9* | *37.0* | *43.2* |
| *Import* | *-52.7* | *-46.3* | *-35.5* | *-45.0* | *-44.1* | *-51.9* |
| Balance of services | 3.5 | 4.0 | 6.0 | 6.1 | 6.3 | 6.4 |
| Net revenues | -3.2 | -1.6 | 6.3 | 0.3 | 1.7 | -1.5 |
| Current transfers, net | 1.3 | 2.2 | 3.4 | 3.6 | 3.4 | 3.2 |
| **B. Capital account** | **2.0** | **1.5** | **2.4** | **1.9** | **2.2** | **2.4** |
| **C. Financial account*** | **24.7** | **11.5** | **-6.9** | **-1.5** | **-0.6** | **-1.0** |
| Direct investments | 6.8 | 3.0 | 0.6 | 1.5 | 0.8 | 5.8 |
| *Abroad* | *-1.3* | *-0.7* | *0.2* | *-0.1* | *-0.7* | *-0.3* |
| *In Latvia* | *8.1* | *3.8* | *0.4* | *1.6* | *1.6* | *6.1* |
| Portfolio investments ** | -1.6 | 0.8 | 2.3 | -1.8 | -0.8 | -2.8 |
| *Assets* | *-1.0* | *1.8* | *3.2* | *0.3* | *0.8* | *-3.0* |
| *Liabilities* | *-0.5* | *-1.0* | *-0.9* | *-2.1* | *-1.7* | *0.2* |
| Other investments | 19.4 | 7.6 | -9.8 | -1.1 | -0.6 | -4.0 |
| *Assets* | *-21.0* | *-1.4* | *-4.0* | *-3.7* | *3.3* | *1.7* |
| *Liabilities* | *40.1* | *9.0* | *-5.8* | *2.5* | *-3.9* | *-5.7* |
| **D. Net errors and omissions** | **-0.8** | **-1.8** | **0.8** | **-0.5** | **0.6** | **-0.8** |
| **E. Reserve assets** | **-3.4** | **2.0** | **-5.0** | **-4.0** | **-6.6** | **0.1** |

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

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. The investment level increased from 33% to 40.4%, but the level of savings decreased from 20.2% to 18.1%, if compared with 2004, ensuring less than a half of domestic investment financing.

As the conditions in the global financial markets deteriorated, the situation changed drastically. A heavy debt burden, decrease of economic activities and income, as well as uncertainty about the future development fostered economy of households. Along with the increase in the level of savings, the investments are decreasing rapidly. In 2009, the investments share 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 in 2010, though this difference has reduced mainly because of the decreasing level of savings. Yet, the deteriorating balance of the current account in 2011 is mainly related to a more rapid increase in investments while savings remained at the level of the previous year.

### 4.3.2. Financial Flows

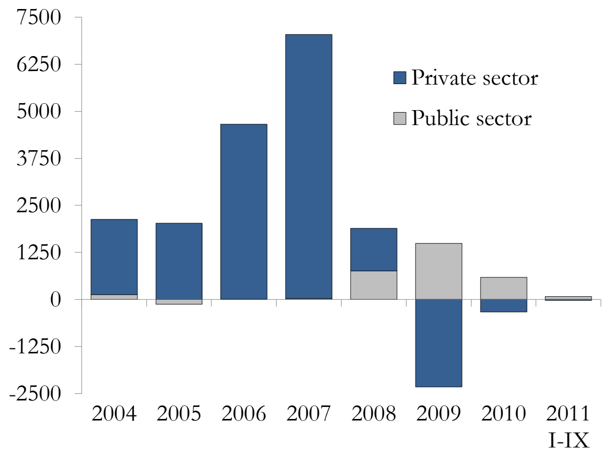
The global financial crisis resulted in significant changes in international capital flows, which were reflected in the fluctuating financial account of the balance of payments. Liberalization of the capital account ensures the inflow of foreign capital in Latvia – there are no limitations with regard to convertibility of the national currency in Latvia, foreign companies may freely withdraw their investments and profits after paying taxes. All residents of Latvia are free to use financial services of foreign companies. Furthermore, there are no restrictions for operations with securities.

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 with 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 rapidly decreased 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.

Overall, 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 banking sector.

Figure 4.24

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

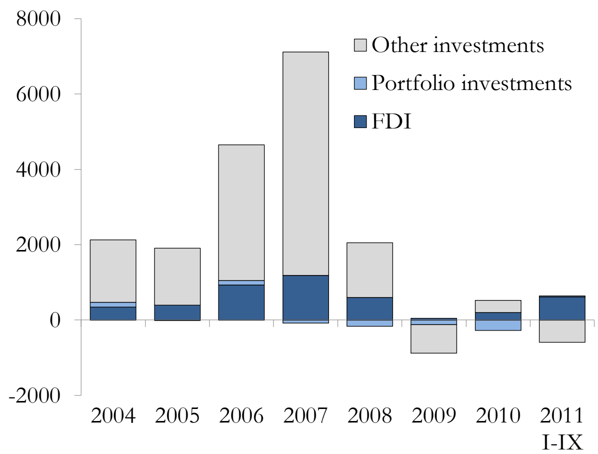



In the 1st quarter of 2011, the foreign private capital flows were negative due to the increase in external assets of the banking sector mainly in portfolio investments, but liabilities of the financial account increased in the 2nd and the 3rd quarter due to the impact of foreign direct investments in equity capital of enterprises. There was a slight deficit to the financial account balance in the nine months of 2011.

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

Figure 4.25

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




* portfolio investment and derivative financial instruments

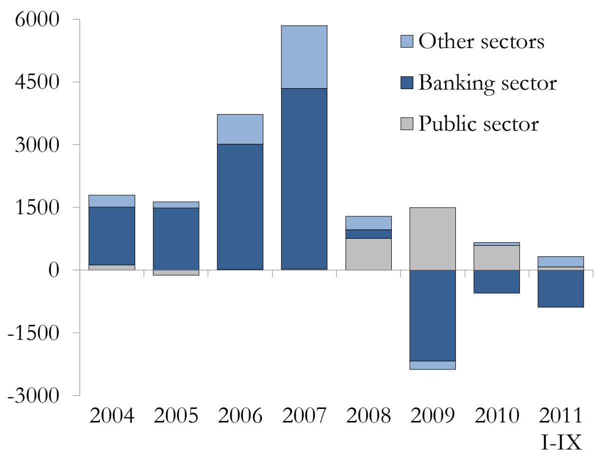
During the period of 2005–2007, the foreign direct investments (FDI) in the inflowing foreign capital structure on average constituted almost 20%. In comparison with 2004, the volume of FDI has tripled, but in 2008 compared with 2007, the FDI stock decreased by almost a half and covered 30% of the negative 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 greater than in 2009 and constituted almost 1/3 of foreign investments attracted to the Latvian economy in 2010. Also in 2011, inflow of FDI continued increasing. The volume of direct investments in the nine months of 2011 was almost three times greater than in 2010.

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 in the three quarters of 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.

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 reduced and was only 1.1% of GDP determined by the decrease of long-term government loans and debt commitments.

In the first half of 2011, the negative balance of other investments increased reaching 6.5% of GDP, but there was a slight surplus of the balance of other investments in the 3rd quarter of the year. The fluctuating indicator of the balance of other investments was mainly influenced by the decreasing deposits in the banking sector.

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

The data of the international investment balance of Latvia show than the government gross external debt was LVL 4455.4 million (32.5% of GDP) at the end of the 3rd quarter of 2011. The government external debt has increased by 10.6% in comparison with the end of the 3rd quarter of 2010. At the same time it should be noted that the total Latvian gross external debt was 151.3% of GDP at the end of September 2011, which is by almost 14 percentage points lower than a year ago.

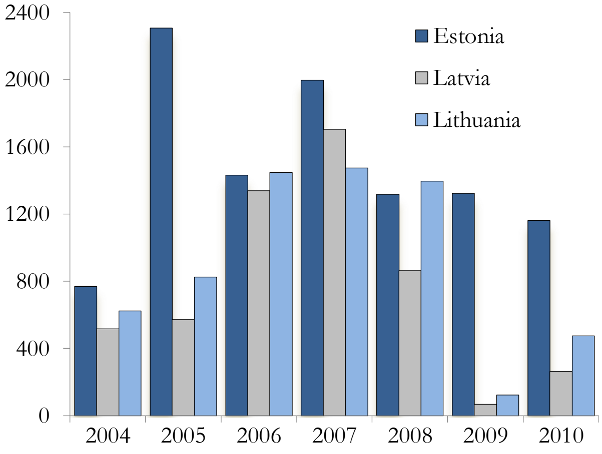
## 4.3.3. Foreign Direct Investment

Due to the impact of the global financial crisis, foreign capital flows in the economy of Latvia have significantly decreased. The intensity of FDI flows in Latvia, like in the entire world, grew weaker due to considerable losses suffered by entrepreneurs during the period of rapid recession, which weakened the investment capacity, as well as reduced the tendency to invest. 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 national economic stabilization policy.

A decrease of FDI inflow is observed also in our neighbour countries. 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 correspondingly by 80% and 94% lower than a year ago. However, in 2010, flows of incoming FDI in Estonia constituted 88% of the flows in 2009, while in Latvia and Lithuania they increased nearly 4 times.

Figure 4.27

**Inflow of FDI in the Baltic States**
(million EUR)




Since 2008, the activities of Latvian investors abroad have decreased, as well. In comparison with 2007, foreign direct investments of Latvian entrepreneurs reduced almost twice, but in 2009 they were negative. The activities of Latvian investors have been increasing since 2010, however, in very low level.

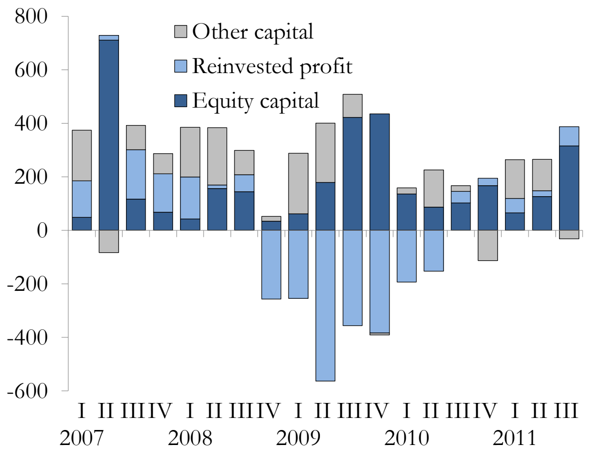
The structure of the incoming FDI shows that since the 4th quarter of 2008, direct investment enterprises have been operating with losses. In 2009, they reached LVL 1094.5 million (EUR 1542 million). Losses of the direct foreign investment enterprises were fully compensated by investments in equity capital and other capital, therefore the incoming FDI flows were positive in 2009 (LVL 47.5 million). In the 1st quarter 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 recovering economic growth. The amount of incoming FDI in 2010 was fourfold the FDI in 2009, while in the nine months of 2011, FDI flows exceeded almost threefold the indicator of the previous year and reached 6.1% of GDP.

According to the international investment balance of Latvia, the FDI stock in the economy of Latvia reached LVL 6563.6 million (EUR 9339.2 million) at the end of the 3rd quarter of 2011 which is by 14% more than at the end of 2010. The share of FDI in the structure of foreign capital stock constituted 26 per cent.

The global financial crisis has left no impact on the geopolitical structure of foreign capital stock of Latvia. Mainly these are investments of the EU countries. At the end of September 2011, the FDI of the EU countries constituted 72.2% of all FDI stock, fourth 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)




The biggest investor country in the economy of Latvia is Sweden. At the end of September 2011 investments by Sweden constituted almost 24% of the total FDI stock. Mainly they are investments in financial intermediation (56.7% of all FDI stock).

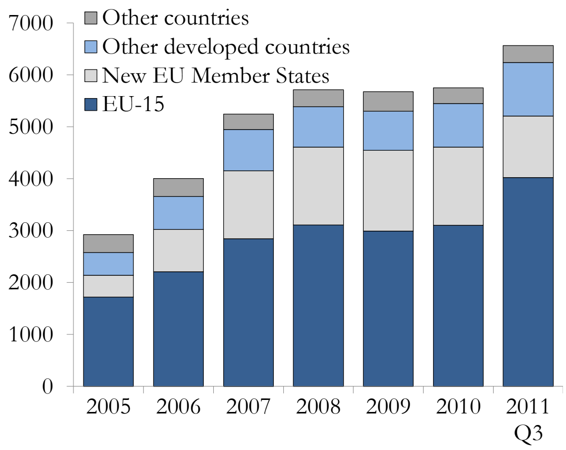
Since the end of 2010, direct investments of Sweden have almost doubled which is mainly due to mutual transactions between Estonian and Swedish owners as a result of barter transactions of the banking sector. At the same time, the direct investment stock of Estonia in Latvia decreased by 50% including financial intermediation sector – almost 10 times. At the end of September 2011, direct investment of Estonia in Latvia constituted 5.6% of the total FDI stock (at the end of 2010 – 14.1%). 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 September 2011 constituted almost 60% of the total FDI stock in the Latvian economy.

Annual investments of German entrepreneurs have been rather small since 2004; therefore their share in the total FDI stock is decreasing. At the end of 2007, they constituted 8.5% but at the end of the 3rd quarter of 2011 – only 4.7% of the FDI stock. The FDI of Germany focuses on the energy sector (32.5%) and real estate operations (22.6%). German investments in the energy sector have decreased by more than a half since the end of 2005. In the 4th quarter of 2010, also the German investments in the financial intermediation sector decreased almost 8 times. At the end of September 2011, they constituted only 1.1% of the FDI stock of Germany.

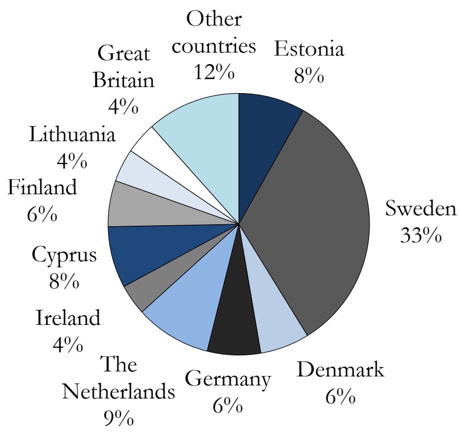
Figure 4.29

**FDI Stock**

**By Groups of Countries**
(million LVL, at the end of the period)




**FDI of EU Member States**
(per cent, at the end of September, 2011)




The FDI are focused mainly on service sectors.

Until 2008, the growth rates of the FDI in service 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 sectors of manufacturing goods (respectively by 6.6% and 10.6%), while the level of the FDI stock in services sectors remained unchanged in 2009, but in 2010 it reduced by 7.4%. At the end of September 2011, the FDI stock in service sectors constituted 79.4% of the accrued FDI in national economy of Latvia.

Table 4.7

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

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 IX |
|---|---|---|---|---|---|---|---|---|
| Primary sectors | 49.8 | 59.5 | 71.6 | 113.1 | 145.2 | 167.5 | 207.9 | 205.2 |
| Manufacturing | 276.1 | 376.0 | 395.8 | 516.8 | 611.0 | 654.5 | 725.0 | 804.6 |
| Energy | 164.7 | 327.6 | 348.1 | 270.7 | 204.9 | 190.5 | 216.0 | 249.9 |
| Construction | 36.5 | 49.7 | 67.6 | 85.5 | 107.1 | 126.6 | 109.4 | 91.7 |
| Trade | 395.7 | 437.8 | 562.3 | 676.4 | 862.0 | 856.5 | 737.4 | 842.2 |
| Transport and communications | 333.3 | 336.4 | 347.0 | 392.5 | 466.3 | 428.1 | 424.7 | 448.9 |
| Financial intermediation | 375.9 | 625.4 | 964.6 | 1486.2 | 1647.3 | 1645.1 | 1326.8 | 1568.5 |
| Other services | 439.2 | 529.0 | 795.3 | 1223.5 | 1251.3 | 1371.3 | 1492.1 | 1671.2 |

After the accession of Latvia to the EU, foreign investors have made significant investments in the financial intermediation sector, the share whereof in the FDI stock increased from 24% at the end of

2004 to 40% at the end of 2008. At the end of September 2011, the level of the FDI stock in this sector was 24%. It should be noted that the decrease of domestic demand had a negative impact on investment in trade and communication sectors, the FDI stock in the abovementioned sectors at the end of September 2011 was respectively by 2.3% and 3.7% lower than at the end of 2008. The decrease of the FDI in these sectors was partially compensated by investments in the real estate sector (by 38.5%), therefore the overall level of the FDI stock in the service sectors has not changed since the end of 2008.

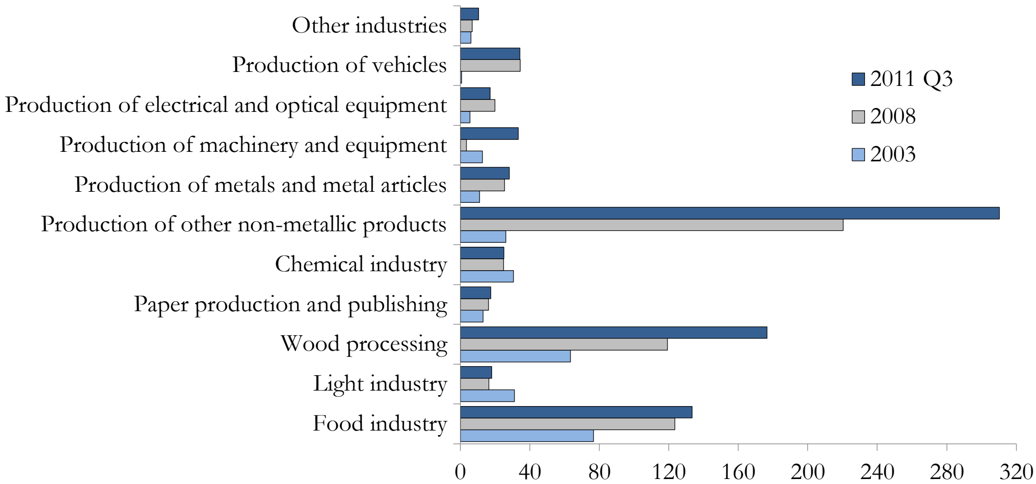
Since the end of 2008 until the end of September 2011, a particularly rapid increase of the FDI stock in production of goods was observed in the energy sector and manufacturing industry – respectively by 22% and 31.5%. The increase of the FDI stock in the manufacturing to a great extent was influenced by substantial investments in production of construction materials (increase by 40.8%) and wood processing (increase by 48%). The share of sectors mentioned above in the FDI stock constituted 60.5% in manufacturing at the end of the 3rd quarter of 2011 (at the end of 2008 – 55.6%).

Overall, upon evaluating the FDI structure in the manufacturing industry, 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 it is loss of competitiveness in foreign markets. The volume of the FDI stock in the light industry in 2010 was by 7.3% lower than in 2008. Similar tendencies are observed in several EU Member States. Yet, the decrease of the FDI stock in 2009 and in the 1st quarter of 2010 was mainly based on the decreasing demand in domestic market. It should be noted that the FDI in this sector has been gradually increasing since the 3rd quarter of 2010. At the end of September 2011, the FDI stock in food industry increased by 8.1% and constituted 16.6% of the FDI stock in manufacturing in comparison with the end of 2010 (at the end of 2010 – 13%). The FDI have reduced also in production of electric and optical equipment (by 17.7% in comparison with the end of 2008).

Figure 4.30

**FDI Stock in Manufacturing**

(end of the period, million LVL)



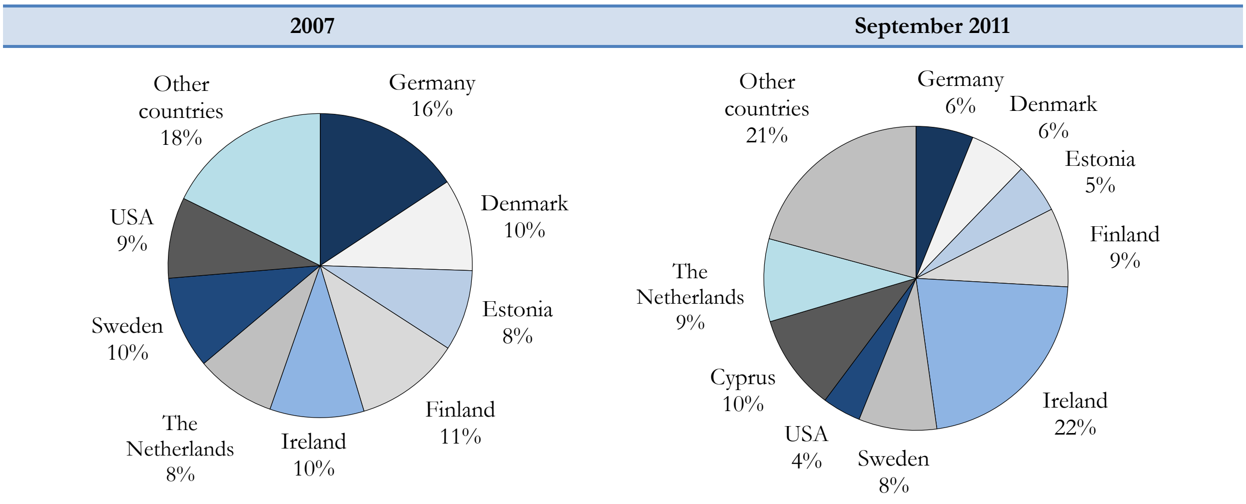

It should be noted that overall, the interest of foreign investors about the manufacturing sector has not decreased, but it has even increased in some manufacturing sub-sectors. Foreign investments in manufacturing of machinery and equipment have been growing significantly. The share of the aforementioned sector in the structure of the FDI stock in manufacturing is increasing and it constituted 4.2% at the end of September 2011 (at the end of 2008 – 0.6%). Changes of the FDI stock in other manufacturing sub-sectors are insignificant.

Upon evaluating the changes of FDI stock in the structure of manufacturing, it can be concluded that the share in high and medium-high technologies sectors constituted almost 12.2% at the end of September 2011 (at the end of 2008 – 11.3%).

Largest investments in the manufacturing have been made by investors from Denmark, Finland, Germany, Sweden, Ireland, Estonia, the Netherlands, and Cyprus. The investments of the abovementioned countries constituted 75% of the FDI stock in the 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 the manufacturing. Due to the financial crisis, the situation has significantly changed. At the end of September 2011, the capital of Ireland was dominating in the structure of the FDI stock constituting more than a fifth of the FDI stock in the manufacturing, which was greatly influenced by the rapid increase of investments of this country. It has increased almost three times since the end of 2008. The volume of the FDI stocks of other largest investor countries has decreased, for example, that of Germany and Denmark – respectively by 17.8% and 3.5%, as well as of the USA – by 21%. At the same time, investment stock of Russian entrepreneurs in the manufacturing at the end of September 2011 was by 13.5% larger than in 2008 and constituted 3.2% of the FDI stock in the manufacturing.

Figure 4.31

**Structure of the FDI Stock in Latvian Manufacturing by Countries**
(at the end of the period, per cent)




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

IDAL continues developing its range and supply of services on the basis of FDI market needs and ensuring a link between 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 IDAL experts in the process of project implementation.

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

In 2011, the number of requests for information serviced by IDAL reached 272 which is by 70% more in comparison with the indicators of 2009 (158 requests), hence the interest of possible investors is increasing in general, after the initial interest about the investment environment. The majority of projects are particularly focused on the manufacturing sector. The largest number of projects is in manufacturing metals and metal articles and electronics (24%), green technologies (15%), wood processing (10%) etc., while services constitute only 27%, and 12% of them are projects of shared services and outsourcing.

In 2011, 10 enterprises have made a decision to implement projects in Latvia through the support of IDAL both in the service sector and manufacturing (for example, investments from Russia in the production unit of optical equipment, investments from the United Kingdom in data centre, investments from Luxemburg/Belgium in the project of renewable energy resources, investments from Russia in the production of semiconductor materials and recycling of silicon waste for electronic industry, investments from Norway in the centre for divided services, etc.). Many investors have made a decision to expand the production units – Ferroplan (Finland, conveyor and warehouse systems), Bucher Schoerling Baltic (Switzerland, street cleaning equipment), Malmar Sheet Metal (Belgium, metal components for machinery sector), etc. In the implementation of the projects, investments in the amount of EUR 40 million are expected, thus creating more than 600 new jobs.

Unfortunately, many foreign investment projects are lost due to the still unsolved problematic issues, for instance, lack of industrial land lots and infrastructure, deficiencies in territorial planning, as well as due to lack of qualified labour force.

For solving these problematic issues, an important programme of infrastructure development is planned to be launched and implemented in the period from 2014 to 2020. In order to solve issues regarding sectoral needs for qualified labour force, a reform of the higher educational system is currently underway, as well as the role of employers in professional education programmes is fostered and increased by establishing professional education competence centres.

In order for Latvia to be competitive among other European countries, state support instruments and investment stimuli for the attraction of foreign investment are necessary, for example, as in other countries competing with Latvia in investment attraction – state financial support for investment projects important to the national economy, grants for creation of new jobs, infrastructure support, tax relief.

Some improvements can be already observed in this area – new investment stimuli for attracting foreign investments are being developed, for example, as of January 1, 2011, entrepreneurs are offered company income tax relief for large investment projects, as well as financial support is sought for investment projects important to the national economy, and grants for creation of new jobs. A grant for creation of new jobs is planned to be approved as of February 2012. But since the last quarter of 2011, entrepreneurs including investors can receive support within the EU Structural Funds programme *High value added investments*, yet, this will not be a long-term support as the available amount of the support is expected to be used already within the first month, therefore a long-term state financial support for investment projects important to the national economy should be considered.

In order to improve the progress of local and foreign investment projects important to Latvia, IDAL continues implementing investment attraction according to the *Polaris* methodology 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 private sector, universities, and scientific institutions in this process.

The Coordination Council for Large and Strategically Important Investment Projects has been established within *the Polaris process*, and it is dealing with issues related to implementation of specific investment projects, improvement of investment environment by, for example, ensuring electricity connection and improved quality thereof in industrial territories, increasing the responsibility of local municipalities within implementation of investment projects, making the harmonization of construction designs faster.

## 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 of the Bank of Latvia is to maintain price stability in the state, as well. 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). On 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 fulfilling the required criteria to join the Economic and Monetary Union (EMU)[2].

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 range 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 ERM II will depend on the capability of Latvia to reach the economic convergence level set in the Maastricht criteria. The Bank of Latvia will continue to realize former policy of fixed exchange rate until the introducing the euro in Latvia.

According to the Convergence Programme of Latvia 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 introducing the euro* by approving the amendments to the *National Plan* for 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 European Monetary Union in 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 214% at the end of the 3rd quarter of 2011.

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

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

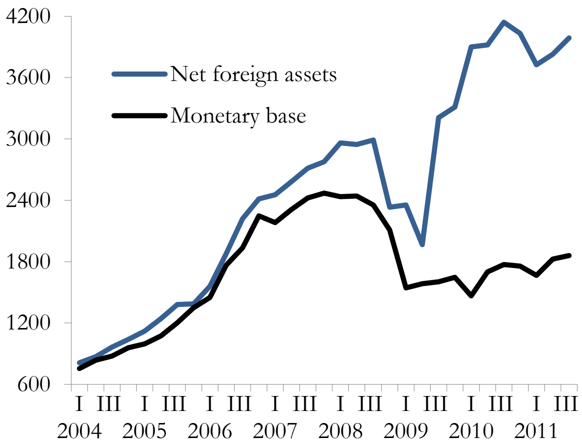
2 Participation in the EMU has been defined in the EU Accession Treaty, but Latvia is allowed to choose the most appropriate time plan for introducing the euro

safe and liquid financial instruments, mainly in debt securities issued by the governments of the USA, Euro zone countries, United Kingdom, and Japan, as 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 December 2011 decreased in comparison with the end of 2010 and were USD 6384.1 million (at the end of December 2010 – USD 7605.1 million, at the end of December 2009 – USD 6905.2 million).

Figure 4.32

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

(million LVL, at the end of the period)




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. It shows the relative export competitiveness of Latvia in the global markets.

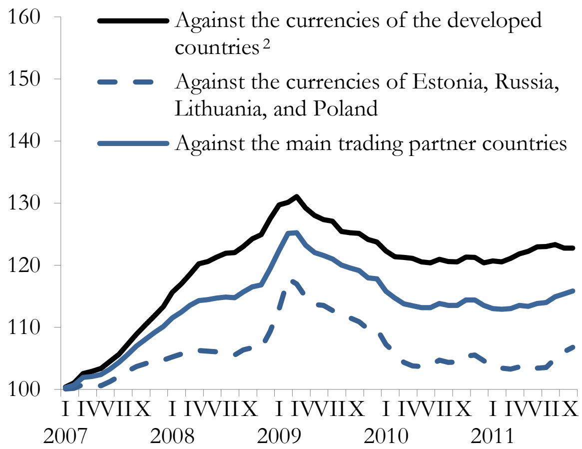
Due to the comparatively high inflation during the years of rapid growth, the real exchange rate of the lats increased against the currencies of the developed and currencies of Estonia, Lithuania, Poland and Russia. An especially rapid increase of the exchange rate of the lats occurred during the 2nd 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 gradually decreased 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 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.

[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

Figure 4.33

**Index of the Real Effective Exchange Rate of the Lats***

(December 2006 = 100)




* Calculated using the consumer price index.

## 4.4.2. Market Structure and Development

At the end of the 3rd quarter of 2011, 22 **banks** operated and 9 branches of foreign banks were registered in Latvia. 11 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).

In 2011, the Latvian banking system went through several structural changes that affected some of Latvian banks:

- JSC "Latvijas Krājbanka" (although JSC "Latvijas Krājbanka" concluded the first half of 2011 with profit and loan portfolio resumed increasing, on December 23, 2011, JSC "Latvijas Krājbanka" was declared insolvent);
- JSC "Citadele banka" (in July 2011, the process of selling the shares of JSC "Citadele banka" was launched, though it is suspended at the moment until the situation in international financial markets improves. JSC "Citadele banka" remains in possession of current shareholders until further decisions of the shareholders. The decision on suspension of selling has no impact whatsoever on the operation of JSC "Citadele banka" and it continues implementing the restructuring plan. The restructuring plan envisages that the state shall 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 funding).

[2] Denmark, Finland, France, Germany, Great Britain, Italy, the Netherlands, Sweden, and the USA are included in the group of developed countries

In the 3rd quarter of 2011, performance indices of all Latvian banks complied with the regulatory requirements. Liquidity ratio of banks was 60.05% (minimum regulatory requirement is 30%), and in comparison with the corresponding period of 2010, it has increased.

The bank profit indices also prove the fact of stabilizing situation. At the end of November 2011, a total of 15 Latvian banks and 5 foreign bank branches operated with profit (total LVL 75.5 million). In the 3rd quarter of 2011, the average banking sector capital adequacy ratio increased significantly reaching 17% (minimum regulatory requirement is 8%) and even 17.3% at the end of November. The return on assets (ROA)[1] of the banking sector was 0.4%, and the return on equity (ROE)[2] was 4.7%, which has significantly increased in comparison with the corresponding period of 2010 (in the 3rd quarter of 2010, ROA was -1.9% and ROE was -24.5%).

At the end of the 3rd quarter of 2011, 12 **insurance companies**, three of which provided life insurance and 9 – non-life insurance, as well as 10 branches of foreign insurance companies, operated in Latvia.

At the end of the 3rd quarter of 2011, the amount of gross premiums signed by insurance companies has increased by 27.7% in comparison with the corresponding period of 2010; but the amount of paid gross compensations has increased by 12.1 per cent.

The situation in the global financial markets significantly affects the Latvian **securities market** – in 2008 and 2009, the securities market experienced low demand and amount of sold shares. The share price index also decreased significantly, yet the situation considerably improved in 2010 and the share index of NASDAQ OMX Riga increased.

In 2011, prices for securities have decreased not only in global markets abut also in Baltic stock exchange markets. It is mainly due to the euro zone crisis and instabilities in the USA. In early 2011, the situation continued improving yet it deteriorated at the end of the year, and the OMX Baltic Benchmark index value was 533.9 points which is by 19.1% lower than in the corresponding period of 2010, but the NASDAQ OMX Riga index value reached 371.2 points which is by 5.7% lower than in the corresponding period of 2010. NASDAQ OMX Riga experienced the smallest drop among all Baltic stock exchange markets. In 2011, the stock exchange activity in Latvia was EUR 37.2 million (Lithuania – EUR 176 million, Estonia – EUR 187.4 million).

In the 3rd quarter of 2011, the amount of central government debt securities in bank assets has significantly increased (by 33.5%) if compared with the corresponding period of 2010, inter alia the amount of Latvian central government securities has increased by 22.7%, but the amount of foreign central government securities has almost doubled. Out of other securities, shares and other variable-yield securities experienced the most rapid increase (77%).

On June 9, 2011, Latvia successfully emitted 10-year Eurobonds in the amount of USD 500 million with the interest rate set at 5.25% a year, which is lower than in the previous emission of Eurobonds in March 2008, when the interest rate was 5.5% a year**,** also proves the financial stabilisation. The total amount of pledges sevenfold exceeded the supply and reached USD 3.6 billion. The emission carried out can be considered as a benchmark emission by returning Latvia to international markets after the last Eurobond emission in March 2008. This Eurobond emission was carried out by implementing the approved medium-term borrowing strategy and enforcing agreement concluded by the government of Latvia, the Bank of Latvia, and FCMC with the international borrowing programme partners envisaging the return of Latvia to international financial markets, as well as envisaging no further use of resources from programme funding.

### 4.4.3. Assets, Deposits and Loans

At the end of the 3rd quarter of 2011, Latvian **bank assets** were LVL 20.7 billion, which is by 1.8% less than in the corresponding period of the previous year. Bank loans constituted the largest part of bank assets (65.1%).

The amount of currency in circulation has increased constituting LVL 888.6 million in circulation at the end of the 3rd quarter of 2011, which is by 16.9% more than in the corresponding period of 2010.

At the end of the 3rd quarter of 2011, the balance of private and corporate deposits attracted by banks slightly decreased (by 0.2%) in comparison with the corresponding period of the previous year. Insolvency of JSC "Latvijas Krājbanka" has not had any significant influence on the total deposit portfolio. It can be explained with the insignificant share of the bank deposits in the total deposit portfolio as the most of it can be recovered.

At the beginning of 2011, changes of the deposit currency structure continued. At the end of the 3rd quarter of 2011, the amount of residents' deposits in lats decreased by 3.2% if compared with the corresponding period of 2010 and constituted 44.2% of all residents' deposits. The residents' deposits in USD have increased by 11.8% in this period. The greatest part of residents' deposits (49.3%) is still in EUR; however, the amount of these deposits has slightly decreased.

The balance of bank **loans** granted to residents still continues decreasing. The shrinking bank loan portfolio is mainly related to the fact that the total number of new loans granted to individuals in the banking sector is still below the number of loans paid by customers and written-off loans. The balance of loans granted to residents (loans to households, financial institutions and non-financial corporations

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

include all requirements for the private sector, removing these requirements from other assets) decreased by 8.2% at the end of the 3rd quarter of 2011 in comparison with the corresponding period of the previous year. The balance of loans granted to companies (financial institutions and private and public non-financial corporations) and households at the end of the 3rd quarter of 2011, in comparison with the corresponding time period of 2010, decreased by 7.5 per cent.

Table 4.8

**Monetary Indicators of the Latvian Banking System**

| | 2007 | 2008 | 2009 | 2010 | 2011 I-IX |
|---|---|---|---|---|---|
| *at the end of the period, million LVL* | | | | | |
| Net foreign assets | -4482.8 | -5914.6 | -3022.0 | -1219.8 | -466.9 |
| Net domestic assets | 10 654.0 | 11 846.1 | 8842.3 | 7609.8 | 6777.1 |
| Domestic loans | 13 018.2 | 14 279.7 | 12 204.3 | 11 215.1 | 10 351.0 |
| to government (net) | -87.4 | -370.0 | -1474.6 | -1430.8 | -1688.2 |
| to companies and individuals | 13 105.6 | 14 649.7 | 13 678.9 | 12 645.9 | 12 039.2 |
| Other assets (net) | -2364.2 | -2433.6 | -3362.0 | -3605.3 | -3573.9 |
| Broad money M2X | 6171.3 | 5931.4 | 5820.3 | 6390.0 | 6310.2 |
| Cash in circulation (without vault cash balance) | 900.0 | 866.1 | 667.3 | 807.4 | 888.6 |
| Deposits of individuals and companies | 5271.3 | 5065.3 | 5153.0 | 5582.7 | 5421.6 |
| including: | | | | | |
| overnight deposits | 2864.9 | 2308.0 | 2206.2 | 2782.1 | 2839.2 |
| time deposits | 2406.4 | 2757.3 | 2946.8 | 2800.6 | 2582.4 |
| *changes in comparison with the corresponding period of the previous year, %* | | | | | |
| Domestic loans: | 31.8 | 9.7 | -14.5 | -8.1 | -8.2 |
| including | | | | | |
| to companies and individuals | 34.0 | 11.8 | -6.6 | -7.6 | -7.5 |
| Broad money M2X | 12.6 | -3.9 | -1.9 | 9.8 | 1.9 |
| Cash in circulation (without vault cash balance) | -7.1 | -3.8 | -23.0 | 21.0 | 16.9 |
| Deposits of individuals and companies | 16.9 | -3.9 | 1.7 | 1.1 | -0.2 |
| **GDP at current prices** | **32.3** | **9.5** | **-19.2** | **-2.7** | **12.6** |

In the 3rd quarter of 2011, the banking sector has issued a total of 22.9 thousand new loans in the amount of LVL 454.7 million which is by 10.4% more than in the previous quarter. Almost 121 thousand new loans for the amount of nearly LVL 1.1 billion have been granted to non-banks since the beginning of 2011 (in three quarters).

In the three quarters of 2011, the most new loans for national economy have been granted to the transport and storage sector and agriculture, forestry, and fishery sector, but in terms of amount, 18.2% of all new loans within national economy have been granted to electricity, gas, and water supply sector, 17.3% – wholesale and retail trade sector, and 16.3% – financial and insurance operations.

Like before, in the 3rd quarter of 2011, mortgages dominate in the structure of loans granted to domestic companies and individuals; the share of mortgages in the total loan structure is 56.6%. The share of commercial credits and industrial credits slightly increased reaching total 32.6% in comparison with late 2010.

The balance of granted mortgage loans continued decreasing also in 2011 and in the 3rd quarter they decreased by 9.5%, compared to the same period of 2010.

A similar situation is also observed in the field of consumer crediting. At the end of the 3rd quarter of 2011, the balance of consumer credits decreased by 0.6% in comparison with the corresponding period of the previous year.

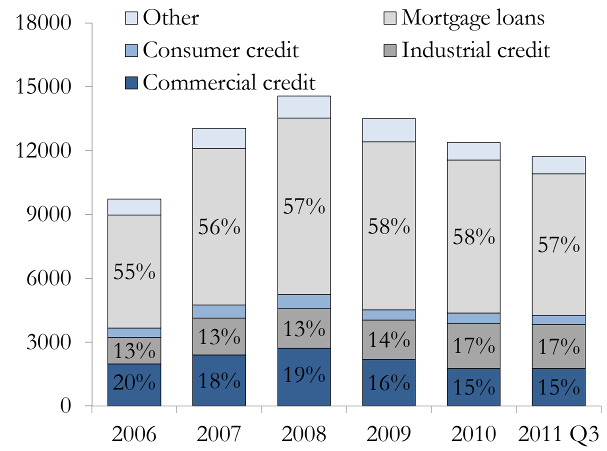
The balance of commercial and industrial credits has been decreasing already since the end of 2008 and continued declining also in 2009. At the end of the 3rd quarter of 2011, the balance of granted loans lagged behind the result of the corresponding period of the previous year by 5.9 per cent.

In 2011, the amount of loans granted to residents (financial institution and private and public non-financial corporations) **in the national economy** in general continues decreasing, and the loans granted in the 3rd quarter of 2011 constituted LVL 6319 million which is by 9.1% less than in the corresponding period of 2010. The most rapid decrease in the balance of granted loans has been observed for financial and insurance activities (by 23.4%) and the information and communication services sector (by 20.3%), whereas the number of granted loans increased significantly in the electricity, gas, and heat supply sector (by 51.4%).

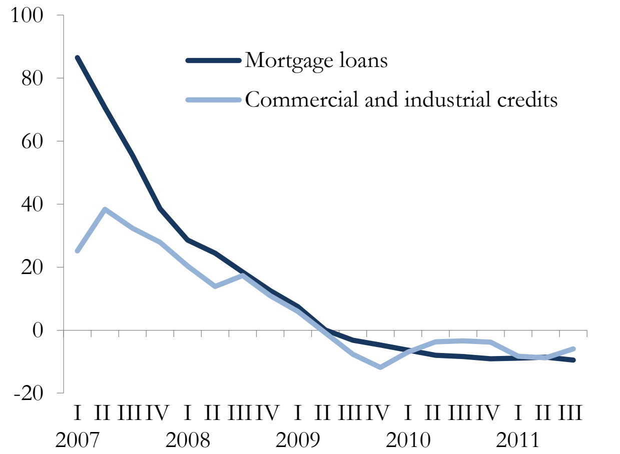
The largest share of loan balances is still related to real estate operations (33% of the total loans granted to the sectors of national economy). A relatively high share of granted loans is also observed in the manufacturing (14%), trade, accommodation, and catering sectors (14%), as well as construction sectors (9%).

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**
(increase in comparison with the respective quarter of the previous year, %)

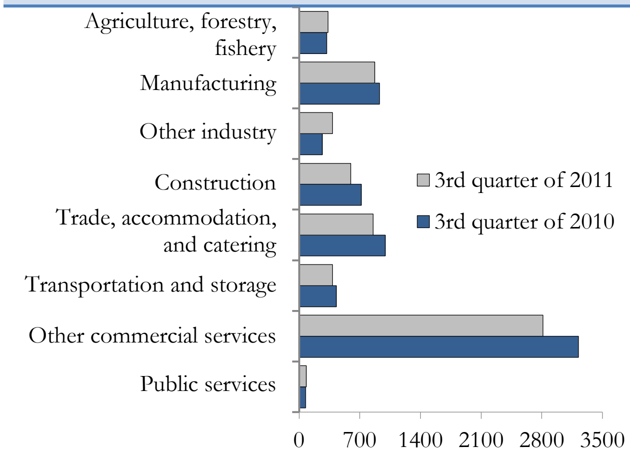



9.6% of all loans granted to the residents are loans in lats. The majority of the loans (86.8%) are granted in EUR so far due to much lower interest rates for loans granted in EUR; however as the LVL interest rates neared the euro rates, an increase in loans granted in lats has been observed. In the 3rd quarter of 2011, the amount of loans granted in LVL has increased by 17.9% in comparison with the corresponding period of the previous year, whereas the amount of loans granted in EUR has decreased by 11 per cent.

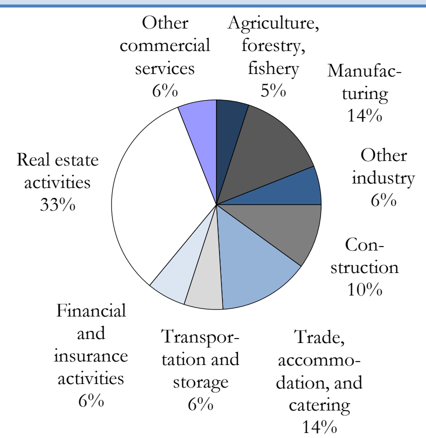
Figure 4.35

**Loans to Residents by Sectors of National Economy**

**Balance of loans granted**
(at the end of the 3rd quarter of 2010 and of 2011, million LVL)




**Structure of balance of granted loans**
(at the end of the 3rd quarter of 2011, %)




In the 3rd quarter of 2011, **the amount of delinquent loans** shrank by 15.6% in comparison with the corresponding period of 2010, yet it should be noted that the amount of loans with overdue payments in total loan portfolio reached the highest rate – 28.6% in the 2nd and 3rd quarter of 2010. In the 3rd quarter of 2011, the amount of loans with overdue payments in total loan portfolio remained rather high – 26.2%. The amount of loans with overdue payments from 91 to 180 days shrank the most rapidly, and that is a positive tendency.

31% of loans granted to households are loans with overdue payments, pointing that loan quality of individuals still has not improved. Different situation is observed regarding quality of corporate loans which has significantly improved along with recovering growth of the national economy. At the end of the 3rd quarter of 2011, 22% of loans granted to sectors of the national economy were loans with overdue payments (at the end of 3rd quarter of 2010 – 27%).

In 2011, the banks continued to cooperate with the clients facing difficulties to repay the loans. At the end of the 3rd quarter of 2011, restructured loans and loans currently being recovered constituted 32.9% of total loan portfolio, though the amount of these is decreasing.

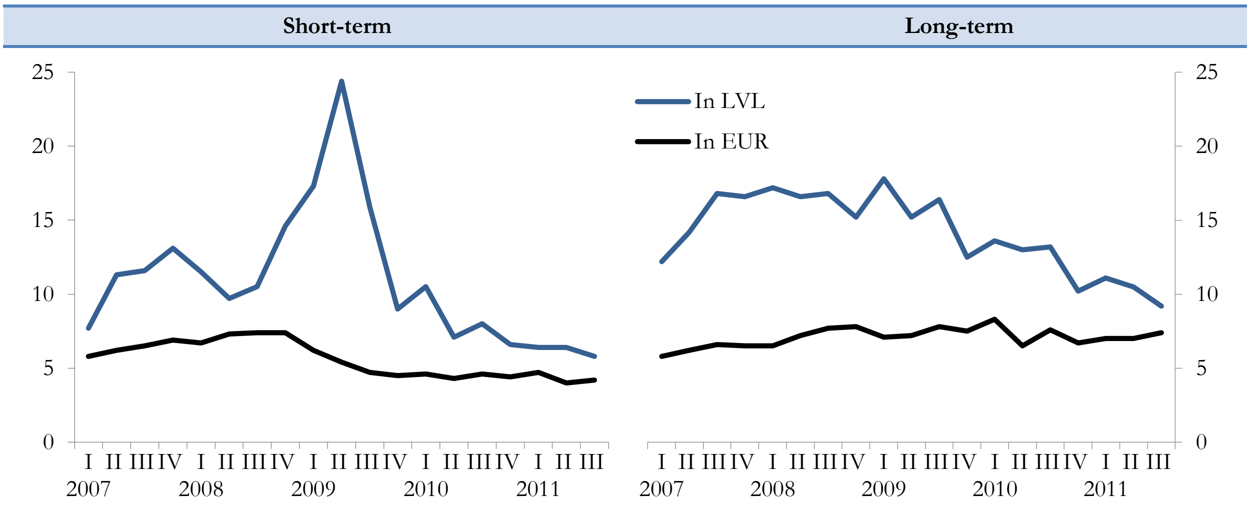
The share of restructured loans in the total banks' loan portfolio decreased from 19.9% at the end of 2010 to 19.3% at the end of the 3rd quarter of 2011.

The share of loans currently being recovered continued increasing in the 3rd quarter of 2011, reaching 13.6% of total banks' loan portfolio.

Figure 4.36

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

(per cent)

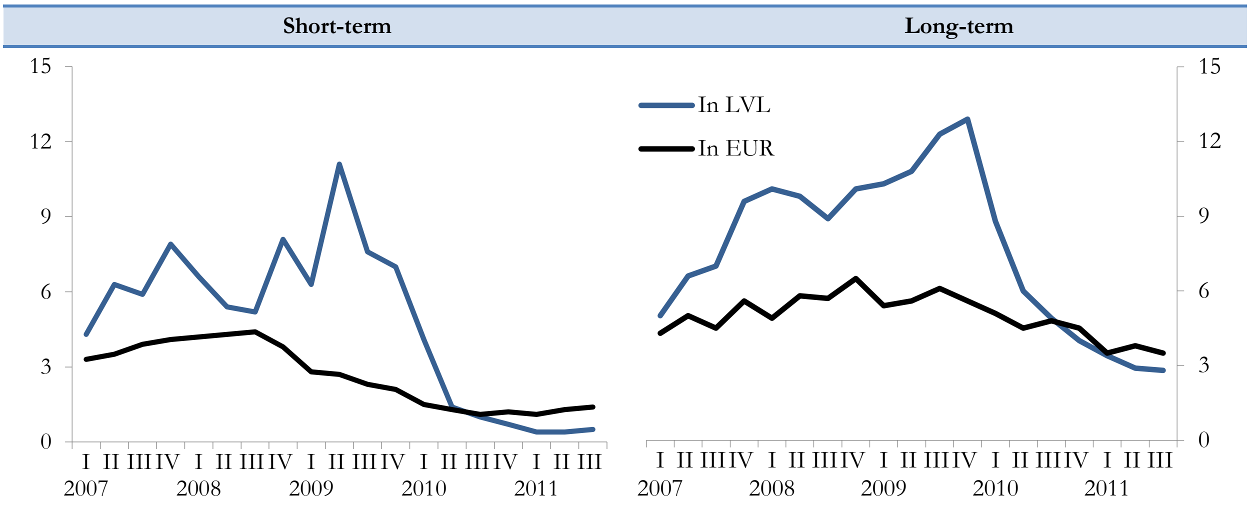



In the 4th quarter of 2011, the weighted average **interest rates** on short-term and long-term loans granted to companies and individuals reached the lowest point over several years: 4.6% and 7.1% respectively, thus indicating stability in comparison with 2009 when the interest rates on loans granted in lats reached the highest point mainly due to the consequences of the global financial crisis, uncertainties about state budget, as well as rumours of possible devaluation of the lats.

Figure 4.37

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

(per cent)



In recent years, convergence of LVL exchange rate with EUR exchange rate has been going-on.

The interest rates on loans granted in EUR were as usual lower and their fluctuations less explicit. At the end of the 4th quarter of 2011, the weighted average interest rate on short-term loans granted in EUR was 4.3%, but on long-term loans – 6.1 per cent.

The weighted average interest rate in LVL in respect to the attracted short-term deposits in credit institutions increased most rapidly in the 2nd quarter of 2009, reaching 11.1%, yet the situation gradually stabilised and the interest rates dropped to 0.6% at the end of the 4th quarter of 2011. A similar situation is observed also with long-term deposits attracted in LVL in credit institutions reaching the highest point (12.9%) in the 4th quarter of 2009 and gradually decreasing since 2010, and dropping to 2.8% at the end of the 3rd quarter of 2011, thus reaching the lowest point over several last years and 3.1% in the 4th quarter. In 2011, the interest rates on short-term and long-term deposits attracted in LVL in credit institutions was even lower than those of short-term and long-term deposits in EUR, which was correspondingly 1.3% and 3.7% in the 4th quarter of 2011.

# 5. LABOUR MARKET

## 5.1. Employment and Unemployment

Growth in 2010 and 2011 has resulted in consistent employment growth, thus reducing the high unemployment rate caused by the crisis.

In the 3rd quarter of 2011, the number of the employed has increased by 7.5% or 68.6 thousand and reached 984.7 thousand, in comparison with the 1st quarter of 2010[1]. The employment rate has increased accordingly, constituting 62.7% (population aged 15-64 years)[2] in the 3rd quarter of 2011 contrary to 57.7% in the 1st quarter of 2010. The number of the employed has increased by 24.4 thousand, while the employment rate – by 2.1 percentage point in a year (the 3rd quarter of 2011 compared to the 3rd quarter of 2010).

The unemployment declined along with the employment growth. According to the data of labour survey, the unemployment rate in the 3rd quarter of 2011 has dropped to 14.4%, which is by 3.5 percentage points lower than a year ago and by 6.1 percentage points lower than in the 1st quarter of 2010. It should be noted that in the period from the 3rd quarter of 2010 to the 3rd quarter of 2011, Latvia had the second fastest unemployment decline among the EU Member States (seasonally adjusted harmonized unemployment rate shrank from 18.2% to 14.8%). Yet, despite the decline, Latvia had the fourth highest unemployment rate in the EU at the end of 2011.

The economic activity of population continues decreasing. The number of economically active population has decreased by 1.7% in a year and was 1150 thousand people in the 3rd quarter of 2011, which is by 0.1% less than in the 1st quarter of 2010. The decrease to a great extent is due to the negative demographic tendencies.

Table 5.1

**Key Indicators of Employment and Unemployment**

| Indicators | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 I-IX |
|---|---|---|---|---|---|---|---|
| Number of employed persons (aged 15-74, thousand) | 1033.2 | 1087.6 | 1119.0 | 1124.1 | 986.7 | 940.9 | 965.2 |
| Economic activity rate (aged 15-64, %) | 69.5 | 71.3 | 72.9 | 74.5 | 73.9 | 73.2 | 73.2 |
| Employment rate (aged 15-64, %) | 63.2 | 66.3 | 68.4 | 68.6 | 61.1 | 59.3 | 61.4 |
| Unemployment rate (share of job-seekers aged 15-74, %) | 9.0 | 6.8 | 6.0 | 7.5 | 16.9 | 18.7 | 15.7 |
| Number of unemployed (job-seekers) (aged 15-74, thousand) | 102.4 | 79.9 | 72.1 | 91.6 | 200.7 | 216.1 | 180.2 |
| Registered unemployed persons (end of the period, thousand) | 78.5 | 68.9 | 52.3 | 76.4 | 179.2 | 162.5 | 131.7 |

The unemployment caused by the crisis has affected men much more than women. Yet, since the beginning of 2010, the male unemployment has rapidly shrunk – from 25.7% in the 1st quarter of 2010 to 16.1% in the 3rd quarter of 2011. The female unemployment rate slightly decreased during this period from 15.1% to 12.6%. In the 3rd quarter of 2011, the male unemployment rate exceeded the female unemployment rate by 2 percentage points – the male unemployment rate was 63.7% while the female unemployment rate – 61.7 per cent.

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 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. Yet, there are some doubts that the changing structure of the national economy and the increased role of tradable sectors in the national economy may lead to **structural unemployment** or disparity between the labour supply and demand (skills of job seekers fail to meet employer requirements). The number of long-term unemployed grew along with the overall unemployment rate during the crisis. At the end of 2011, there were 56.9 thousand long-term unemployed registered at the State Employment

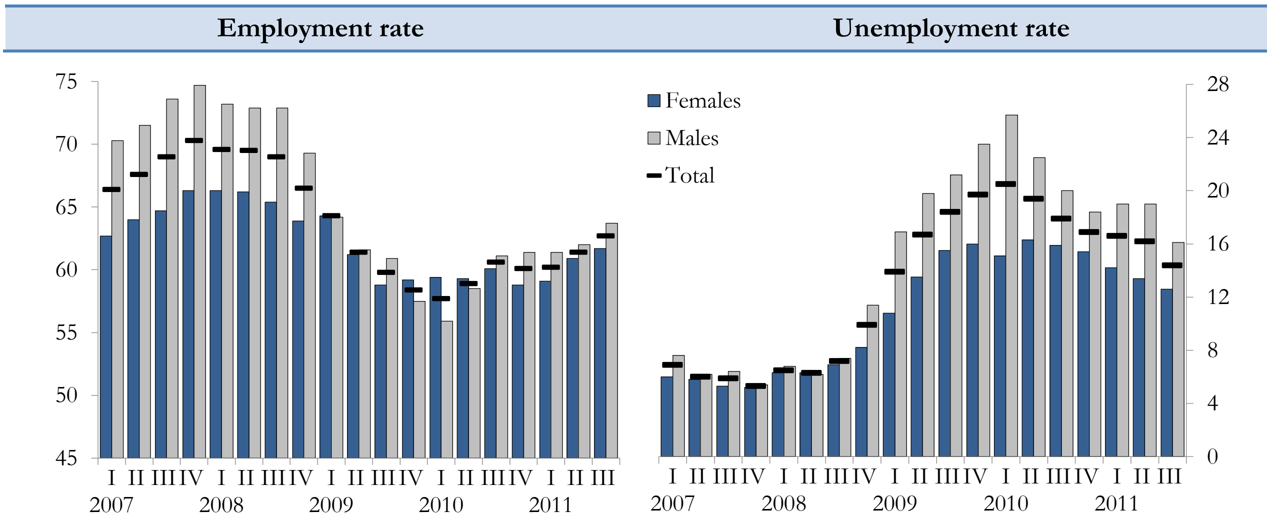
[1] Unemployment rate in the 1st quarter of 2010 reached the highest point – 20.5 per cent

[2] According to the methodology approved in the EU, the unemployment rate and the level of economic activity are reflected for age group 15-64 years but the rest indices of employment and unemployment (except the registered unemployment) – 15-74 years

Agency. High long-term unemployment may cause growth of structural unemployment, namely, the longer these people have no job, the higher is the risk for them to lose work skills and competences.

Figure 5.1

**Employment and Unemployment in Latvia**
(per cent)




The number of vacancies is one of the indicators reflecting changes in the labour demand. After the rapid decrease in 2008, the number of vacancies stabilised remaining at a low level. Since the 2nd quarter of 2010, the number of vacancies started growing along with the gradually improving economic situation, and there were 3.1 thousand vacancies in the 3rd quarter of 2011, which is by 0.9 thousand more than a year ago (there were 16.8 thousand vacancies at the end of 2007).

In the three quarters of 2011, the structure of the employed people has slightly changed in the breakdown of sectors of the national economy (the share of the employed in agriculture, forestry, and fishery has increased, but the share of the employed in manufacturing has decreased mainly due to the decrease in the share of the employed in mining (see Table 5.2).

Figure 5.2

**Vacancies**

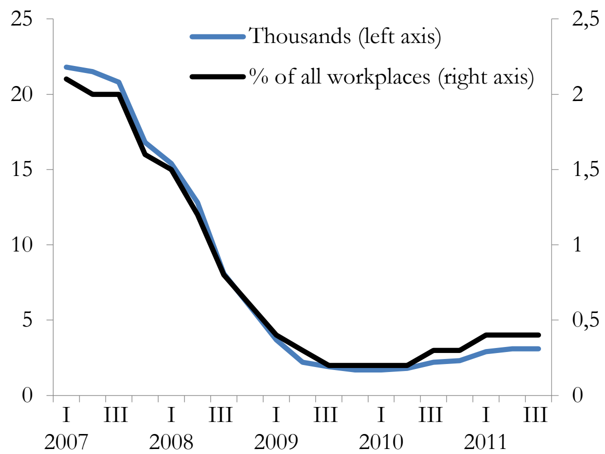



Table 5.2

**Employed by Economic Sectors**
(aged 15-74)

| | Structure (%) | | | Changes (%) | | |
|---|---|---|---|---|---|---|
| | **2009** | **2010** | **2011 I-IX** | **2009/2008** | **2010/2009** | **2010/2008** |
| Total | **100** | **100** | **100** | **-12.2** | **-4.6** | **-16.3** |
| including: | | | | | | |
| Agriculture and forestry | 8.8 | 8.8 | 9.7 | -2.1 | -5.0 | -7.1 |
| Manufacturing | 13.2 | 13.7 | 13.7 | -21.6 | -0.7 | -22.1 |
| Other industries | 3.0 | 3.2 | 2.6 | -7.3 | 1.0 | -6.3 |
| Construction | 7.8 | 7.1 | 7.3 | -39.9 | -13.6 | -48.1 |
| Trade | 19.1 | 19.0 | 18.8 | -11.5 | -4.8 | -15.7 |
| Transportation and storage | 8.9 | 8.7 | 8.7 | -9.0 | -7.4 | -15.7 |
| Other commercial services | 16.9 | 17.7 | 17.5 | -0.8 | -0.2 | -1.0 |
| Public services | 22.3 | 21.8 | 21.7 | -5.3 | -6.6 | -11.5 |

The decrease in employment related to the economic downturn affected almost all sectors. The number of the employed has increased in almost all sectors as the employment resumed growth. A slight decrease was observed in such manufacturing sectors as electric power, gas supply, heat supply and air conditioning, and water supply and waste management. The number of the employed in both sectors has decreased by nearly 5 thousand people during the period from the 1st quarter of 2010 to the 3rd quarter of 2011.

During this period, the highest increase in the number of the employed was observed in the agriculture, forestry, and fishery sector (the number has increased by 19 thousand people), and in construction (by 15 thousand people).

In 2012 and 2013, the growth may be slower mainly due to the debt crisis in the world, which appeared in late 2011. Therefore, the demand in the labour market of Latvia expects moderate improvements in the coming years without any significant changes in employment and unemployment indicators. Latvia should take into account that a relatively high unemployment rate will be the reality in the coming years. No employment growth is expected in a medium-term that would allow exceeding the pre-crisis level, because the growth will be based on the increase in productivity. Therefore, certain population groups, in particular the youth and people having a low level of education and qualification are likely to experience improvement of the situation less expressly.

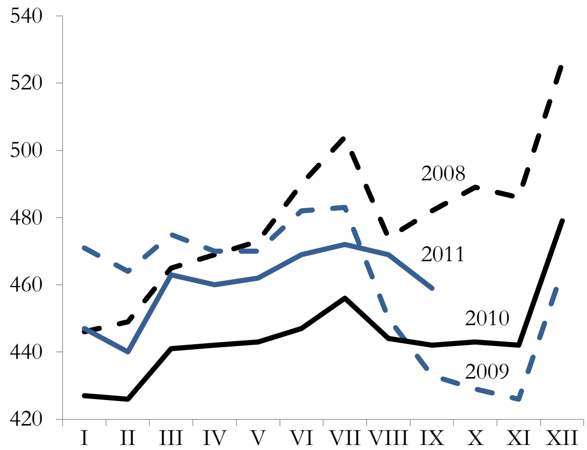
It should also be taken into consideration that the balance between the labour demand and supply is influenced not only by labour education and skills but also by wages, therefore vacancies stay open even under high unemployment conditions.

## 5.2. Labour Costs and Productivity

During the economic recession, significant adjustments took place in the labour market resulting in a reduced number of the employed and wages. Decreasing economic activities in 2008 first led to a reducing number of the employed; the wages, on the other hand, remained at a rather high level. In 2009, along with the reduced employment, adjustment of wages was observed, as well. When the economic situation stabilized, changes in wages and in employment were moderate.

Figure 5.3

**The Average Monthly Gross Wage of the Employees**
(in lats)

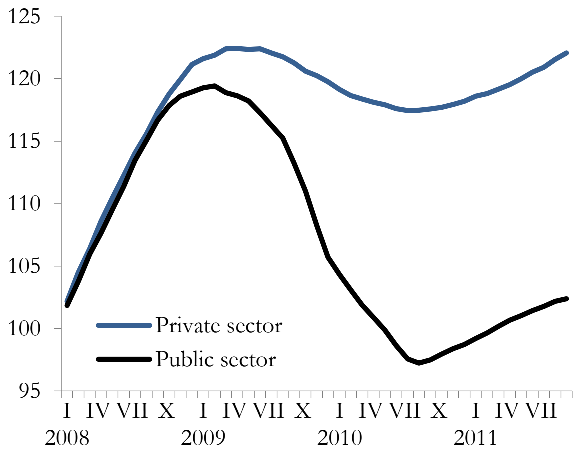



Overall, in 2010, the average monthly wages were lower than in 2009. As the economic activities gradually restarted, the situation in the labour market improved and it was reflected also on the dynamics of wages. Since September 2010, the average gross monthly wage of the employed was already higher than in the corresponding period of 2009. Also in 2011, the dynamics of wages remains positive.

The average gross wage in 2011 was LVL 460, i.e. by 4.3% higher than in the previous year, yet by 4.6% lower than in 2008. As regards assessment of wages, it should be noted that, considering the severity of the economic downturn in Latvia, overall, the wage adjustments were relatively small and the labour market was balanced mainly on the account of the decrease in the number of the employed.

Figure 5.4

**The Average Monthly Gross Wage of the Employees in Public and Private Sectors**
(December 2007 = 100, 12-month moving mean)




The adjustment process of wages differed considerably from sector to sector The decrease in the average gross wage was mainly due to the wage cuts in the public sector determined by the necessity to limit state budget expenditures. As compared with 2008, the average gross monthly wage in the public sector in

2010 was by 17% lower, while in the private sector – by just 2.4%. It shows that the entrepreneurs preferred reducing the number of employees in order to cut their costs. In the nine months of 2011 compared to the corresponding period of 2010, the average gross monthly wage of the employed in public and private sectors increased correspondingly by 5% and 4.4%. Uneven adjustments in the last two years resulted in balancing the average gross monthly wage of the employed in the public and private sectors.

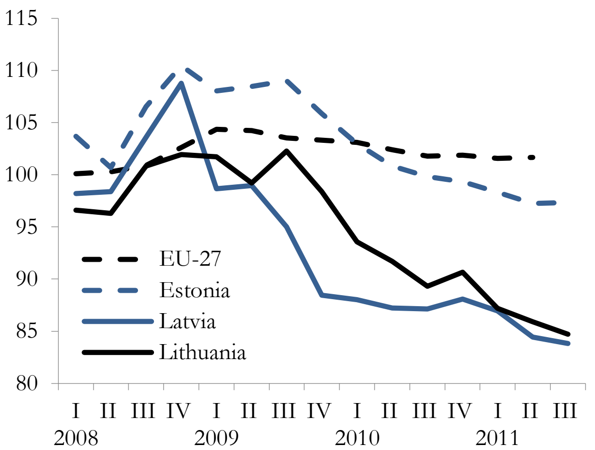
In 2011, wages increased in almost all sectors of national economy. The most rapid increase in wages was observed in services related to real estate. In the nine months of 2011, the average gross monthly wage of the employed in manufacturing was by 4.7% higher than a year ago, however, it was by nearly 3% lower than in 2008.

Since 2009, the production unit labour costs (ULC)[1] have significantly reduced. The ULC is one of the indicators characterising competitiveness (the country in general and individual sectors). The dynamics of this indicator shows that the competitiveness of Latvia in the EU markets has increased.

Figure 5.5

**Changes of Real ULC in the EU and Baltic States**

(4th quarter of 2007 =100)




In 2010, compared to 2008, the real ULC in the EU countries has increased on average by 1.2%. Yet, it decreased in the Baltic States, thus reflecting the improving competitiveness. In 2010, the real ULC in Estonia and Lithuania was respectively by 4.3% and 7% lower than in 2008. But it decreased by 14.4% in Latvia.

Unlike 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.

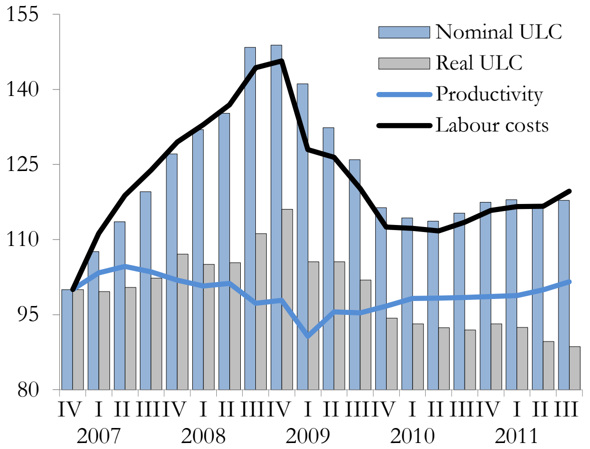
[1] ULC is defined as a relation between labour costs and labour productivity. If the productivity is growing faster than wages, the ULC decreases, which means that competitiveness of the state costs increases and vice versa

The real ULC still continued to grow in 2008 but not as rapidly and it was by almost 7% higher than in the previous year. It was mainly due to the adjustments of different times to commodity and labour markets resulting from the rapid decrease in demand. In 2008, if compared with the previous year, GDP decreased by 4.2%, while the number of the employed and wages still continued growing.

Figure 5.6

**Changes of Labour Costs in Latvia**

(4th quarter of 2006 = 100)




The significant adjustments in the labour market in 2009 affected the dynamics of both productivity and labour costs. If compared with 2008, productivity has decreased by 5.5% as GDP decreased faster than the number of the employed. However, the labour costs in 2009, if compared with 2008, decreased by 12.7% as the number of the employed decreased faster than the payroll. As a result, the real ULC decreased by 6.2 per cent.

The ULC dynamics in 2010 and in the three quarters of 2011 mainly depended on relative changes in the wages and on the number of employed. The high unemployment rate and budget consolidation measures still put a pressure on wages. Yet, considering the low competitiveness of Latvia in the common EU labour market, the changes were already rather moderate. Therefore, the decrease in the unit labour costs, as well as the increase in productivity was to great extent based on changes in the number of employed. The real ULC in 2010 was by 8.2% lower if compared with the previous year, but in the 3rd quarter of 2011 this indicator was by 3.6% lower than a year before.

The dynamics of unit labour costs and productivity in 2010 and at the beginning of 2011 show that the rapid adjustment period is over and opportunities to improve competitiveness at the expense of labour cost cuts have been exhausted.

The increase in competitiveness of Latvia no longer can be based on this factor, moreover, taking into account that it will not be possible to keep low wages under circumstances of free labour movement.

## 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.).

Along with improvement of the situation in the national economy in general in 2011, positive changes have been observed also in the labour market. According to the provisional estimates of the Ministry of Economics, the number of employed in 2011 has increased by about 3%, in comparison with 2010. The unemployment rate has decreased by 3.3 percentage points in a year and was on average 15.4% in 2011.

The situation in the labour market will continue improving also in 2012, yet recovery will be more moderate due to the slowdown in economic growth in the second half of the year.

Overall, in 2012, the number of the employed might increase on average by 15 thousand or 15% in comparison with 2011. Accordingly, the employment rate (in the age group of 15-74 years) in 2012 on average will be 56.5% which is by 1.3 percentage points more than in 2011.

The employment is likely to grow also over the coming years however employment increase will be more moderate than the growth as the output will be based mainly on the increase of productivity.

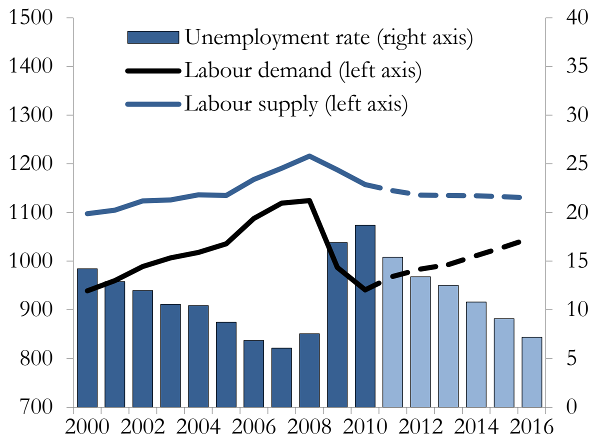
The number of the employed is expected to increase annually on average by 1.6% by the year 2016. Despite the gradual increase, the number of the employed in 2016 still will be below the pre-crisis level. Yet, the employment rate in 2016 might reach the level of 2008 and be close to 63 per cent.

In the medium-term the unemployment will also continue decreasing. The unemployment rate in 2012 is expected to decrease by about 2 percentage points in comparison with 2011and will constitute on average 13.4% a year. The unemployment will continue remaining rather high until 2014 – above 10%, however the situation is going to change as of 2015 when processes in the labour market will be mainly determined by the decrease of economically active population. The unemployment rate in 2015 will be about 9%, but in 2016 – will reduce to 7-8%.

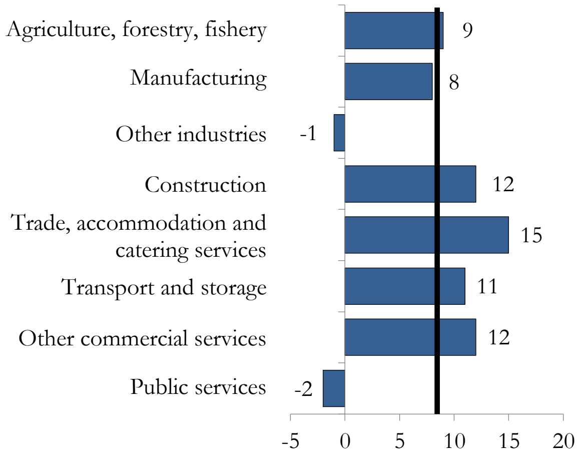
Figure 5.7

**Medium-term Labour Market Development Trends***

**Forecasts of labour force demand and supply***
(aged 15-74 years, thousand persons)




**Changes in the number of employed population in 2016, compared to 2011 by sectors**
(per cent)




* the actual annual data are reflected until 2010

In 2011, the most rapid increase in labour demand by sectors was observed in primary sectors, mainly in agriculture, forestry and forest exploitation, as well as in construction and professional, scientific, and technical service sectors. However, the most considerable decrease has been experienced in arts, entertainment, and recreation sector, mining and quarrying sector, as well as in water supply and waste management sector.

In 2012, the growth is expected in the most of the economic sectors however the growth will be more moderate than in 2011. Despite the slowdown of the growth, considerable contribution in the growth will still be determined by the export oriented sectors (manufacturing, agriculture and forestry and transportation services). Growth is expected also in the construction.

Overall, these tendencies will be reflected in labour demand of sectors, as well. The number of the employed in construction is expected to increase by, 1.8%, but in the information and communication service sector – by 2.6%. Considerable increase in labour demand is expected also in the transport and storage sector (by about 4%) and professional, scientific, and technical service sector (by 2.5%).

The number of employed in 2012 might slightly decrease in the public service sector, as well as in the sectors of electricity, gas, heat and water supply and waste management.

In a medium-term – by 2016 the most notable increase in labour demand is expected in primary sectors, construction, as well as trade, accommodation, catering and other commercial service sectors. At the same time, the number of the employed will continue decreasing in the public service sector determined by making the public service sector more efficient, on the one hand, and by the decreasing demand for such services due to negative demographic tendencies, on the other hand.

Overall, the medium-term and long-term situation in the labour market will depend on the progress of several important factors. The main medium-term risks of the labour market are related to the growing uncertainty about further global economic development and the slowdown of the global economic growth that might greatly influence future growth of Latvia as well and slow down the recovery of labour market.

Yet, the main long-term challenges of the labour market are mainly related to the gradual decrease in labour resources determined by the ageing population and decrease in the number of people entering the labour market. The number of working age population (aged 15-74 years) in Latvia is expected to decrease by more than 8% until 2020 in comparison with the level of 2010. At the same time, the demographic burden might increase by 21 per cent.

## 5.4. Employment Policy

The employment policy has an important role in the EU strategic development documents. The development vision of both *EU 2020 Strategy* and the *Integrated Guidelines* emphasizes the dimension of employment. At the EU level, an aim has been set forth to achieve that by 2020 the employment level for population aged 20-64 years must reach 75 per cent.

At the national level, each Member State prepares the national reform programmes reflecting activity directions and measures to be carried out for the implementation of the *EU 2020 Strategy,* The national reform programme of Latvia for the implementation of the *EU 2020 Strategy* was approved by the Cabinet of Ministers on April 26, 2011 (see Chapter 6.1).

The quantitative objective set by Latvia in the context of implementing the *EU 2020 Strategy* is to reach an employment rate of 73% by 2020 in the age group of 20-64. For reaching the objective, policy directions are planned on both labour supply part and labour demand part.

Policy directions for improving the labour supply:

– reducing structural unemployment, including economic activation of the labour force;
– improving the legal framework of legal labour relations and of labour protection and application thereof;
– promoting self-employment and entrepreneurship;
– structural changes in vocational education;
– modernization of higher education.

Policy directions for improving the labour demand:

– structural reforms in goods and service markets;
– improving business environment.

At the national level, the State Employment Agency (SEA) implements 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.

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

– professional training, retraining, and promotion of qualification;
– measures for specific person groups;
– measures to improve competitiveness;
– paid temporary works (in 2010 and 2011, this measure was completely substituted with the measure *Work Practise 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 had decreased, however, in 2009 due to the significant rise in unemployment, it increased considerably. Also in 2010 and 2011, the demand remained at a high level. 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 (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 promotion 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.

The measure *Work Practice with a Grant* was launched in September 2009 and it was implemented until the end of 2011. It was a crisis employment measure for the unemployed, who no longer receive the unemployment benefit, receiving a monthly grant in the amount of LVL 100 for the work of public benefit. As of July 1, 2011, the amount of the grant was reduced to LVL 80. A work supervisor, inventory, as well as coverage of transportation costs are ensured to the unemployed. In 2009, 19.3 thousand unemployed were involved in the measure *Work Practice with a Grant* with the funding of LVL 8 million. In 2010, the number of the involved unemployed was 52.8 thousand, using LVL 27.2 million during this period. In 2011, 50.6 thousand unemployed were involved and the utilised funding constituted LVL 18.9 million.

The short-term measure *Training Programmes for Employed Subjected to the Risk of Unemployment* provided support to the potential unemployed. It offered training opportunities for those employees in enterprises being temporarily subjected to work stoppage due to the economic crisis providing also the training grant. This measure was implemented using a coupon-system that gives the persons an opportunity to choose the education programme and educational establishment on their own. The measure was commenced in September 2009 and until the end of the year, 3253 persons at the risk of unemployment started the training (the funding used during this period was LVL 0.7 million). Within the framework of the measure, 2634 persons started the training in 2010, a total of 5795 persons were involved this year (the funding used in this period was LVL 3.4 million). The measure is not implemented after 2010.

Along with the active measures, the SEA implements **preventive unemployment reduction measures**:

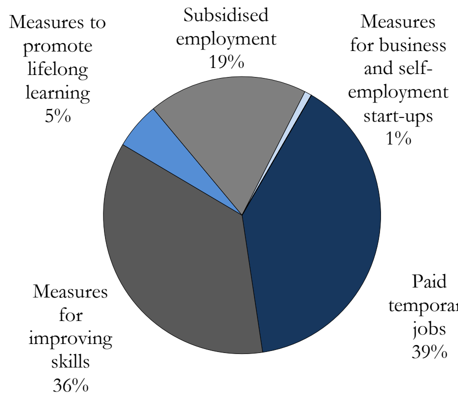
- career consultations;
- training programmes for involving adults in lifelong learning.

The career consultations help clients to increase awareness about their professional direction. 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, but in 2011, 47.7 thousand were serviced, 39.9 thousand of them unemployed and job seekers.

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.

Figure 5.8

**Distribution of labour market policy measures funding in 2011**




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.

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

The measure *Training Programmes for Involvement of Adults in Lifelong Learning* launched in the 3rd quarter of 2010 is taking over the tasks of the measure *Training Programmes for the Employed Subjected to the Risk of Unemployment*, for example, with respect to the administration of the coupon system. The aim is to promote availability of lifelong learning, by giving an opportunity for the people of target groups to increase and improve knowledge and skills necessary for work. 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. Unlike the measure *Training Programmes for the Employed Subjected to the Risk of Unemployment*, the persons involved in the new measure will no longer receive a grant, and they will have to co-finance the set amount of the value of a training coupon (certain groups of persons are exempt from co-financing) in order for them to consider their decisions on education more properly. In 2010, 9895 coupons were issued, and 5155 persons started the training (the used funding – LVL 0.9 million). In the 2011, 15418 persons started to participate in the measure. The funding utilised in this period constitutes LVL 2.6 million.

In 2010, within the framework of professional training, retraining, and promotion of qualification of the unemployed, a new training measure *Mastering the First and Second Level Professional Higher Education Programmes* was launched. The target group of the measure included the unemployed with incomplete higher education willing to complete the commenced education with the training coupon method. A total of 690 unemployed began participation in the measure in 2010. Administration issues, high expenses incompliant with the current limited budget called for re-evaluation of usefulness of the measure implementation. Therefore, it was decided not to continue the measure in the upcoming years, and no new participants were engaged in the measure.

Due to the reduced budget, implementation of several measures was terminated in 2009, and they have not been resumed also until now. Among them are two youth employment-promoting measures: *Employment Measure during Summer Holidays for Persons Acquiring Education in General Education Establishments, Special Education, or Professional Education* and *Youth Summer Employment Project for Youth of Latvian Origin Living Abroad*. The aim of the first measure was to foster pupils' employment during the summer and give them an opportunity to gain work experience, but the aim of the second one – to give the Latvian youth living abroad an opportunity to get acquainted with the working and living conditions in Latvia, thus promoting possible return to their ethnic native country. Similarly, the measure *Promoting Regional Mobility of Persons Employed by Enterprises* for elimination of regional differences in the labour market is no longer implemented.

Due to the increasing economic globalization, rapid development of technology, and negative demographic processes, increasingly more attention in the European employment strategy is 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 throughout the working age. 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 overall public welfare level, on April 20, 2011, the Cabinet of Ministers approved the *Plan of Labour Protection Development for 2011-2013*. It sets several objectives: improving labour protection policy planning, increasing capacity and efficiency of 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 competitiveness 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 Undeclared Employment for 2010-2013* was elaborated. 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 undeclared employment control mechanism; reduction of unfair competition; revision of the penalties policy with respect 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 the administrative burden, support to the honest entrepreneurs, and promotion of transition to legal economy, improving capacity of controlling institutions, elaboration of the 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.

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 implementation of the *EU 2020 Strategy*.

Latvia has decided to foster continuous improvement and development of public knowledge, skills, and competences by ensuring accessibility of lifelong learning so that 15% of the population (aged 25-64 years) would be continuously involved in educational process in 2020. In 2010, the share of the abovementioned persons was 5%, yet, it is expected to reach 12.5% in 2013.

The lifelong learning principle is implemented in several directions:

– developing the national qualification framework structure, and adjusting its levels to the European qualification structure, thus fostering transition to learning 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 outlined the European Commission's vision on the *Europe 2020* strategy. The *Europe 2020* strategy replaces the *Lisbon Strategy* approved by the European Council in March 2000.

On June 17, 2010, the European Council formally approved the *Europe 2020* strategy and its key components: 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 and Convergence Programmes* (developed and implemented for fulfilling requirements of the Stability and Growth Pact).

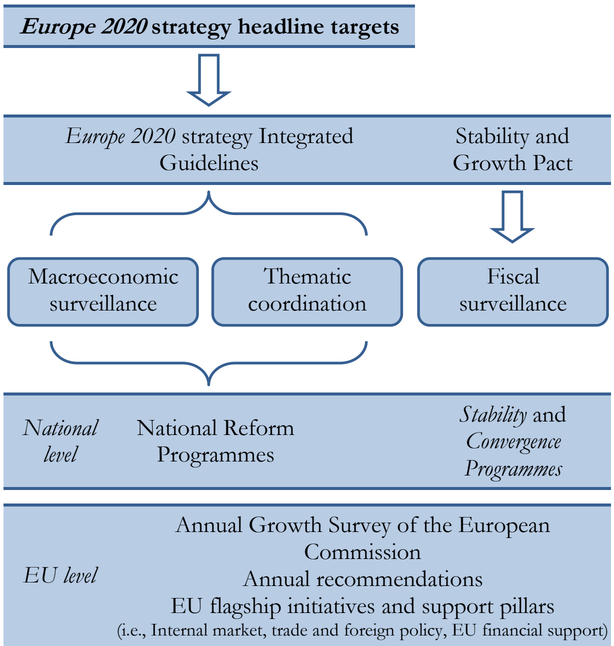
The surveillance of the *Europe 2020* strategy's implementation consists of two pillars (see Figure 6.1) – macroeconomic and thematic surveillance (National Reform Programmes of the EU Member States for the implementation of the *Europe 2020* strategy and their conformity with the *Integrated Guidelines* 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 its Member States, as well as provide recommendations to the EU Member States for the implementation and strengthening of their economic policy[1].

The *Europe 2020* strategy, national reform programmes and *Stability* or *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 so-called European semester (see Figure 6.2).

Figure 6.1

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

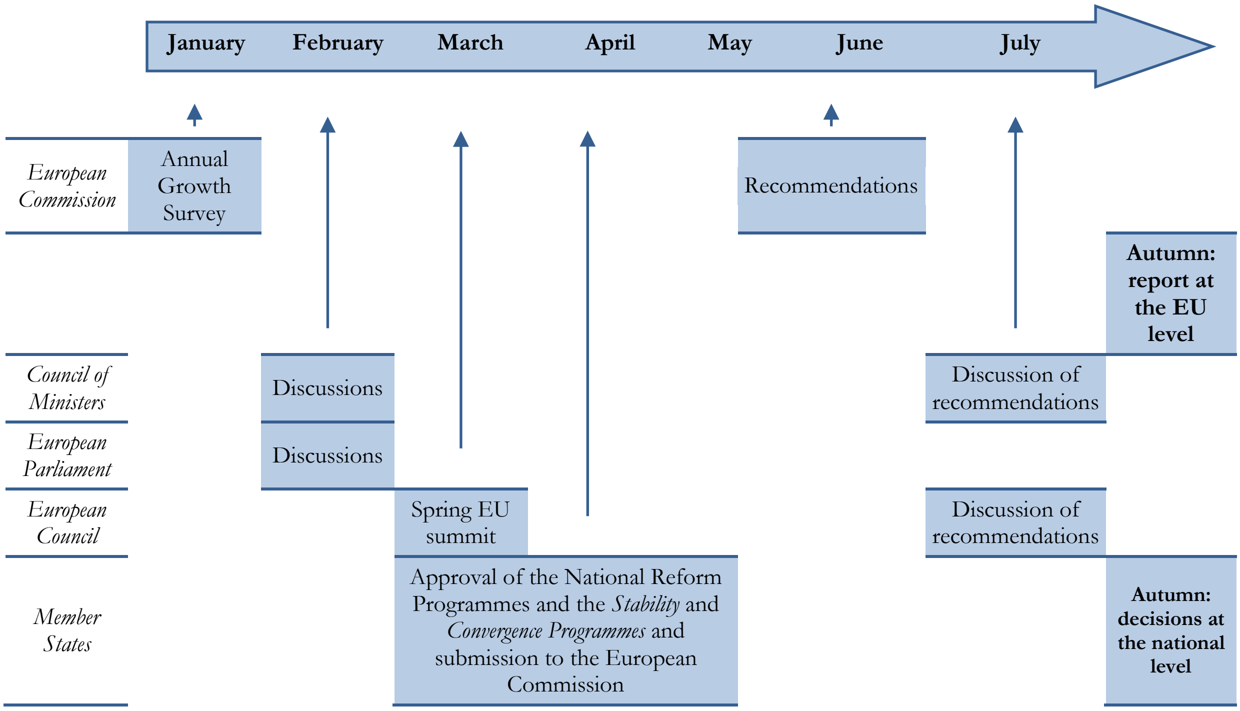



By approving the *Euro Plus Pact*, the European Council on March 24-25, 2011 strengthened the coordination of the EU economic policy even more. The primary focus of the *Euro Plus Pact* (see Box 6.1) is on the areas of eurozone countries, however non-eurozone countries may also join the pact. Currently, apart from the eurozone 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 for implementation of this pact for the next 12 months in their national reform programmes and *Stability* or *Convergence programmes.* Furthermore, 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.

[1] It should be noted that the *Europe 2020* strategy is closely linked with the economic policy and priorities of structural policy of the EU Member States as, pursuant to the *Treaty on the Functioning of the EU*, the EU Member States have to take into consideration the EU approved strategic development documents such as strategies, guidelines, policy, recommendations, etc.

Figure 6.2

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




**Box 6.1**

***<u>Euro Plus Pact</u>***

The *Euro Plus Pact* is **aimed at** strengthening the pillar of the Economic and Monetary Union and 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 prevented.

The *Euro Plus Pact* has four key **priorities**:

– *To foster competitiveness* by ensuring wage dynamics conformity to productivity developments, promoting competitiveness and liberalization of "protected" sectors, eliminating unreasonable restrictions in the field of professional services and retail trade, improving education system, promoting research and development (R&D) and innovation, developing infrastructure, and improving business environment;
– *To foster 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 to eliminate the tax burden imposed on the employed, yet taking into consideration the aim to preserve tax revenues;
– *To ensure 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 introducing the EU fiscal rules based on the Stability and Growth Pact into the national legislation;
– *To reinforce financial sector stability* by adapting the national legislation regarding surveillance of the banking sector in compliance with the EU requirements.

As shown in the Figure 6.2, the ***Annual Growth Survey*** published by the European Commission is one of the key components of the European semester. It serves as a basis for building common understanding regarding necessary priorities at national and EU level for the next 12 months.

On November 23, 2011, the European Commission published the second *Annual Growth Survey*. Just like the first *Annual Growth Survey* (published on January 12, 2011), also the *Annual Growth Survey* of 2012 serves as the starting point for the second surveillance and coordination cycle of the EU economic policy, i.e. the European semester.

The *Annual Growth Survey* of 2012 consists of the main text which discusses 5 priorities proposed by the European Commission, an annex to the main text which discusses the main urgent decisions to be made by the end of 2012, and four additional annexes (1. Progress report on the *Europe 2020* strategy; 2. Macroeconomic report; 3. Draft joint employment report; 4. Growth-friendly tax policies in Member States and better tax coordination in the EU).

The European Commission proposes 5 key priorities for 2012 in the *Annual Growth Survey* 2012:

– Pursuing differentiated growth-friendly fiscal consolidation;
– Restoring normal lending to the economy;
– Promoting growth and competitiveness for today and tomorrow;
– Tackling unemployment and the social consequences of the crisis;
– Modernising public administration.

The *Annual Growth Survey* of 2012 will be discussed at different Council levels during the European semester process from January to March 2012. Based on priorities reflected in the *Annual Growth Survey* and the discussions, the Spring European Council is going to approve the policy guidelines of the European semester for 2012. The EU Member States have to reflect the policy for implementation of the decisions made at the Spring European Council (policy guidelines) in their national reform programmes, *Stability* or *Convergence programmes* to be submitted to the European Commission in the mid-April 2012. Then the European Commission will analyse and assess the national reform programmes of the EU Member States and publish country-specific recommendations to the EU Member States. After approving the country-specific recommendations of the European Commission in the EU Council on July 2012, the European semester 2012 will be over. The EU Member States have to take into consideration the country-specific recommendations approved by the Council by updating their national reform programmes and *Stability* or *Convergence programmes* and making respective decisions regarding their national budget.

### 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 by the Cabinet of Ministers on April 26, 2011, along with the *Convergence Programme of Latvia for 2011-2014*.

Both programmes were submitted to the European Commission on April 29, 2011. According to the *Treaty on the Functioning of the EU,* both of them are components of the EU-level instrument for economic policy coordination and surveillance (in the framework of the so-called European Semester). Multilateral surveillance of both programmes is being 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. The EU funds financing plays an important role in implementation of the measures of *the NRP of Latvia*.

*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 targets of Latvia for 2020 in the context of the *Europe 2020* strategy and main measures for 2011-2013 to achieve them.

*The NRP of Latvia* is based on the *Integrated Guidelines* and requirements of the European Commission regarding preparation of the NRPs of the EU Member States, taking into account national priorities and objectives of Latvia set in other Latvian policy planning documents, such as the *Sustainable Development Strategy of Latvia "Latvia 2030"*, as well as the *Strategic Development Plan of Latvia for 2010-2013*. *The NRP of Latvia* is closely related to the *Convergence Programme of Latvia for 2011-2014,* which was developed together with *the NRP of Latvia*.

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 pre-conditions 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.

*The NRP of Latvia* sets the following frontloading measures:

– Improvement of active labour market policy measures by gradual transition from crisis-related measures to traditional active labour market policy measures;
– Elimination of administrative barriers;
– Modernization of higher education;
– Speeding up the absorption of the EU funds.

As already mentioned, *the NRP of Latvia* reflects the quantitative targets of Latvia for 2020 in the context of the *Europe 2020* strategy (quantitative targets of Latvia) – see Table 6.1.

The targets of Latvia have been set taking into account the medium-term development scenario of the national economy of Latvia, as well as the targets of the *Sustainable Development Strategy of Latvia "Latvia 2030"*.

According to the quantitative targets of Latvia, it is planned to reach a 73% employment level by 2020, to increase investments in research and development (R&D) to 1.5% of GDP, to increase the share of persons having obtained tertiary education to 34-36%, to reduce the share of school drop-outs to 13.4%, to reduce the share of people at risk of poverty to 21%, to increase the share of renewable energy sources in gross energy consumption to 40%, etc.

On June 7, 2011, the European Commission published the assessment of the national reform programmes and *Stability* or *Convergence programmes* of the EU Member States providing also country-specific recommendations to the EU Member States.

It must be noted that the assessments and country-specific recommendations of the European Commission differ among the EU Member States as the economic situation differs from country to country. Thus, for example, those EU Member States that receive international support from the European Commission and the IMF are recommended to continue implementing measures envisaged in these assistance programmes. The EU Member States with high budget deficits are recommended to carry out fiscal consolidation and ensure that wage dynamics are in line with productivity. The EU Member States without significant budget deficit problems and those having budget surplus are recommended to implement measures aimed at promoting growth in the medium term and long term.

Having assessed *the NRP of Latvia* and the *Convergence Programme of Latvia for 2011-2014*, the European Commission recognizes the medium-term macroeconomic scenario of Latvia as plausible. The European Commission emphasizes that the planned fiscal effort for 2011-2012 is in line with the required adjustment. Reduction of budget deficit over the medium term, as foreseen by the programme, would help reduce the risks to the sustainability of public finances.

Taking into account the abovementioned, the European Commission recommends Latvia to implement the measures as laid down in the documents *Council Decision 2009/290/EC*, as amended by the *Council Decision 2009/592/EC,* and further specified in the Memorandum of Understanding of January 20, 2009 and its subsequent supplements, in particular the supplement of the *Memorandum of Understanding* of June 2011.

The measures of *the NRP of Latvia* are implemented according to the schedule. Currently several regulations or activities are at different stages of elaboration; these regulations and activities may have a significant impact on the change of the situation in some areas after their approval by the Cabinet of Ministers and/or the Saeima, for example:

– *Draft Fiscal Discipline Law;*
– Approval of the new *Construction Law*;
– *Financing Model of Higher Education;*
– *Amendments to the Law on Free Provision of Services* envisaging elimination of shortcomings in transposition of the *Services Directive*;
– *Draft Law on Renewable Energy;*
– *Amendments to the Biofuel Law,* etc.

At the same time it should be noted that better progress must be achieved in several areas of *the NRP of Latvia*. Although certain progress was achieved in the elimination of administrative burden (reduced number of days required for harmonization of construction documents), the objective to reduce the number of days required for harmonization of construction documents from 186 to 69 set in *the NRP of Latvia* for 2011 has not been achieved. Adoption of the new *Construction Law* submitted to the Saeima will allow to achieve fully this objective of *the NRP of Latvia*.

Currently, the progress in increasing the share of renewable energy is prevented by delayed improvement of legislation since the Saeima still has not adopted the *Law on Renewable Energy*. The *Draft Energy Strategy 2030* developed by the Ministry of Economics is now undergoing public discussion as policy directions incorporated therein will have influence on increasing the share of renewable energy and improvement of the situation in the renewable energy area.

In the early 2012, the Ministry of Economics in close cooperation with other ministries, social partners and non-governmental organizations involved in the implementation of the *Europe 2020* strategy will start the work on the preparation of the *Progress Report on the Implementation of the NRP of Latvia*. The Progress report will reflect information on the implementation of the current measures of the NRP of Latvia and update the NRP of Latvia with the new measures taking into account the priorities of the *Annual Growth Survey* of 2012 and decisions of the Spring European Council of March 2012.

Table 6.1

**National Targets of Latvia for 2020 in the Context of the *Europe 2020* Strategy**

| | EU-27 | | Latvia | | |
|---|---|---|---|---|---|
| | Fact | Targets | Fact | Targets | |
| | 2009 | 2020 | 2009 | 2020 | *Latvia 2030* |
| **Employment rate** (age group of 20-64 years), % | 69.1 | >75.0 | 67.1 | **73.0** | Increase labour participation and to use maximally all human capital resources available in Latvia, including older people |
| **Expenditures on research and development** (R&D) (% of GDP) | 1.9 (2008) | 3.0 | 0.46 | **1.5** | > 3 |
| **Tertiary education** (share of population aged 30-34 having completed tertiary education) | 32.3 | 40.0 | 30.1 | **34.0 ... 36.0** | >90 per 1000 inhabitants aged 20-29 years |
| **Share of early school leavers** (age group of 18-24 years, %) | 14.4 | <10.0 | 13.9 | **13.4** | Share of population aged 20-24 having completed at least upper secondary education >90 |
| **Persons at risk of poverty after social transfers (%)**[1] | 17.0 (2008) | 20 million less people should be at risk of poverty[2] | 26.0[3] (2008) | **21.0 (121 000 less people should be at risk of poverty or exclusion)**[4] | Persons at risk of poverty after social transfers <16 |
| **Energy efficiency** (gross inland energy consumption, Mtoe) | 1799.29 (2008) | To increase energy efficiency by 20% | 4.6 | **To gain energy savings of 0.668 Mtoe in consumption of primary energy resources or 0.48% that is the total contribution of Latvia in achievement of the common EU energy efficiency target** | <150[5] |
| **Share of renewable energy sources in gross final energy consumption (%)** | 10.3 (2008) | To increase the share of renewable energy sources in gross final energy consumption to 20% | 29.9 (2008) | **To increase the share of renewable energy sources in gross final energy consumption to 40%** | >50 |
| **Greenhouse gas (GHG) emissions** (% compared to 1990 level) | 88.7 (2008) | To reduce GHG emissions by 20% compared to 1990 | 44.4 (2008)<br><br>11.9 Mt (2008) | **To limit GHG emissions in sectors outside the ETS**[6] **so that the increase does not exceed 17% compared to 2005**<br><br>**To limit the overall GHG emissions so that in 2020 they do not exceed 12.19 Mt $CO_2$ equivalent** | – |

[1] Persons with an equivalised disposable income below the risk-of-poverty threshold, which is set at 60% of the national median equivalised disposable income (after social transfers)
[2] Expressed using three indicators – number of people who are either at-risk-of-poverty and/or materially deprived and/or living in jobless households
[3] Indicator includes at-risk-of-poverty rate and/or jobless households
[4] Expressed using two indicators – at-risk-of-poverty rate and/or jobless households
[5] Energy intensity of the economy is reflected here (gross inland energy consumption against GDP (kg oil equivalent per 1000 EUR of GDP)) according to the Eurostat methodology
[6] Sectors not covered by the EU Emission Trading System (EU ETS), for example, transport, small-sized industry and energy sector, agriculture

# 6.2. Integration of Latvia in the Economic Policy and Structural Policy of the European Union

## 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 prior to 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.

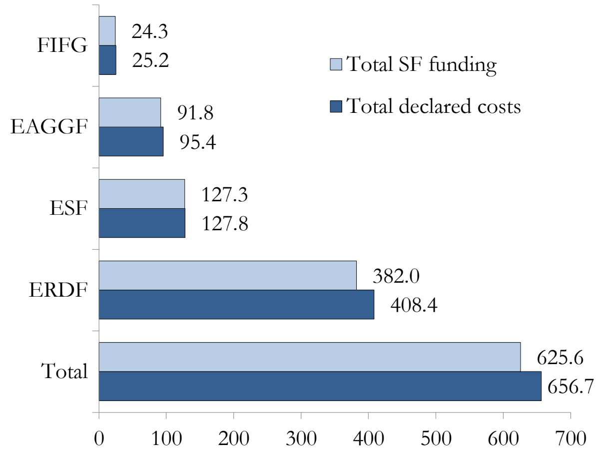
Overall projects for EUR 673.3 million or 107.6% of total SF funding available for Latvia have been approved and finished in the programming period 2004-2006. The sum of approved projects exceeds the available SF funding due to undertaken overcommitments under decrees of the Cabinet of Ministers providing 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 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 rise in costs.

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**

(till December 31, 2011, million Euro)

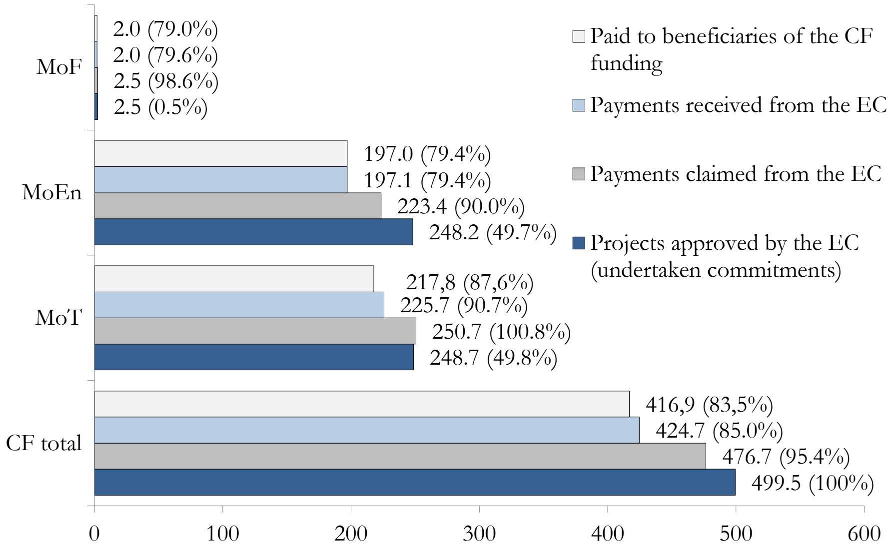



In the period of 2004-2006, the total available funding for Latvia for implementation of the Cohesion Fund projects was LVL 499.5 million.

Figure 6.4

**EU Cohesion Fund absorption in the programming period 2004-2006 (full financial flow) by the end of accounting period on December 31, 2011**

(million LVL, % of undertaken commitments)



Implementation of CF projects for the programming period 2004-2006 is 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 – transport sector and 2 projects were implemented as technical support projects by the Ministry of Finance for administrative capacity-building of the implementation system. By December 31, 2010, work on 45 projects was completed and work on one project was terminated.

As of 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 educating the 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 distribution 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 million 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 551 million or LVL 387 million;
- 2. OP *Entrepreneurship and Innovations* (ERDF) – EUR 737 million or LVL 517 million;
- 3. OP *Infrastructure and Services* (ERDF+CF) – EUR 3.20 billion or LVL 2.24 billion.

Figure 6.5

**Division of funding between OP in period on planning 2007-2013**

(per cent)

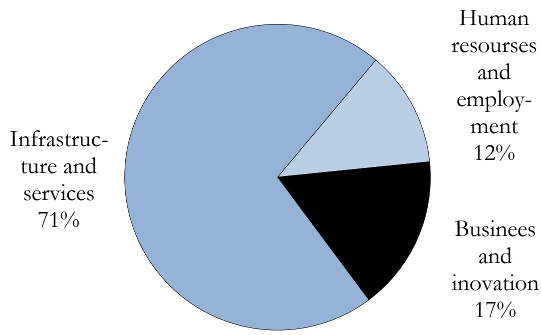



Table 6.2

**EU fund financial progress in the programming period 2007-2013 till December 31, 2011**

| Fund | Financing of the EU fund | Concluded contracts | | Paid to the funding beneficiaries | | Received EC's repayments (incl. advances) | |
|---|---|---|---|---|---|---|---|
| | million LVL | million LVL | % | million LVL | % | million LVL | % |
| ESF | 409.8 | 365.9 | 89.3 | 245.8 | 60.0 | 246.0 | 60.0 |
| ERDF | 1692.0 | 1379.1 | 81.5 | 676.1 | 40.0 | 566.9 | 33.4 |
| CF | 1082.1 | 950.4 | 87.8 | 443.8 | 41.0 | 347.7 | 32.1 |
| **Total** | **3184.0** | **2695.5** | **84.7** | **1365.8** | **42.9** | **1160.0** | **35.3** |

By December 31, 2011, projects for the amount of more than a half (or 84.7%) of all financing of the EU funds available for Latvia within the given programming period had been approved, and contracts for a total of LVL 2695.5 million had been concluded. By December 31, 2011, the funding beneficiaries had received LVL 1160 million.

**Box 6.2**

**Activities under the responsibility of the Ministry of Economics**

A total of LVL 551.7 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 November 28, 2011, 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*, 29 contracts have been concluded for the total amount of LVL 16.9 million
- Within activity *Support to Individually Organised Trainings for Entrepreneurs*, 87 contracts have been concluded for the total amount of LVL 2.3 million.
- Within activity *Attraction of Highly Qualified Employees*, 3 contracts have been concluded for the total amount of LVL 100.9 thousand.
- Within activity *Competence Centres* 6 contracts have been concluded for the total amount of LVL 37.3 million.
- Within activity *Technology Transfer Contact Points*, 8 contracts have been concluded for the total amount of LVL 1.9 million.
- Within activity *Development of New Products and Technologies*, 88 contracts have been concluded for the total amount of LVL 6.7 million.
- Within activity *Introduction of New Products and Technologies into Production*, 137 contracts have been concluded for the total amount of LVL 38.5 million.
- Within activity *Development of New Products and Technologies – Support to Strengthening Industrial Property*, 7 contracts have been concluded for the total amount of LVL 79.3 thousand.
- Within activity *High Value Added Investments*, 24 contracts have been concluded for the total amount of LVL 52.9 million.
- Within activity *Access to International Trade Markets – External Marketing*, 733 contracts have been concluded for the total amount of LVL 4.8 million.
- Within activity *Development of External Markets – Strengthening International Competitiveness of Industry Sectors,* 2 contracts have been concluded for the total amount of LVL 4.9 million.
- Within activity *Support for Self-employment and business start-ups* by October 31, 2011, 2127 agreements on the participation in the programme had been signed and 524 business plans for granting loans for the total amount of more than EUR 8497 thousand had been approved.
- In financial instruments implemented within activity *Holding Fund,* the following results were achieved:
  1) venture capital – On January 22, 2010, the EIF and *BaltCap Management Latvia* concluded a contract on foundation of a venture capital fund. In addition to EUR 20 million invested by EIF, *BaltCap Management Latvia* invested co-funding of private investors in the fund for the amount of EUR 10 million. By December 31, 2011, *BaltCap Management Latvia* has made 5 venture capital investments in the amount of EUR 5 million;
  2) seed and start-up capital – On June 16, 2010, the EIF and *Imprimatur Capital Baltics* concluded a contract on foundation of the seed and start-up capital fund. In total, the planned funding available for seed and start-up capital investments constitutes EUR 20.4 million. By December 31, 2011, *Imprimatur Capital Baltics* has made 7 seed capital investments in the amount of EUR 700 thousand and also an agreement on start-up capital investment of EUR 800 thousand;
  3) high-risk loans – On March 26, 2010, the EIF concluded a contract with *AS Swedbank* and *AS SEB Banka*. In total, the funding available for SMEs is LVL 61.8 million. By December 31, 2011, 29 loan agreements for the funding amount of EUR 14.93 million have been concluded.
- Within activity *Guarantees for Development of Enterprise Competitiveness* by December 31, 2011, 261 guarantee agreements for the total amount of LVL 72.88 million and 74 export guarantee agreements for the total amount of LVL 4.44 million have been concluded by December 31, 2011.
- Within activity *Loans for Development of Enterprise Competitiveness* by December 31, 2011, 359 loans have been granted for the total amount of LVL 135.26 million, including share of the ERDF programme – 49 loans have been approved for LVL 46.6 million.
- Within activity *Measures to Encourage Innovations and Business Start-ups*, 1 contract has been concluded for the total amount of LVL 2 million. 12116 persons are involved in measures, seminars, and tenders organised within the activity.
- Within activity *Business Incubators,* 9 agreements on provision of business incubation services in Latvian regions and 1 agreement on provision of business incubation services to enterprises of creative industry in Riga have been concluded. Within the activity, 421 enterprises receive support at business incubators.
- Within activity *Co-financing to the Investments in Micro, Small and Medium-sized Enterprises Operating in the Specially Assisted Areas*, 136 contracts have been concluded for the total contractual sum of LVL 9 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 amount 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 amount of LVL 4.3 million (ERDF).
- Within activity *Improvement of Heat Insulation of Multi-apartment Residential Buildings*, 399 contracts have been concluded for the total amount of LVL 22.6 million (ERDF).
- Within activity *Improvement of Heat Insulation of Social Residential Buildings*, 59 contracts have been concluded for the total amount of LVL 4.6 million (ERDF).
- Within activity *Measures for Raising Efficiency of Central Heat Supply Systems,* 32 contracts have been concluded for the total amount of LVL 25.8 million (CF).
- Within activity *Development of Cogeneration Power Plants Using Renewable Energy Resources,* 10 contracts have been concluded for the total amount of LVL 21.3 million (CF).

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

By September 30, 2011, in the framework of the OP *Human Resources and Employment*, the most rapid progress of implementation has occurred in social inclusion activities, as well as higher education and science support activities with increased number of both concluded agreements and amount of payments to beneficiaries. 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 agreements for LVL 399.9 million (93.4%) have been concluded, within the priority *Promotion of Employment and Health at Work*, where agreements for LVL 164.6 million (99.7%) have been concluded, within the priority *Education and Skills,* where agreements for the amount of LVL 98.3 million (95.7%) have been concluded, within the priority *Higher Education and Science*, where agreements for LVL 83.4 million (91.3%) have been concluded. Agreements on financing from the EU funds in the amount of LVL 28.9 million have been concluded within the priority *Promotion of Social Inclusion*, whereas within the priority *Administrative Capacity Building* – in the amount of LVL 17.3 million. In terms of payments made within priority *Human Resources and Employment* – LVL 248.7 million (58.1%), but in the priorities *Promotion of Employment and Health at Work* – LVL 124.5 million (75.4%), *Higher Education and Science* – LVL 52.6 million (57.6%). *Education and Skills* – LVL 44.4 million (43.2%), *Promotion of Social Inclusion* – LVL 15.1 million (41.7%), and *Administrative Capacity Building* – LVL 6.6 million (33.2%).

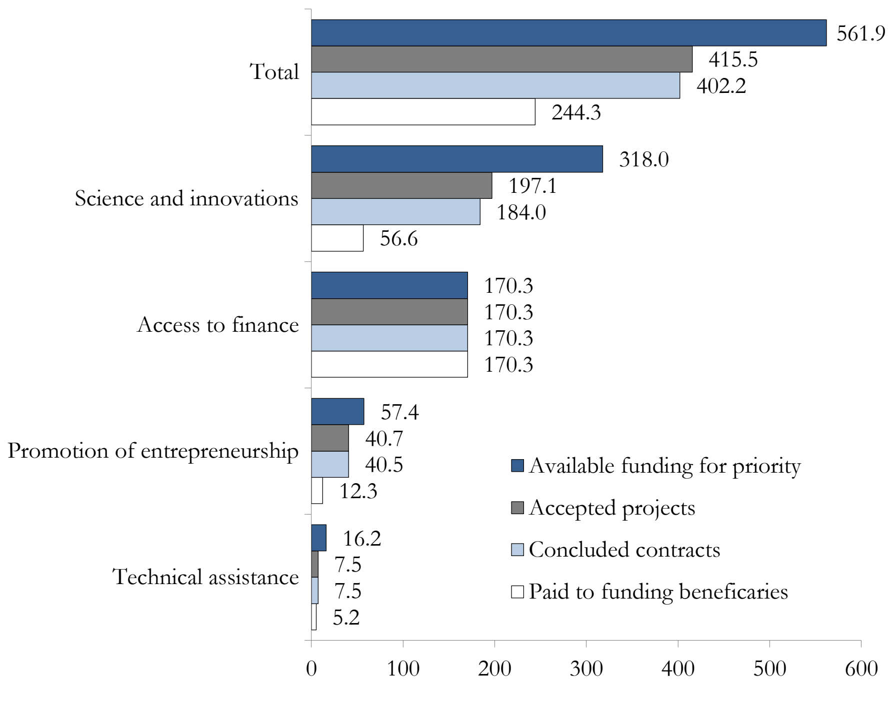
By June 30, 2011, the tendency of activity implementation has slightly decreased within the OP *Entrepreneurship and Innovations* which is proved by the decreasing number of approved projects and concluded agreements. Therefore, in order to promote absorption of the EU funds available within the OP *Entrepreneurship and Innovations*, several new activities have been developed, for example sub-activity 2.1.2.2.4 *Development Programme of SME's New Products and Technologies*, sub-activity 2.2.1.4.2 *Mezzanine Investment Loans for development of Enterprise Competitiveness*, activity 2.3.2.3 *Cluster programme*, within which the selection stages of project application submission is expected to be launched as of 2012. Besides, having regard to the huge interest of enterprises in the activity 2.1.2.4 *High Value-added Investments,* the second selection stage of project application submission is going to be launched from December 12, 2011 until April 2, 2012.

As regards achieving indicators in the priority, some of them exceed the final plan, for example, number of approved projects oriented to access to international trade markets, number of persons involved in motivation programmes, number of economically active enterprises supported by the business incubators. *Measures to Encourage Innovations and Business Start-ups* and *Business Incubators* have been the most efficient in terms of achieving activity indicators.

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

Figure 6.6

**Absorption of EU funds in the operational programme *Entrepreneurship and Innovations* till September 30, 2011**
(million LVL)



Overall, within the OP *Infrastructure and Services,* the most significant progress was observed regarding the approved projects and concluded agreements in comparison with other OP, mainly in field of health infrastructure and polycentric development. Although in the 3rd quarter of 2011, the payments made within the OP reached over LVL 75.5 million of public funding, the payments still are below those set in the objective of funds absorption.

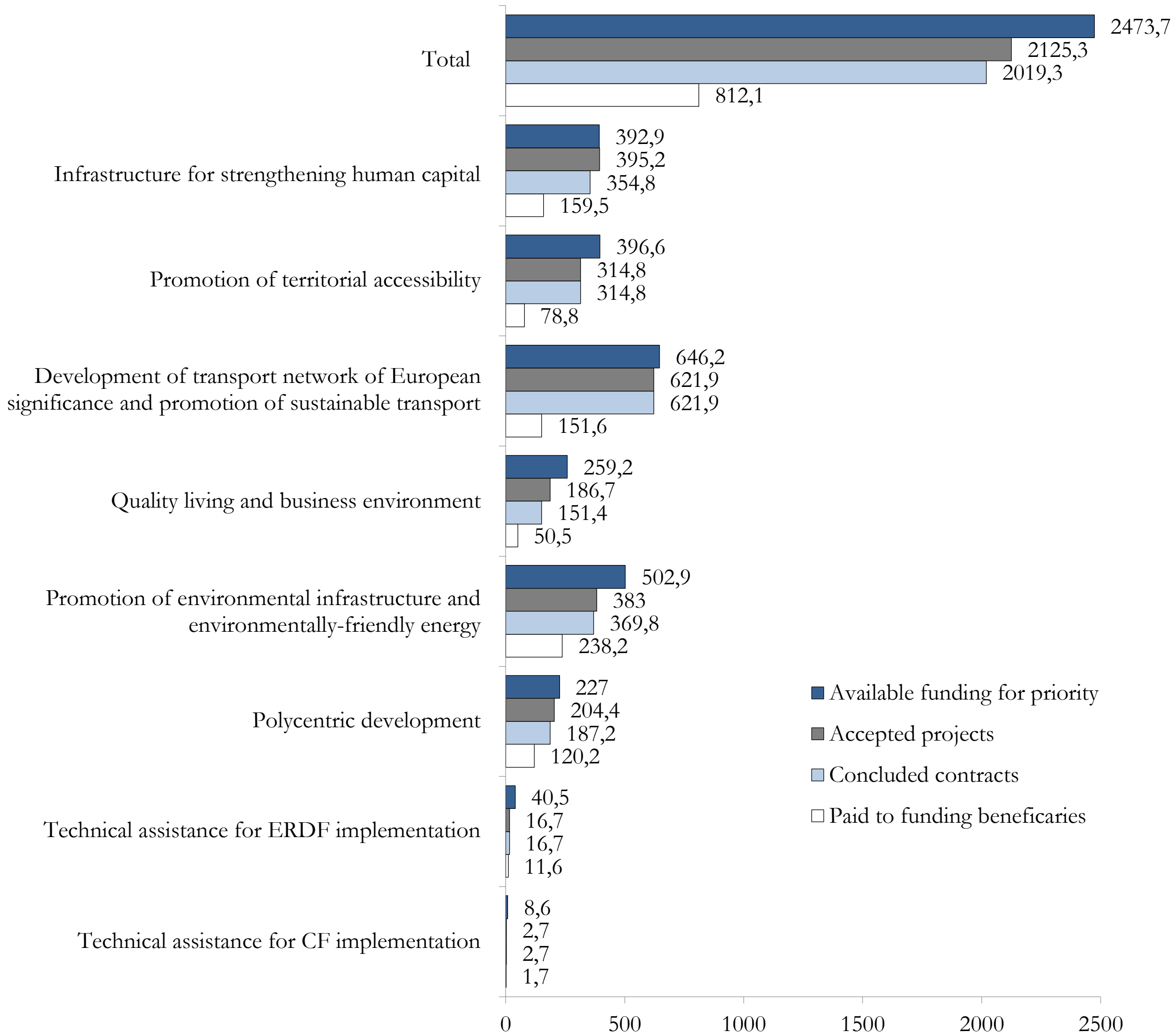
Taking into consideration the seasonal impact on infrastructure projects, the responsible institutions expect significant progress in payments in November and December 2011, when funding beneficiaries will report on work performed during summer and fall.

Fund absorption in the OP *Infrastructure and Services* is reflected in Figure 6.7.

Figure 6.7

**Absorption of EU fund financing in the operational programme *Infrastructure and Services till September 30, 2011***

(million LVL)



**Box 6.3**

**Amendments to the OP and their additions before September 30, 2011**

***OP Human Resources and Employment* and its addition.**

On September 12, 2011, amendments to the addition to the OP *Human Resources and Employment* have been approved by the Decree No 444 of the Cabinet of Ministers, envisaging implementation of temporary public works and defining target group – long-term unemployed registered for at least six months as of January 1, 2012, within the second stage of the activity 1.3.1.5 *Support for the Implementation of Regional Action Plans for Promotion of Employment*. On September 15, 2011, criteria for evaluation of project applications were approved in the meeting of the EU funds monitoring committee.

On September 27, 2011, the CoM approved amendments to the addition to the OP *Human Resources and Employment,* envisaging reallocation of the funding in the amount of LVL 14.8 thousand from the activity 1.5.3.2 *Development Planning Capacity Building of Planning Regions and Local Governments* to the activity 1.5.3.1 *Attracting Specialists to Planning Regions, Towns and Amalgamated Municipalities* to provide funding for approving additional project applications thus encouraging attraction of specialists to local municipalities.

On September 28, 2011, the Cabinet of Ministers approved amendments to the OP *Human Resources and Employment* by the Decree No. 486 envisaging the following:

– funding in the amount of LVL 5.3 million from unabsorbed funding for activities of OP under competence of the Ministry of Education and Science is reallocated to implementation of second selection stage of project applications within the activity 1.1.1.2 *Attraction of Human Resources to Science*. As 860 persons are expected to obtain academic doctoral degree in the upcoming three years, it is necessary to provide ESF support to creation of workplaces for young scientists also after 2012, as well as to encourage specialists currently working or studying in doctoral programmes in international universities and scientific institutes to return;
– additional ESF funding in the amount of LVL 11.2 million is granted to the sub-activity 1.3.1.1.3 *Training of Unemployed and Job Seekers* of the addition to the OP under competence of the Ministry of Welfare for training the unemployed upon employers' request within priority fields of Latvia;
– additional funding in the amount of LVL 25.9 million (including ERDF funding in the amount of LVL 22.8 million from the OP *Entrepreneurship and Innovations*) is granted to active labour market policy measures under competence of the Ministry of Welfare, thus providing additional funding for training of unemployed and job seekers and measures to encourage them in the situation of economic crisis.

***OP Entrepreneurship and Innovations* and its addition.**

In order to make financial resources more available to enterprises, as well as to support scientific development, the Cabinet of Ministers approved amendments to the addition to the OP *Entrepreneurship and Innovations* in the meeting of June 14, 2011 (Decree No. 296 of the CoM of July 5, 2011).

In order to restructure EU fund financing and efficiently direct it to national economy, as well as to fulfil the task under the Supplemental Memorandum of Understanding (the third addendum to the Memorandum of Understanding) concerning structural issues and reforms – to develop and implement Strategy for Attracting Foreign Direct Investments for 2011-2015, on September 5, 2011, the CoM approved amendments to the OP *Entrepreneurship and Innovations* by the Decree No 425.

The main scheduled measures within the OP *Entrepreneurship and Innovations* in the 4th quarter of 2011 are the following:

– to approve Regulations of the CoM regarding implementation of the activity 2.2.1.1 *Holding Fund for the Investment in Guarantee, High-risk Loans, and Venture Capital Funds and Other Financial Instruments* (discussed in the CoM meeting on October 19, 2011). Draft regulations have been developed in accordance with the ERDF *Concept of Holding Fund Implementation* approved by the CoM on August 9, 2011 (CoM Decree No. 399 of August 22, 2011), pursuant to which implementation functions of the EIF Holding Fund are planned to be assigned to the LGA on January 1, 2012;
– within the sub-activity 2.2.1.4.2 *Mezzanine Investment Loans for Development of Enterprise Competitiveness* to sign an agreement on project implementation with LGA for the total available funding within the sub-activity.

**Operational programme *Infrastructure and Services* and its addition.**

In the 3rd quarter of 2011, the addition to the OP *Infrastructure and Services* has been amended by reallocating the saved ERDF funding in the amount of LVL 3.4 million within the sub-activity 3.4.2.1.1 *Maintenance and Renewal of Town Planning Monuments of National Importance and Infrastructure Adjustment to Develop a Tourism Product*, the sub-activity 3.4.2.1.2 *Development of Cycling Tourism Product of National Importance* and the activity 3.4.4.2 *Improvement of Heat Insulation of Social Residential Buildings* to the activity 3.4.4.1 *Improvement of Heat Insulation of Multi-apartment Residential Buildings*. Considering that the average ERDF funding per one project within the activity 3.4.4.1 is LVL 53.8 thousand, additional 63 projects on renovation of multi-apartment residential buildings are expected to be implemented within the activity 3.4.4.1.

As regards the information provided in the previous report envisaging evaluation of implementation progress of activity 3.2.2.2 *Development of Public Internet Access Points* and the activity 3.2.2.3 *Provision of Equal Access Opportunities to Electronic Communications Services in the Whole Territory of the Country (Development of Broadband Network)* and conformity thereof to the Economic policy criteria under the Memorandum of Understanding during the reporting period, it should be noted that in the meeting of the Coalition partner working groups for EU fund matters on September 5, 2011, an agreement regarding the activity 3.2.2.2 *Development of Public Internet Access Points,* as well as the activity 3.2.2.3 *Provision of Equal Access Opportunities to Electronic Communications Services in the Whole Territory of the Country (Development of Broadband Network)* was reached stipulating that further implementation of the activity 3.2.2.3 *Provision of Equal Access Opportunities to Electronic Communications Services in the Whole Territory of the Country (Development of Broadband Network)* should be supported by positive decision of the EC on state support notification regarding development of broadband network in Latvia.

## 6.2.2. Foreign Trade Policy

Implementation of the medium-term strategy of the EU trade policy *Trade, Growth and World Affairs* approved in December 2010 has revealed a range of topical issues in 2011, among them inclusion of direct foreign investments into the common EU trade policy, improvement of international trade conditions for candidate states to access the World Trade Organization's (WTO) Doha Round (DDA) and WTO, as well as negotiations on the EU Free Trade Agreements. At the same time, obligations regarding access to existing third country markets are implemented and new protective measures are restricted at the EU level, as well as evaluation regarding review of conditions for third countries' possible access to the EU public procurements market, and a strategic discussion about the EU support to foster competitiveness of small and medium-sized enterprises in the third countries markets has been launched.

**Multilateral relations**

In November 2011, a decade had passed since the launching the World Trade Organization (WTO) Doha Round (DDA) negotiations aimed at reducing the global trade barriers. Taking into account that over the past few years the WTO member states have not been able to solve the main problematic issues and agree on the DDA completion, the role of the WTO in development of multilateral trade system and necessity to continue improving the system was acknowledged and necessity to solve development issues through trade in more poor countries was also emphasized at the WTO's 8th Ministerial Conference in Geneva (Switzerland) held on December 15-17, 2011.

At the same the Ministerial Conference supported accession of Russia, Montenegro, Samoa, and Vanuatu to the WTO. In order to fully complete the accession process, these countries must approve the WTO obligations in their national parliaments within the coming months. Considering the broad contractual framework of the WTO, participation in organization will foster integration of these countries in global economy and ensure transparency of their foreign trade regimes, what is particularly important in relation to Russia. Having evaluated the reached obligation level, the WTO accession package of Russia is a sound base for further Latvian-Russian foreign trade development in comparison with other, so called *BRIC* countries (Brazil, India, and China). Besides, membership of Russia in the WTO in case of need will allow finding more successful solutions to trade-related disputes.

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

**Bilateral relationships within the framework of the EU Common Trade Policy**

At the moment, a number of **EU non-preferential agreements** are in force, including Partnership and Cooperation Agreements (PCA) with Armenia, Azerbaijan, China, Georgia, Moldova, Russia, Ukraine, and others. These agreements cover a general cooperation framework on the basis of multilateral trade system norms, without stipulating more profound economic integration of the contracting parties. Among the key third countries for Latvia's foreign trade, it is important to note the work on trade and investment conditions continued within the EU-Russia PCA negotiations in 2011 taking into consideration that currently these issues have impact on the overall PCA negotiation process, as well as on the EU regulatory dialogues with China, Japan, and the USA on solving specific trade issues.

At the same time, the EU has concluded a number of **preferential agreements** comprising mutually favourable trade conditions with such partners as the Balkan countries[2], European Economic Area countries[3] and Switzerland, as well as Chile, South Africa, South Korea[4], and Mexico.

Currently preparation for the approval of the EU-Central American[5] free trade agreement (FTA) initialled in the spring 2011 and the EU-Andean Community[6] Free Trade Agreement (FTA) is in process. At the end of 2011, the EU has formally ended FTA negotiations also with Ukraine, and this agreement is expected to be applied in practice as of 2012/2013. Similarly, if the parties can agree on the open issues, the EU FTA negotiations with Canada, Singapore, and the Southern Common Market countries[7] (*Mercosur*) are expected to be completed in the coming months. At the same time, the EU is negotiating with India, Malaysia, the Gulf Cooperation Council countries[8] (GCC), and Mediterranean countries[9] on the FTA, as well as negotiating on economic partnership agreements (EPA) with the majority of African, Caribbean and Pacific Group of States (ACP). As regards the Mediterranean countries, it is significant that at the end of 2011, the EU has

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[1] Afghanistan, Algeria, Andorra, Azerbaijan, the Bahamas, Belarus, Bhutan, Bosnia and Herzegovina, the Comoros Islands, Equatorial Guinea, Ethiopia, Iran, Iraq, Kazakhstan, Laos, Lebanon, Liberia, Libya, Montenegro, Russia, Samoa Islands, Sao Tome and Principe, Serbia, the Seychelles, Sudan, Syria, Tadzhikistan, Uzbekistan, Vanuatu, Yemen

[2] Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro, Serbia, and Turkey

[3] Iceland, Liechtenstein, and Norway

[4] Temporarily in force as of July 1, 2011 (till ratification completion by all parties; Latvia has completed the ratificationon August 4, 2011)

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

[6] Bolivia, Ecuador, Columbia, Peru

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

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

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

adopted a decision on launching negotiations on deepening economic integration with Egypt, Jordan, Morocco, and Tunisia. According to approved directives, during the new agreement negotiations it is expected to focus on solving issues of investment protection, sustainable development and protection of public procurement, competition, intellectual property rights and trade promotion conditions in comparison with the existing FTA processes. Taking into consideration that overall Moldova and Georgia have fulfilled the EU recommendations on required economic reforms, the FTA negotiations with these countries are going to be launched in the coming months. The FTA negotiations with Armenia are expected in a slightly later perspective due to the ongoing preparation process, as well as possible FTA negotiations with Azerbaijan, Russia, Kazakhstan, and Belarus, which can be launched only after accession of those countries to the WTO. Current work of the EU and Japanese experts on preparation of the EU-Japan FTA process should also be noted, including assessment of possible FTA impact on the EU and its Member States, as well as setting negotiation priorities.

**Promotion of accessibility to the third country markets**

In order to ensure efficient access of exporters from the EU, including Latvia, to the markets of the third countries, relevant instruments for ensuring market accessibility are being applied for identifying, eliminating, and preventing barriers. In the second half of 2011, the work on strengthening the Market Access Partnership was continued. 12 Working groups[1] and 33 Market Access Teams[2] are working within its framework, dealing 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.

Taking into account the EU Common Trade Policy Strategy *Trade, Growth and World Affairs*, the European Council of March 24-25, 2011, approved the first annual *Trade and Investment Barriers Report*. Next such report is expected in the spring 2012.

Since launching the supervision of world country trade policy instruments in 2009, the most trade restrictions have been or are planned to be imposed not only in such markets important to Latvian export as Russia, Ukraine, Belarus, and Kazakhstan, but also in the markets of the strategically important trade partner countries of the EU-Argentina, Brazil, Canada, China, India, Japan, and USA. The trade restrictions are mainly imposed on the trade of products, raw materials, and services of agricultural, steel, automotive, textile, and electronic industry, and generally the restrictions are manifested in a form of raised import duties, import licensing, public procurement procedures, investment restrictions, non-transparent certification procedures, supporting measures for domestic exporters, measures for domestic market protection, as well as compensations and anti-dumping measures.

Improvement of the EU Market Access database *(http://madb.europa.eu)* was continued at the beginning of 2011.

**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.

Three IGC meetings have been held in 2011 – with Azerbaijan, Russia, and Ukraine. Business forums of Latvian-Azerbaijani, Latvian-Armenian, Latvian-Russian, and Latvian-Ukrainian entrepreneurs and Latvian Days in Azerbaijan have been organized as well.

The IGC meeting at the end of 2011 – at the beginning of 2012 is planned to be held with Belarus (Riga), while the IGC meetings with China (Beijing), Kazakhstan (Astana), and Uzbekistan (Riga) are planned to be held in the first 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, and the Pskov Oblast are in force. Negotiations are currently held with the governments of Kirov, Ivanovo, Yaroslavl, and Kaluga Oblasts on 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 the Pskov and Vologda Oblasts.

Although Latvia has signed no bilateral economic cooperation agreement with Japan, trade and economic relationship between these two countries is developing. Minister for Economics and business delegation visited Japan on July 11-17, 2011. The visit was initiated by the Japanese government which is implementing a special programme for promotion of foreign economic relations. During the visit, Latvian delegation met high-level Japanese officials, among

[1] Established Working Groups in sector of the EU market access – SPS/Animal products; SPS/Vegetation products; Medical devices; Electronics and information and communication technologies; Tyres; Automotive; Postal services; Distribution services; Textiles; Wine and spirits; Leather; Chemistry sector

[2] EU Market Access Teams are acting in Argentina, Algeria, Australia, Brazil, Canada, Chile, China – Hong Kong and Macao, Columbia, Egypt, Iceland, India, Indonesia, Israel, Japan, Kazakhstan, Korea, Malaysia, Mexico, Morocco, Nigeria, New Zealand, Norway, the Philippines, Russia, South Africa, Switzerland, Taiwan, Tunisia, Turkey, Ukraine, USA, Venezuela, Vietnam

them representatives of the government and of the parliament and also of different business sectors including management of such companies as “Toshiba”, “Panasonic”, “Hitachi”, and “Mitsubishi”. As a result of the visit, Latvian representatives have sent proposals of cooperation to Japanese companies.

On September 4-10, 2011, the Minister for Economics was on a business visit to China (Changchun, Beijing), during which he participated in the 7th *Northeast Asia Investment and Trade Expo*, as well as met with several Chinese officials and representatives of organizations to discuss the latest events in cooperation of both countries. As the result of the meeting the LIAA prepared and sent to China information about Latvian wood processing and pharmacy enterprises interested in cooperation with China and Jilin province.

**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. EU is the second largest steel producer in the world after China.

The EU currently applies quantitative restrictions on import of particular 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. As regards to Kazakhstan, autonomous measures are currently being applied, and in 2011 import quota is defined in the amount of 0.2 million tons. After accession of Russia and Kazakhstan to the WTO, the EU steel agreements with these countries will automatically become invalid; respectively the double-checking system with quantitative restrictions with Russia in 2012 is expected to be terminated.

Additionally, for the purpose of the 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 2011 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 on January 1, 2009, but on May 5, 2010, the double-control monitoring system (licensing) without quantitative restrictions applied to the import of certain textile goods originating from Uzbekistan was cancelled, as well. Thereby, the EU is currently applying quantitative restrictions only to the import of textiles from Belarus and North Korea. It must be noted that these countries are not the member states of the WTO, besides they are recognized as violators of human rights and democratic principles.

**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.

Overall in 2011, the EU has applied 76 anti-dumping and 7 anti-subsidy measures to various products of other countries. More than a half of the afore-mentioned measures were applied to China, India, Indonesia, Russia, Taiwan, Thailand, and Ukraine. For comparison – there were 250 anti-dumping measures and 48 anti-subsidy measures in force in the USA, 208 anti-dumping measures in India, 121 anti-dumping and 1 anti-subsidy measures in Turkey, 118 anti-dumping and 2 anti-subsidy measures in China, 91 anti-dumping and 1 anti-subsidy measure in Argentina at the end of 2010. From the perspective of interests of Latvian producers, the most significant measures performed during this half-year are the following:

- introduction of anti-dumping duties on the import of continuous filament glass fibre products and glass fibre mesh fabric from the People’s Republic of China, as well as initiated inspection with respect to avoiding payment of anti-dumping duty for import through Malaysia;
- anti-dumping measures introduced by the USA in 2001 with respect to import of steel bars from the EU. The WTO Disputes Settlement Institution has recognized the anti-dumping duty calculation method used by the USA as unjustified and non-compliant with the WTO’s norms. Currently, the EU and the USA has reached an agreement on extending the period

for implementing the WTO panel recommendations to January 9, 2012.

In order to encourage small and medium-sized enterprises to get involved in TDI inspections, the European Commission has established the SME Helpdesk, and provide training on TDI within the European Business Support Network, provides access to non-confidential documents, as well as plans to simplify SME's involvement in TDI inspections, etc. The European Commission in cooperation with the Member States has developed a guide aimed at introducing the EU enterprises to their rights and obligations in inspections carried out in third countries (*http://trade.ec.europa.eu/doclib/docs/2010/october/tradoc_146710.pdf*).

### 6.2.3. Internal Market of the European Union

The internal market of the European Union – a cornerstone of European integration – is recognised as one of the most significant and successful EU projects. The EU internal market currently comprises 30 countries (including European Economic Area countries – Norway, Iceland, and Liechtenstein) with approximately 500 million consumers, and it encompasses a territory without internal borders where free movement of goods, persons, services, and capital is ensured. After long 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, 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 successful, and high results regarding the transposing efficiency of the directives have been achieved. Latvia has once again achieved its best result of deficit of directives' implementation in the amount of 0.5% and has been ranked 3rd out of 27 Member States, after Malta and Denmark, thus achieving the Lisbon objective of 2009 to transpose 99% of directive requirements or allow transposition deficit of 1 per cent.

In Latvia, the process of implementing the principles of free movement of goods and services and the rights to do business are 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, *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 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 define 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 purpose 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 economic operators. 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 different products received from merchants of 25 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, requirements of the laws and regulations are regularly analysed, and proposals on necessary amendments are being 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. By making amendments to laws and regulation, the adoption of silence means consent principle in administrative practice is expected to be launched as of March 1, 2012.

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 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 responsible institutions of other Member States for cooperation purposes and a set of prepared questions and answers to make 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 in charge of 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 workers posting, 2 – in the sphere of workers posting and services. At the moment, the *Warning mechanism* has involved 3 supervisory institutions and 2 ministries – the Consumer Rights Protection Centre, the *State Environmental Service*, the Health Inspectorate and the Ministry of Health, the Ministry of Economics, as well as the *Warning message* coordinators. The Ministry of Economics is the national *IMI system* coordinator in Latvia. As of January until November 2011, the *IMI system* in Latvia has registered 15 requests for information.

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 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). Since starting the activities in Latvia, the *SOLVIT coordination centre* has examined 165 *SOLVIT* cases complying 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.). The Latvian *SOLVIT coordination centre* has solved 70 of the submitted cases, 22 cases has not been solved, 70 cases has been closed/rejected (mainly because of the lack of additional information and because of the cases being passed for the further examination in the court), 3 – are currently solved.

## 6.3. Energy Policy

The main approaches to the energy policy (see also Chapter 6.11) 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 sphere of energy both within the medium-term and long-term period. Taking into consideration policy priorities and significant changes in the Latvian economy, a long-term planning document of energy sector 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.

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

- Competitive national economy – balanced, efficient, economically, socially and ecologically justified energy policy based on market principles ensuring further development of the national economy, its competitiveness in the region and world;
- Sustainable energy – reduced dependency from import 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.

**Box 6.4**

**Energy Sector in Latvia**

Both the imported (natural gas, electricity energy, 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 2010, energy resource generation and recycled products in Latvia reached 88.6 PJ, but import of energy resources was 129.9 PJ, out of which 37.9 PJ was the import of natural gas.

In 2010, the total consumption of primary energy resources in Latvia amounted to 200.5 PJ, and self-security in the total consumption of primary energy resources was 33.5%. In the total consumption of primary energy sources, firewood with its total consumption forming 51.4 PJ was the most widely used local energy resource, electricity generated in hydropower stations and wind power stations constituted 12.8 PJ.

**Electric energy market**

More than 90% of electric energy generated in Latvia is generated by JSC "Latvenergo", which also ensures electric energy import and supply to the consumers. Currently, 36 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 of electric energy transmission system are performed by JSC "Augstsprieguma tīkls", which has become an independent transmission system operator as of

January 1, 2012. Since July 1, 2007, the functions of electricity distribution system operator are performed by JSC "Latvenergo" subsidiary company JSC "Sadales tīkls".

A well-operating internal electricity market should properly encourage producers to invest in new types of energy production, among all energy production from renewable energy sources. According to the provisions set in the *Third Internal Energy Package* of the European Union without separation of network services from production and trading activities (efficient separation), there is not only the risk of facing discrimination in network management but also the risk that vertically integrated merchants lose stimulus to make proper investment in networks. Separation of ownership at transmission level can be considered the most efficient way to foster investments in infrastructure indiscriminately, fair access to the network for new participants and transparency in the market.

Table 6.3

**Consumption of primary energy resources in Latvia, PJ**

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|---|
| **Total consumption*** including: | **184.3** | **188.4** | **191.9** | **199.0** | **204.6** | **196.5** | **183.3** | **200.5** |
| coal and coke | 2.8 | 2.8 | 3.3 | 3.6 | 4.4 | 4.4 | 3.5 | 4.5 |
| peat | 0.9 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.0 | 0.1 |
| petroleum products | 59.3 | 61.0 | 61.9 | 67.5 | 73.3 | 69.3 | 56.7 | 64.6 |
| natural gas | 56.4 | 55.8 | 56.8 | 58.9 | 56.9 | 55.8 | 51.4 | 61.3 |
| firewood | 47.0 | 49.4 | 49.4 | 49.8 | 48.7 | 46.0 | 52.6 | 51.4 |
| electricity | 17.8 | 18.9 | 19.9 | 18.9 | 20.8 | 20.5 | 18.6 | 16.0 |
| other energy resources** | 0.2 | 0.3 | 0.5 | 0.4 | 0.4 | 0.5 | 0.5 | 2.8 |

* all energy resources have been calculated based on the lowest calorific value
** used tyres, municipal waste for heating, charcoal, straw, biogas, bioethanol, biodiesel

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

**Box 6.5**

**Electricity 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 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 2010, JSC "Latvenergo" generated 78% of the total electricity supply, it purchased 10% from small electricity energy producers, and 12% constituted net import of electricity energy. Comparing to the previous year, the total electricity energy supply has increased by 4 per cent.

In 2010, 2981 GWh (10.73 PJ) of electricity was produced by **high efficiency cogeneration** which is 63% 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. Replacement thereof 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%. 1.6% of the total generated heat energy has been supplied to industry, 70.2% – to households, 28.2% – to other consumers. However, the breakdown of heat energy distributed by regions is the following: Riga region – 54.6%, Pieriga region – 10.5%, Vidzeme – 6.1%, Kurzeme – 10.5%, Zemgale – 7.2%, and Latgale – 11 per cent.

In 2010, heat energy for sale was produced in 668 boiler houses and 71 cogeneration plants having generated 7.96 TWh heat energy for sale.

In 2010, 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 81.4%, woodchips – 11%, wood – 3.6%, heavy fuel oil – 2%, and other fuel types – 2 per cent.

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

On June 17, 2009, a protocol of intent on development of the ***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.

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 states to ensure that electricity exchange could start operating in the Baltic, 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 *JSC Nord Pool Spot,* and organization of indirect auctions have to be implemented within time period from 2011 to 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 6.4

**Electricity Supply in Latvia, TWh**

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|---|
| **Total electricity supply** | **6.6** | **6.8** | **7.1** | **7.4** | **7.8** | **7.8** | **7.2** | **7.5** |
| **Electricity generation** including: | **4.0** | **4.7** | **4.9** | **4.9** | **4.8** | **5.3** | **5.6** | **6.6** |
| HPPs* | 2.2 | 3.0 | 3.3 | 2.7 | 2.7 | 3.0 | 3.4 | 3.4 |
| CHPs** | 1.4 | 1.2 | 1.3 | 1.7 | 1.5 | 1.5 | 1.5 | 2.4 |
| Other CHPs | 0.3 | 0.3 | 0.3 | 0.4 | 0.5 | 0.6 | 0.6 | 0.6 |
| Small HPPs | 0.1 | 0.1 | 0.1 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 |
| wind power plants | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 |
| **Net electricity imports** | **2.6** | **2.1** | **2.1** | **2.5** | **3.0** | **2.5** | **1.7** | **0.9** |

Source: JSC "Latvenergo", the Ministry of Economics, CSB
* Daugava cascade and Aiviekste HPP (HPP of JSC "Latvenergo")
** CHP of JSC "Latvenergo"

Due to free and open market operation, the **energy supply safety** is no longer based on subsistence with capacities amounting to 100% but is now based on diversified and reliable energy supply routes and sources. Latvia as the EU Member State must ensure national fulfilment of the common requirements set in the EU legislation in energy sector. In the field of electricity supply, it means that the electric energy sector in Latvia is operating in accordance with provision of the European Union directive on the promotion of the use of renewable resources for electricity production, common rules of electricity market, cogeneration based on a useful heat demand, electricity supply safety, and investments in infrastructure.

The Ministry of Economics has establish a Working group for voltage quality problems dealing with finding solutions to voltage drops in some territories of Latvia where electric equipment and technological processes with increased capacity depending on voltage quality are used in a concentrated manner. The working group initiated an analysis of information on the current situation regarding voltage drops and short electricity interruptions in Latvia and neighbouring countries adversely affecting enterprises. The results of the analysis show that the problem of voltage drops and short electricity interruptions in distribution networks has been observed in all countries and should not be considered as a phenomenon of Latvia. Working group discussions resulted in development of an interactive map by JSC "Sadales tīkls" introduces the new investors via the Investment and Development Agency of Latvia (IDAL) to the available free electricity capacities in the existing 110 kV substations. Information about damages in electricity network can also be published in the map.

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 taken over European Union standard LVS EN 50160:2010 *Voltage characteristics of electricity supplied by public electricity networks* is mandatorily applicable in Latvia.

**Natural gas market**

Currently, 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 are CHP and heat supply enterprises of the JSC "Latvenergo" – 61.7%, manufacturing – 16.5%, other consumers – 21.8%. 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 the most of gas is supplied to Latvia by the Russian enterprise JSC "Gazprom" and a small amount by LLC "Itera Latvija" which is controlled by JSC "Gazprom". 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.

Currently, the *Directive 2003/55/EC* of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in natural gas and repealing *Directive 98/30/EC* are transposed into the *Energy Law*. The *Directive 2003/55/EC* envisaged derogation from transposition of some requirements of the Directive, including the access of third parties to the natural gas market until Latvia no longer will conform to the characteristics of a new market, i.e. after 10 years from the first supply of natural gas under the long-term contract on natural gas supply. On July 18, 2003, JSC "Latvijas Gāze" concluded the first long-term contract with the Russian concern "Gazprom" on natural gas supply until 2015. The first natural gas supply under this contract was launched on April 5, 2004. Therefore Latvia is recognized as a new market from April 5, 2004 to April 4, 2014, according to the *Directive 2003/55/EC.*

According to the *Law on Procedure for Entering into Force of Some Sections of the Energy Law,* until April 4, 2011, Latvia is subject to the derogation from requirements stipulated in the *Directive 2003/55/EC* regarding requirements for 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.

The Directive of the European Parliament and of the Council *2009/72/EC* of July 13, 2009, requirement of concerning common rules for the internal market in electricity and repealing *Directive 2003/54/EC* envisages several new requirements for the development of natural gas market. The *Directive 2009/73/EC* keeps possibility to apply the derogation from the abovementioned requirements to Latvia as it was envisaged in the *Directive 2003/55* – it means that Latvia must provide third party access to the transmission and distribution system and liquefied natural gas objects not later than from April 4, 2014. Moreover, the *Directive 2009/73* envisages application of a derogation to Latvia from several additional requirements, among them separation of ownership of natural gas transmission system operation until Latvia will directly join an interconnected system of any Member State, except Estonia, Lithuania, and Finland. Thus, contrary to the derogations in the Directive *2003/55/EC,* Latvia must provide third party access to a transmission and distribution system and liquefied natural gas objects not later than from April 4, 2014.

A feasibility study on the possibility to construct **a regional liquefied natural gas (LNG) terminal** in Latvia was carried out by JSC "Latvenergo". It provides a conclusion that in order to ensure competitiveness in the Baltic natural gas market, thus achieving favourable prices for both consumers, households and industrial users, it is more economically reasonable to construct only one regional liquefied natural gas terminal. Geographically and economically suitable location of the terminal is Latvia and Riga in terms of available infrastructure, lowest costs, and time schedule of project implementation. By implementing the LNG terminal project by 2016, it would become an important infrastructure object in Europe, it would improve safety of infrastructure of the Baltic States, eliminate policy risks of natural gas supply prices, and ensure competitive prices for natural gas supply for industries. The dependence of the Baltic States on one gas supplier would decrease by a minimum of 25 per cent.

The geographically most favourable location, the existing and proper infrastructure, as well as the developed natural gas connections with Lithuania and Estonia are considered as the main advantages of Latvia for construction of the LNG terminal. The existing Inčukalns underground gas storage is also of great importance as its capacity can be expanded to 3.2 billion $m^3$, if necessary. Latvia also has suitable geological conditions for creating new storages. The advantages of Latvia for the construction of the terminal will ensure lower costs for adjusting the infrastructure to integrate the terminal into the regional gas supply system while Inčukalns underground gas storage will allow achieving the lowest possible price by purchasing natural gas in its lowest price period. It is considered that the main advantage of Riga for the creation of the LND terminal is the possibly lower costs for the connection infrastructure as it is located near the transmission lines, as well as the fact that Riga is located geographically closer to Inčukalns underground gas storage.

Considering that no agreement has been reached between the Baltic States on the optimal location of the LND terminal construction, the European Commission will carry out an independent feasibility study by the end of 2012, and based on the results of the study will make a decision on the location of the regional terminal.

**Renewable energy resources**

Latvia and other Member States of the European Union have undertaken to achieve the quantitative objective set for Latvia in the *Directive 2009/28/EC* and *the National Reform Programme of Latvia for implementation of the EU 2020 strategy* – to achieve 20% share of renewable energy in the gross final energy consumption, as well as 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.

**Box 6.6**

**Renewable energy in Latvia**

In 2010, the total share of renewable energy decreased by 1.8 percentage points in comparison with 2005 and 2009, and constituted 32.5%, although the share of RE in producing electric energy increased by 0.1 percentage points reaching 42.1%, but the share of RE in transport tripled reaching 3.3%. The decrease of the total RE share during this period is based on the decrease of RE share in heating and cooling reaching 43.8% in 2010 (47.9% in 2009). Moreover, heat energy consumption constitutes the largest part of final consumption.

The RE share in transport increased in 2010 mainly due to the introduction of the obligatory 5% biofuel addition to fossil fuel reaching the share of 3.3% and increasing the GHG emissions savings. Contribution of renewable energy to transport was small in 2010: a total of 1.1 million tons of fuel have been sold and used for own consumption in Latvia in 2010, including pure biofuel or mixture of fossil fuel and biofuel – 34.3 thousand tons. In 2009, the final energy consumption consisted of bioethanol – 108 TJ, and biodiesel fuel – 65 TJ, experiencing an increase in 2010 (bioethanol – 350 TJ and biodiesel fuel – 787 TJ). Besides its contribution is two and a half times as much as biofuels to the 10% transport objective.

The share of biofuels in 2010 was 3% of the total energy capacity of diesel fuel available on market for petrol and transport needs. It has increased by 2.5 percentage points in comparison with 2009.

In order to fulfil the objective for 2020, biofuel consumption should be significantly increased, as well as additional measures oriented towards the development of public and private electric transport infrastructure, for example, railroad electrification and charging of private electric vehicles should be implemented.

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*, a tender for the right to sell electricity produced from renewable energy resources within public procurement was organized in October 2010, within the framework of which the following decisions were issued:

– 18 decisions on biogas power plants determining the annual procurement volume of electric energy up to 134308.5 MWh;
– 6 decisions on biomass power plants determining the annual procurement volume of electric energy up to 98007.9 MWh;
– 4 decisions on wind power plants with capacity above 0.25 MW, determining the annual procurement volume of electric energy up to 63665.3 MWh;
– 7 decisions on wind power plants with capacity below 0.25 MW, determining the annual procurement volume of electric energy up to 3800 MWh on granting the rights to sell electricity produced from renewable energy resources in a form of mandatory procurement volume of electric energy;
– 15 decisions on hydroelectric power plants with the capacity of up to 5 MW, determining the annual procurement volume of electric energy up to 13188.3 MWh.

Overall in 2010, 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 50 power plants with the total installed energy production capacity of 84.4 MW, determining the annual procurement volume of electric energy up to 312969.9 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,* 97 decisions on granting the right to sell electricity produced in an cogeneration power plant within the mandatory procurement for power plants with the total installed electric capacity of 930.4 MW and the total volume of electricity of 3 154028.1 MW were issued in 2010 including.

– on the use of natural gas as fuel – 74 decisions (904.9 MW/ 2974090.2 MWh);
– biogas – 10 decisions (10.5 MW/ 82859.1 MWh);
– biomass – 12 decisions (14.7 MW/ 96075.8 MWh);
– liquefied gas – 1 decision (0.24 MW/ 1003 MWh);
– as well as 1 decision issued granting the right to receive a guaranteed payment for the installed electric capacity of 23 MW in a cogeneration power plant.

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 changes and reduce import 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.

Also in 2012, first generation biofuel will be the main type of renewable energy in the transport sector thus further fostering competitiveness of such technologies and production practices that ensure the required greenhouse gas emissions savings. In order to promote biofuel consumption in Latvia, obligatory 5% biofuel addition to fossil fuel has been introduced as of October 1, 2009. The requirement for obligatory 5% biofuel addition to fossil fuels does not apply to Class 0, 1, 2, 3, and 4 diesel fuels for the use in arctic and rigorous winter weather.

In order to foster production of biofuel, the state support programme *Support for production of biofuel* (*No 540/2005*; with amendments *No. 254/2007* and amendments *No 26/a/2010*) was implemented from 2005 to December 31, 2010, within the framework of which direct state support (financial assistance quotas) was provided to biofuel producers. Within the framework of this programme, Latvian biofuel producers have received support payments in the amount of LVL 67.3 million, thus ensuring development of new production capacities and availability of 168.63 thousand litres of biofuel for the Latvian market.

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 and interests of Latvian population, as well.

**Energy efficiency**

The *Second Energy Efficiency Action Plan of the Republic of Latvia for 2011-2012* (2EEAP) 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 *2. 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, correspondingly 35.5% and 28.2% of the total final energy consumption, these sectors are identified as a priority in the *2.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 municipalities, and increase of energy efficiency in heat energy production and transport sector are planned.

**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 and June 2012 is set to be the implementation deadline. 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, which foresees development of power-lines and interconnections in the Baltic. Within the framework of *NordBalt* project, it is planned to construct the Lithuania-Sweden interconnection and strengthen the transmission system in the western part of Latvia – the Kurzeme circle. 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 project *Kurzeme circle* amount to EUR 88 million, and deadline is 2014.

The work within the project *Kurzeme circle* is envisaged to be carried out in two stages. In the first stage, it is planned to construct a 330 kV cable joining Riga CHP-1 with substation "Imanta", as well as to reconstruct a 110 kV cable "Mīlgrāvis-Bolderāja". Reconstruction of a 110 kV line and construction of a new 330 kV overhead line in the section Grobiņa-Ventspils is planned within the second stage. There are no delays in implementation of the projects. The project works were started by JSC "Latvenergo" and JSC "Augstsprieguma tīkls" already in 2009 in compliance with the strict co-financing schedules determined by the European Commission.

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 in winter season. Works to be done within the project in Latvia have to be finished in 2011, but in Lithuania – in 2013.

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 Ingalina 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 promise involvement of the Latvian energy company "Latvenergo". It shoul 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 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 CF funding in 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 CF funding in the amount of LVL 1.3 million have been finished.

From September 19, 2011 to November 21, 2011, heat supply enterprises could apply for the third selection stage of the project application within this activity for the CF funding of LVL 16.4 million.

Selection of project application within the activity *Measures to improve energy efficiency of heat supply systems in enterprises* (the CF funding – LVL 13 million) is open from December 1, 2011 to February 1, 2012.

In order to significantly increase the production of electricity and heat energy from renewable resources, diversify primary energy resource supply, and increase coverage of electricity, 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 CF funding in the amount of LVL 21.4 million.

## 6.4. 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.

At the end of 2010, the Ministry of Economics has revised in details the new draft ***Construction Law*** to create modern and up-to-date legal framework for the construction process. The new *Draft Construction Law* is aimed at significant simplification of the construction process and promotion of its transparency, as well as facilitation of development of the construction market and wherewith entire national economy. An innovative construction sector with high added value 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 to be observed within the construction process:

– principle of architectonic quality – according to which, when designing buildings, the quality aspect of architecture is implemented highlighting the individual identity of natural or urban landscape and is easily integrated in the cultural environment, thus enriching it and creating quality living-space, as well as observing and preserving the existing cultural heritage;
– principle of openness – according to which the construction process is open and the society is informed about the planned construction and related decisions;
– principle of sustainable construction – according to which the construction process creates the quality aspect of living environment, *inter alia* providing energy resources necessary for the building for present and further generations, and promoting the usage and

adjustment of existing buildings and effective usage of natural resources;
- principle of accessible environment – according to which in the construction process such environment is created where it is convenient for people to get around and use the buildings according to their function.

**Box 6.7**

**Data characterising the construction sector**

Data of the Central Statistical Bureau show that in the 3rd quarter of 2010, the construction production volume (in current prices) was LVL 247.5 million while in the 3rd quarter of 2011 – LVL 301.8 million.

In the 3rd quarter of 2011, the construction production volume in accordance with balanced data of working days in comparable prices has increased by 19.6% if compared with the corresponding quarter of the previous year.

CSB data show that in the 3rd quarter of 2011, construction permits have been issued for double dwelling or multi-apartment buildings construction for an area of 95989 $m^2$, which is 3.5 times more than in 2010, but for construction of office buildings for an area of 6143 $m^2$, which is 3.9 times more than in 2010. The area of constructed residential buildings in the 3rd quarter of 2011 exceeds the area constructed in the corresponding period of 2010 by 7.8 thousand $m^2$.

In the 3rd quarter of 2011, the volume of construction work (in current prices) performed by Latvian builders abroad was LVL 21.2 million, while in the 3rd quarter of 2010, the volume of construction work (in current prices) performed by Latvian builders abroad was LVL 14.2 million, which is by LVL 7 million more than in the 3rd quarter of 2010. However, in the 3rd quarter of 2011, foreign builders in Latvia have performed construction works in the amount of LVL 6833.2 thousand, which is by LVL 4761 thousand more than in the 3rd quarter of 2010 (LVL 2072.2 thousand).

In the 3rd quarter of 2011, the construction costs have increased on average by 2.1%, compared with the 3rd quarter of 2010. Costs for machinery and machines maintenance and use increased by 13.7%, however costs for construction materials decreased by 1.9%. In comparison with September of the previous year, prices for construction materials decreased by 1.7%. Price decrease was mainly observed for wall and ceiling finishing materials and flooring.

Recently, several **changes in normative acts regulating construction** have been made.

On November 9, 2010, the Cabinet of Ministers approved the Latvian Construction Standard LBN 007-10 *Requirements for Building Harmlessness*. Foreign manufacturers of construction materials had been taking advantage of the lack of restrictions regarding the use of hazardous substances in construction materials in Latvia thus endangering Latvian consumers and distorting the construction material market of Latvia.

The Latvian Construction Standard LBN 201-07 *Fire Safety of Buildings* is significantly restructured, thus facilitating its use for construction designers and updating requirements regarding materials and methods for insulating building facades. The Construction Standard sets the essential fire safety requirements arising from building layout and for reaction of building structures and used construction materials to fire, requirements for load carrying capacity of building structures in case of fire and explosion depending on the type of use and potential fire load, requirements for emergency routes and marking thereof, minimum requirements for installation of fire alarm and fire protection systems.

Consequentially, update of construction standard requirements for fire safety and their harmonization with requirements of the EU laws lead to changes to the Latvian Construction Standard LBN 002-01 *Thermotechnics of Building Envelopes* stipulating that the design solutions for plastered facades of external wall co-financed by the European Union, state, or local municipality must be developed in accordance with the European technical approvals issued on the basis of the Guidelines for European technical approval of External thermal insulation composite systems with rendering ETAG 004 thus ensuring quality of construction objects, appropriate use of the European Union, state, and local municipality funding, as well as conformity of building thermotechnical properties to the requirements of the construction standards.

According to the evaluation included in the World Bank research *Doing Business* regarding dealing with construction permits Latvia was ranked one of the last in comparison with other European countries. In order to improve the situation, a range of amendments to the *General Construction Regulations* were made resulting in reducing the number of days required for harmonization procedures by 41 days.

In continuation of simplifying administrative procedure, on August 2, 2011, simultaneously three regulations of the Cabinet of Ministers were amended defining the technical requirements for windows intended for replacing the existing ones, thus revoking the impractical harmonization procedure and promoting change of windows saving energy resources used for building heating.

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, Regulation of the Cabinet of Ministers of April 30 of 2011 *Procedures for the Conformity Assessment of Construction Products in the Regulated Sphere* was amended by clarifying the application of national standards of other European Union Member States regarding conformity of construction materials and clearly defining circulation of documentation regarding conformity of construction materials. Diversification of construction materials and improving solutions of building-acoustic constructions have resulted in increasing consumer demand for premises of increased comfort level; therefore on June 28, 2011, the Latvian Construction Standard LBN 016-11 *Building Acoustics* was approved.

The Construction Standard is developed based on the experience of the Northern countries, and classes A, B, C and D are applied to premises designing from the acoustic comfort aspect. Class D requirements are applied to premises of present buildings and should not be applied to design of new buildings. But class C requirements for premises are the minimum requirements defined as mandatory in designing new buildings and ensuring noise restriction for people present in the premises to such level that is not harmful to their health and make their stay in the premises comfortable. According to class A and B requirements, particularly high acoustic comfort level will be ensured in the premises by maximum reducing the source and spread of noise. A range of significant changes been made to the construction standard, for example, requirements for sound insulation in internal envelope constructions are set, and required sound insulation for external envelope constructions of buildings situated near the sources of environmental noise including protection against transport noises are graphically defined.

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 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 building.

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 obligatory carried out.

Whenever detecting conditions causing heat loss, the multi-apartment buildings will be subject to the energy efficiency measures[1] related to equipping street doors with 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 studied the reasons for debts, it has been concluded that the main reasons are insufficient or reduced financial resources of residents, 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 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 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 when the delayed payment for services does not exceed the amount of the average payment of 3-4 months, foster debt recovery out of court, reduce the amount of state fee for bringing an action for claims in cases of a small amount claim, revise the payment amount related to enforcement of a court decision which consists of remuneration of court bailiffs according to their rates and costs required to perform execution actions, ensure execution of the decision whenever the claim for debt recovery is satisfied in relation to services provided to the owner of the apartment.

In 2011, 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*.

The ERDF funding reserved for this activity is LVL 26774 034.66 (finished, to be implemented, approved and projects under evaluation).

In the nine months of 2009, applications of 117 projects were submitted, 71 of them were approved, while in 2010, 170 projects were submitted, and 95 of them were approved for implementation. By December 31, 2011, the Investment and Development Agency of Latvia has received 461 project applications. Currently, 277 of them have been approved while 60 project applications are under evaluation.

The average saved heat energy achieved as a result of the implemented renovation measures ranges from

[1] Energy efficiency measures are to 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/m$^2$ per year. According to data of 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/m$^2$ per year. Good practice shows that proper management and use of non-renovated buildings leads to consumption from 140 to 160 kWh/m$^2$ per year. Renovation of multi-apartment residential buildings may result in achieving heat energy consumption from 70 to 100 kWh/m$^2$ per year

30% up to 57%, thus the implementation of the activity leads to significant energy efficiency of multi-apartment residential buildings. Moreover, the housing stock is undergoing improvements that could not be possible without such support.

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 implementing this activity.

## 6.5. Tourism Policy

The tourism policy in Latvia is formed to promote development of local and international tourism, its main goal is to promote growth of the tourism sector turnover in the economy and export capability of tourism services in the medium term stimulating changes in the structure of demand and supply.

In 2010, the *Latvian Tourism Marketing Strategy 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 the target markets. 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. An active integration of the new image into all activities to promote awareness of Latvia as a tourism destination continued in 2011.

In order to promote development of the tourism sector, the following economic objectives have been set for the time period until 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 percentage growth in export of the total tourism services.

**Box 6.8**

**Tourism development indicators**

According to the data of the UN World Tourism Organization, international tourism has grown by almost 5% in the first half of 2011, reaching the largest number of tourists ever – 440 million in this period. Despite countless challenges, statistics show that international tourism has gotten back on the growth track since 2010.

The tourism sector is also a significant source of export income providing a considerable contribution to the national gross domestic product. The value added to 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 value added.

In 2010, the number of border crossings by foreign tourists in Latvia reached 5.04 million, which is by 6.6% more than in 2009. Like in the previous years, the average duration of visits of tourists in Latvia was 1.2 days, which is slightly less if compared to 2009. It must be added that also the average expenses of one tourist per day have faced a slight decrease – in 2010 it was respectively LVL 54. Despite the increase in the number of the entrants, the total expenses of foreign tourists in Latvia have decreased to LVL 333.9 million.

In 2010, 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 34.3 million.

At the end of 2010, there were 628 tourism campsites in Latvia, which is by 69 more than at the end of 2009. At the same time, also the number of persons served in hotels and other tourist campsites in 2010 has increased by 17.7 per cent.

The tourism policy in Latvia is implemented by the Latvian Tourism Development Agency (LTDA) (see Box 6.9).

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 2011, and the Advisory Council of Latvian Tourism Development Agency 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.

The annual state budget funding for 2011-2013 that is envisaged for promoting tourism development is planned 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 2011, the total amount of funding (state budget funding and the ERDF co-funding) for tourism marketing is LVL 878 992.

**Box 6.9**

**Activities of the Latvian Tourism Development Agency in 2011**

In accordance with the *Latvian Tourism Marketing Strategy 2010-2015*, the LTDA organized marketing activities in foreign target markets and ensured measures for development of tourism products and promotion of local tourism:

- in order to ensure efficient communication in foreign markets, the *Latvian Tourism Marketing Foreign Communication Strategy 2011-2014* has been developed for high priority markets – Germany, Russia, Finland, Sweden, Lithuania, and Estonia. The Strategy sets priority target audience in the foreign tourism markets, communication tasks in each target market, information to be communicated and tourism products to be promoted in each market;
- in cooperation with the Latvian tourism sector, organization of Latvian national stand's participation in 4 international tourism exhibitions (in Russia, Finland, Germany, Great Britain) has been implemented;
- implementation of advertising campaigns in German and Russian internet media, thus raising awareness about Latvia and fostering demand of Latvian tourism products in winter season;
- in 3 quarters of 2011, 8 foreign journalist visits in Latvia have been organized for journalists from Russia, Lithuania, Estonia, Germany, and the Great Britain, as well as 4 publications in cooperation with the journalists were published in respective national mass media;
- provision of Latvian tourism portal *www.latvia.travel* development according to the demand of the target markets and development of strategy for search engine optimization of the portal and social media, as well as launching development of applications to adapt the portal to mobile devices;
- in cooperation with Lithuanian and Estonian national tourism organizations, the tourism campaign of the Baltic States *Great Baltic Travel 2011* (from May 5 to September 15, 2011) has been implemented including 10 objects from Latvia and organizing extensive marketing campaigns, as well as promoting tourist flow among the Baltic States. In 2011, 56763 unique visitors viewed the campaign website while 953 visitors registered for the lottery;
- organization of international event for tourism professionals *Baltic Connecting 2011* (September 25-29, 2011) attended by 174 participants from 26 countries (including Latvia). The event included business matchmaking of the participants and visits for foreign tourism operators to get acquainted with Latvian tourism services;
- 6 types of brochures were issued and published electronically: *Day Trips in and around Riga* (in English, German and Russian), *Health. Well-being. Harmony.* (in English, German and Russian), *Latvian Tourism Image* (in English, German and Russian ), *Business Tourism Brochure* (in English), *Greater Riga Tourism Map* (in English, German, Russian, Finnish, and Swedish), and *Riga Top 15 Tourism Objects* (in German);
- monthly issue of Latvian tourism newsletter *www.greetingsfromlatvia.lv* in English, Russian, and German, distributing them to 12 500 foreign tourism professionals and journalists;
- launching implementation of a quality system of Latvian tourism services *Q-Latvia* into tourism enterprises to increase quality level of tourism services provided by Latvian tourism enterprises. An agreement was signed with the Latvian Hotel and Restaurant Centre on administering the process of granting the *Q-Latvia* Quality label to reach involvement of the first 30 enterprises in the granting of *Q-Latvia* and Quality labels;
- maintenance and development of tourist help-line telephone was ensured, receiving 7300 calls from foreign lines within the 3 quarters of 2011;
- together with cooperation partners, 10 local and international training measures for Latvian tourism sector were organized on creating tourism products and developing tourism destinations according to the target market requirements – seminars *How to create "Best enjoyed slowly" products outside Riga?* and *Creation and development possibilities of tourism product "Riga+"*, training measures on creation of natural and food tourism products, as well as the 7th International Hotel Industry Conference and the annual conference of the Association for International Tourism and Leisure Education;
- the European Commission project *European Destinations of Excellence* (EDEN) was implemented in Latvia, recognizing Līgatne as the best tourism destination of Latvia in 2011, which is a successful example of cooperation in destination framework and use of available resources for needs of tourists. Overall 12 applications from across Latvia were submitted for the project;
- representation in the *Joint Tourism Committee of Baltic States* and the Baltic Joint Marketing Council was ensured.

## Improvement of legal framework

Implementation of measures to support Latvian resorts development was one of the main tasks of the Ministry of Economics set in 2011, envisaging establishment of legal framework for granting a resort status. The draft law *Amendments to the Tourism Law* was developed for this purpose. Development thereof is the first step towards elaboration of legal framework of resorts aimed at creating appropriate framework for fostering development of resort sector. The *Amendments to the Tourism Law* defines authorizing the Cabinet of Ministers to pass regulations prescribing 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 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 order to ensure efficient enforcement of the European **Council Directive of 13 June 1990 on package travel, package holidays and package tours**, informing both 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, 421 entrepreneurs were registered in the database by November 1, 2011, 29 of them were registered as tourism operators, 103 – as tourism agents and operators, but 289 – as tourism agents. Information included in the database is publicly available for anyone interested, and the Ministry of Economics asks Latvian tourists to verify the conformity of service providers' activities to the requirements of law and regulations, particularly provision of security guarantee for money deposited by tourists.

**International cooperation in the field of tourism**

In 2011, Latvia continues developing and strengthening 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 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.

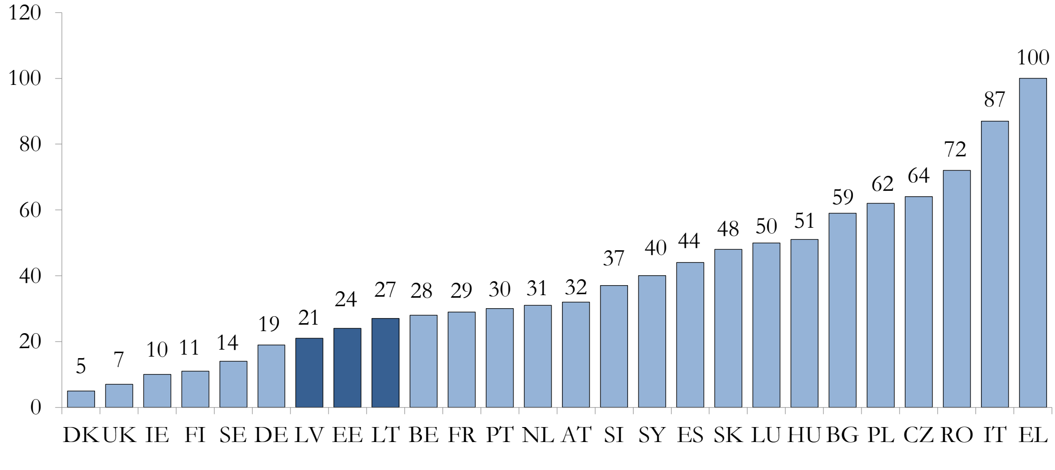
Since 2005, Latvia is also a full member of the United Nations World Tourism Organization (UNWTO). In 2010, a discussion with tourism sector on necessity for participation in the organization was initiated as present experience cooperating with the UNWTO shows that continued participation in the abovementioned international organization is not a critical factor for Latvia to implement the set objectives and tasks for development of tourism sector. Having analysed benefits from being a member of the UNWTO and the amount of annual membership fee, it was decided that further participation in the organization no longer is useful. Members of the Latvian Tourism Advisory Council and the LTDA Advisory Council have supported the adopted decision. Therefore the draft law *On Denouncement of the Statutes of the World Tourism Organization* has been developed.

## 6.6. Improvement of Business Environment

The World Bank's international research *Doing Business*, as well as the *Study of Administrative Procedure Impact upon Business Environment* show the opinion of entrepreneurs about the factors hindering their activity.

Figure 6.8

**Rank of the EU Member States in the World Bank's study *Doing Business* in 2012**
(business environment in general)



Latvia has achieved significant progress in improving business environment – **Latvia has improved its rank in the World Bank's research *Doing Business 2012* by 10 positions** moving from 31st place[1] (*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. If compared to neighbouring countries, Latvia has outpaced Lithuania and Estonia for the first time in this ranking. Estonia has lost its position by 6 places (from 18th to 24th place) while Lithuania ranks 2 positions lower than last year (from 25th to 27th place).

Table 6.5

**Rank of Latvia in the World Bank's research *Doing Business***

| Indicators | 2011 | 2012 | Changes |
|---|---|---|---|
| Starting a Business | 52 | 51 | +1 |
| Dealing with Construction Permits | 103 | 112 | -9 |
| Registering Property | 56 | 32 | +24 |
| Credit Register | 4 | 4 | 0 |
| Protecting Investors Rights | 60 | 65 | -5 |
| Paying Taxes | 64 | 67 | -3 |
| Trading Across Borders | 15 | 15 | 0 |
| Enforcing Contracts | 14 | 17 | -3 |
| Resolving Insolvency | 86 | 32 | +54 |
| Getting Electricity | 115 | 84 | +31 |
| **Overall rank** | **31** | **21** | **+10** |

Latvia launched measures to improve business environment already in 1999 when the Ministry of Economy prepared the first *Action Plan to Improve the Business Environment.* More active involvement is seen on the part of a wide range of organizations representing entrepreneurs, therefore every year the government approves the updated plan.

The Plan for 2011 envisages providing simple and qualitative services in entrepreneurship – more e-services – and it includes 31 measures. The following are the most important:

– **Starting a business** – reduced average time for reviewing applications at the State Revenue Service (SRS) for registration in the Register of VAT Taxable Persons – from 11 days in 2010 to 7 days in 2011. On June 15, 2011, an arrangement on cooperation was reached between the Register of Enterprises (RoE) and the Association of Commercial Banks of Latvia in order to ensure electronic receipt of documents confirming payment of equity capital. *Amendments to the Commercial Law* in 2010 regarding extension of the term of office of capital companies' board and council are also beneficial for the entrepreneurs – according to the data of Lursoft, on average, 1600 changes in the lists of officials have been registered every month in 2011 (before the *Amendments to the Commercial Law* came into force, approximately 2600 changes in the lists of officials were registered every month), thus making it easier for entrepreneurs to deal with the necessary formalities and reducing the load of duties of the notaries in the RoE;

– **Construction process** – during the meeting of May 24, 2011, the Cabinet of Ministers approved amendments to the CoM Regulations of April 1, 1997 *General Construction Regulations* reducing the number of days required for planning and architectural process, obtaining approval of technical regulations and construction design, as well as setting the minimum terms for obtaining the construction permit. The abovementioned amendments are expected to be an additional process simplifying entrepreneurship in the context of the new *Construction Law.* In 2011, the new draft *Construction Law* was prepared and submitted to the Saeima. In *Doing Business* indicators, it envisages reducing the period required for construction harmonization procedures from 23 procedures and 205 days to 6 procedures and 69 days;

– **Protecting investor rights** – the responsible ministries have prepared amendments to the *Commercial Law,* the *Financial Instrument Market Law* and the *Annual Accounts Law* envisaging to define decision-making in an enterprise if members are involved in a conflict of interests and ensure transparency of transactions of entrepreneurs which are board members in respective enterprises, etc. At the beginning of 2012, the draft laws will be forwarded for harmonization/approval to the Cabinet of Ministers;

– **Tax and customs** – the threshold has been raised for registration in the SRS Register of VAT Taxable Persons – persons are entitled to be not registered in the SRS Register of VAT Taxable Persons if the amount of performed applicable transactions in 12 months does not exceed LVL 35000 (previously LVL 10000), entrepreneurs are offered an opportunity to clear cargos around the clock, as well as a reduced

[1] Every year upon publishing new *Doing Business* ranking, data of the previous year are recalculated according to the current methodology

number of reports and documents to be submitted to the SRS by persons acting as customs brokers;

– **E-service development** – developed roadmaps for entrepreneurs on the possibility to complete electronically the required procedures/public services; in entrepreneurship processes defined by *Doing Business* there were prepared and published new e-instructions on portal *www.latvija.lv* and website *www.solipasolim.lv*.

In summer 2011, after the order of the Ministry of Economics an **entrepreneur polling about the impact of administrative procedures on business environment** was conducted, surveying over 700 enterprise managers throughout Latvia. The results were published on October 25, 2011. The polling data show that the entrepreneurs need to spend less time to perform various administrative procedures in 2011 than previously – in 2011 the procedures take approximately 11% of entrepreneurs' time. In 2011, entrepreneurs most often – 78% of responses – named tax rates as a factor hindering business, more than a half of entrepreneurs considers inflation (61%), frequency of changes in laws and regulations (59%) and tax declaration (59%) as barriers. Additional information on the polling results is available on the website of the Ministry of Economics: *http://www.em.gov.lv/em/2nd/?cat=30111*.

In September 2011, the Ministry of Economics organized expert discussions about the polling results and prepared proposals on the required measures for improving business environment. Recommendations are summarized in the *Report of Business Environment Evaluation Reforms of Latvia*. At the end of 2011, the Ministry of Economics was engaged in preparation of the identified measures for entering into the *Plan of Measures for Improving Business Environment* for 2012. The draft plan of 2012 is planned to be submitted for approval in the Cabinet of Ministers by February 15, 2012.

## 6.7. Small and Medium-Sized Enterprises

In Latvia, like elsewhere in Europe, small and medium-sized enterprises (SMEs) form a major part of the national economy and play a significant role in building the GDP and in employment.

**Box 6.10**

**<u>The number of small and medium-sized enterprises in Latvia</u>**

There were 73 thousand 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 – 2.7%, large enterprises – 0.5 per cent.

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 32 in 2010.

However, it is equally important to emphasize the number of performers of individual work (self-employed persons) in 2010 – 49.1 thousand (22 per 1000 inhabitants), as well as the number of farms and fish farms in 2010 – 13.1 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 indicator characterizing the economic activity as the number of enterprises per 1000 inhabitants, it is difficult to perform an objective comparative analysis of this indicator. 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 "Lursoft" and the Register of Enterprises, in the year 2010, 13421 subjects were registered in the Register of Enterprises and Commercial Register, and 8035 subjects of the Register of Enterprises and Commercial Register were liquidated. Within 11 months of 2011, 16659 subjects of the Register of Enterprises and Commercial Register were registered, but 3556 – excluded.

Definition of SMEs is stipulated in the *Law on Control of Aid for Commercial Activity,* Regulations No 964 of the Cabinet of Ministers of November 25, 2008 *Regulations on Declaration Procedures of Commercial Companies According to Small or Medium-sized Commercial Company*, and *Commission Regulation (EC)* No 800/2008:

**Definition of SMEs:**

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 6.11**

**Activities of the EU for 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 10 politically binding guidelines (additional information is available on the website of the Ministry of Economics: *http://www.em.gov.lv/em/2nd/?cat=30109*.

On May 30, 2011, the EU Competitiveness Council approved the Council Conclusions regarding the Medium-Term Report on Implementation of the Act setting the following key priorities for further action of the EU and Member States institutions:

– smart regulation: emphasises the need to reduce the legislative burden and implement the SME test and the "only once" principle in the legislation of all the EU Member States, including cross-border cooperation issues. There is also a reference to the need to reduce accounting requirements and non-applicability thereof to micro-enterprises, as well as further importance of e-government is emphasized;
– availability of financing for SME: particular attention is paid to micro- and SME's needs to access financing, including provision of cross-border venture capital investment flow and prevention of double taxation. Emphasis is placed on the need to implement the Directive of cross-border trade transactions as soon as possible;
– SME's access to market: development of technological and non-technological innovations, call to provide free-of-charge access to standards, continuing work on simplification of public procurement procedures regarding SMEs are set as the priority tasks. Importance of e-identification and e-authorization is emphasized;
– promoting entrepreneurship: it is indicated that one of principles for promoting entrepreneurship is support to women and new entrepreneurs. Member States are invited to spread the good practice in business transfer and in encouraging entrepreneurs to improve skills, among all by implementing different informative campaigns;
– better governance: dialogue and involvement of the EU, Member States, and non-governmental organizations are important for further efficient implementation of the Act, as well as more qualitative monitoring of the implementation of the Act must be carried out.

In order to achieve the objectives of the Act, in 2011 already for the third year, the European Commission organized a European scale campaign *European SME week – for small and medium sized enterprises* to provide information 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.

The *European SME week* in 2011 officially took place from October 3-9 when various conferences, seminars, trainings, discussion forums, and awarding ceremonies were held in 37 European countries. 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 topicalities of insolvency process (for example, auctions, debt recovery in insolvency process, etc.), evaluation of innovation management in an enterprise, 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 2011*. Overall, more than 12 informative events for entrepreneurs were organized in Latvia involving over 1000 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 and implementation of promoting micro-enterprise establishment and development support measures;
– measures to promote business start-ups;
– providing enterprises access to finance.

**Development and implementation of promoting micro-enterprise establishment and development support measures**

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. The main directions for achieving the objectives of the concept are the following:

– to reduce costs related to micro-enterprise start-up;
– to introduce tax policy friendly to micro-enterprises;
– to enable micro-entrepreneurs to deal with accounting by themselves;
– to ensure micro-enterprise access to financing;
– to provide complete information access for micro-enterprises.

The Concept undergoes successful implementation, and amendments have been made to the relevant regulatory acts.

In May 2010, when the amendments to the *Commercial Law* came into force, costs required to start a business were significantly reduced, 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 "Lursoft", 15655 limited liability companies were registered in the Register of Enterprises within the time period from May 1, 2010 until November 29, 2011, 69% or 10778 of them were limited liability companies with reduced equity capital.

As of September 1, 2010, individual merchants, individual enterprises, farms and fisheries, natural entities registered at the State Revenue Service as economic operators, as well as limited liability companies can obtain the status of a micro-enterprise taxpayer subject to complying with certain criteria (members are natural entities, turnover does not exceed LVL 70000 per calendar year, and the number of employees does not exceed 5). The micro-enterprise tax rate is 9% of turnover or profit from economic activity, and it includes the mandatory state social insurance contributions, personal income tax, and entrepreneurship risk state duty for employees of the micro-enterprise, as well as the corporate income tax or the personal income tax of the owner of the enterprise for the income share of the economic activity of the micro-enterprise. A total of 16238 micro-enterprise tax payers were registered at the State Revenue Service from September 1, 2010 until November 29, 2011 (72% 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 – a total of 2939 enterprises have used the offered opportunity from September 1, 2010 to November 1, 2011.

As of January 1, 2010, any natural entity performing economic activity in specific professions or operations may choose to pay 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. Patent fees are applied to over 60 professions (mainly for craft services), and the monthly payment of the fee is set in detail for each group, the extent ranging from LVL 30 to LVL 70 per one calendar month. Relevant social guarantees are ensured to all payers of the patent fee. A total of 3200 applications for patent fees have been submitted to the SRS from January 1, 2010 until November 4, 2011. The number of the patent fee payers has increased by 40% in 2011.

The Ministry of Finance is continuing work on simplifying transparency of legal framework regarding small enterprises and therefore has developed a concept *On Consolidation and Simplification of Small Enterprise Taxpaying System*. The Concept envisages a simplified tax system to be applied to small enterprises; the system is made more simple and understandable. The implementation will lead to easier detection of failure to pay the tax thus promoting tax payment to the state budget.

**Measures to promote business start-ups**

In order to foster establishment and development of micro, small, and medium-sized enterprises, IDAL is implementing the project *Development of Business Incubators in Latvia* co-financed by the European Regional Development Fund[1].

**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 which is located in Ventspils and Talsi;
– Kurzeme Business Incubator which is located in Liepāja, Saldus, and Kuldīga;
– JIC Business Incubator which is located in Jelgava and Dobele;
– JIC Business Incubator which is located in Aizkraukle and Jēkabpils;
– Valmiera Business Incubator which is located in Valmiera, Gulbene, and Valka (provides virtual incubation services);
– Business Incubator "Cēsis" – Magnus which is located in Cēsis, Madona, and Alūksne (provides virtual incubation services);
– Latgale Machinery Technology Centre which is located in Rēzekne, Balvi, and Ludza (provides virtual incubation services);
– Latgale Machinery Technology Centre which is located in Daugavpils and Līvāni;
– Riga Region Business Development Incubator which is located in Ogre, Limbaži, and Tukums;
– Creative Industry Incubator "HUB – Riga" which is located in Riga, Andrejosta.

At the end of the 3rd quarter of 2011, 366 micro-, small, and medium-sized enterprises providing (maintaining) 1111 work places receive 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 typical for a development bank, plays a substantial role in implementation of support instruments.

[1] A business incubator is a combination of infrastructure and personnel aimed at aiding new and small businesses to develop through supporting them in their early stage of development with infrastructural, day-to-day consultations and services concerning basic business development issues

**Box 6.12**

**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 transforming 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 providing foundation 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 annually will 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 for rendering 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.

In 2011, the Mortgage Bank continued to implement both existing and new support programmes providing support to definite groups of enterprises and population assigned by the government:

- *Support Programme on Improvement of Competitiveness of the Enterprises* co-financed by ERDF;
- Support programme *Support for Self-employment and Business Start-ups* co-financed by ESF;
- *Micro Crediting Programme of Latvian Small and Medium-Sized Enterprises*;
- *Micro Crediting Programme of Latvia and Switzerland*,
- *SME Growth Loan Programme*;
- *Programme of Agricultural Current Assets*;
- *Agricultural Investment Loan Programme*;
- *Agricultural Credit Fund Loans*.

Currently, the most significant support programme by credit amount 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 end of November 2011, 377 loans have been granted in the amount of LVL 161.4 million, among which loans in the amount of LVL 108.7 million have already been issued. 65 loans in the amount of LVL 72.7 million were granted from the part of the programme funded by the ERDF including granted loans in the amount of LVL 35.7 million[2]. The fields receiving 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. Support may be granted to persons of working age, including unemployed persons, as well as to the newly established enterprises, who have expressed their wish to start commercial activity or self-employment. For the purposes of this programme, newly established enterprises are such enterprises, which have registered their activity lawfully not earlier than 3 years before

[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)

applying for the support under the programme, as well as entrepreneurs having experience in business activities who plan to produce a completely new product or provide a new service if they found a new enterprise for this purpose. 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's and the state budget – LVL 14 million, and co-financing of the Mortgage Bank 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 2190 interested entrepreneurs have been concluded, 1097 clients have submitted business plans, including 586 start-up projects that have already been supported for the total loan amount of LVL 7.1 million. In cases of 539 projects, also grants have been awarded, and the total amount awarded is LVL 2.3 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[1].

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, 1094 programme participants have been trained.

In December 2008, the Cabinet of Ministers approved the *Micro-crediting Programme for Latvian Small and Medium-Sized Enterprises*. The programme is aimed at introducing a mechanism of micro-crediting for small and medium-sized enterprises and self-employed persons, as well as at promoting access to micro-credits for start-up or development of a business activity. The micro-credits up to LVL 3 thousand are intended for implementation of business projects – for investments and liquid assets – for enterprises with up to 10 employees, as well as for self-employed persons.

The total budget of the programme is LVL 565 thousand, including a contribution from the Ministry of Finance in the amount of LVL 452 thousand and financing from the Mortgage Bank in the amount of LVL 113 thousand. Since February 2009, when the implementation of the programme was launched, until September 2011, the Mortgage Bank has granted 395 loans in the amount of LVL 1.1 million including issued loans in the amount of LVL 1 million. The funding for the programme was completely absorbed already at the end of 2010; however, taking into account the high demand of micro-enterprises for micro-credits, the bank is continuing the micro-crediting from the repaid loan resources also in 2011.

Since October 2011, the abovementioned micro-crediting programme is replaced with a new programme – the *Micro Crediting Programme of Latvia and Switzerland*. The total funding of the programme is LVL 4.7 million, including LVL 4.3 million that are earmarked for micro-loans 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 the funding within the framework of the programme. Already the first two months of the new micro-crediting programme have been very successful. Micro-loans have been granted to 73 micro-enterprises in the amount of LVL 434 thousand including issued loans in the amount of LVL 274 thousand.

In September 2009, the Cabinet of Ministers adopted regulations *On Loans for Promotion of Development of Small (Micro), and Medium-Sized Enterprises and Agricultural Service Cooperatives*. In accordance with these regulations, in February 2010, the Mortgage Bank launched implementation of the *SME Growth Loan Programme*. It is envisaged that within the framework of the programme, until December 2013, loans for liquid assets and investments in the amount of LVL 140 million will be available for promoting development of micro, small, and medium-sized enterprises and agricultural service cooperatives. The total loan amount per one performer of economic activity may not exceed LVL 300 thousand; the maximum loan amount for liquid assets is LVL 200 thousand. Besides, according to the conditions of the programme, the total amount of the loan within this programme per one micro-entrepreneur operating in service industry may not exceed LVL 30 thousand. By the end of November 2011, within the framework of the programme, 404 loans in the amount of LVL 19.5 million have been granted, including the loans in the amount of LVL 15.9 million that have already been issued.

In May 2010, the Mortgage Bank launched the *Programme of Liquid Assets Loans for Producers of Agricultural Products*. Producers of agricultural products, as well as groups of fruit and vegetable producers may

[1] In the Riga region, training is provided by companies "Riga College of Accounting and Finance" and "Biznesa komplekss"; in the regions of Vidzeme and Latgale – association of LLC "Mācību un konsultāciju centrs ABC" and LLC "Mensarius"; in the regions of Kurzeme and Zemgale – LLC "Stockholm School of Economics in Riga"

[2] 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

receive liquid assets loans from LVL 5 thousand up to LVL 700 thousand with a term of up to 2 years, while the maximum loan for agricultural service cooperatives can reach LVL 2 million. Guarantees of Rural Development Fund may be attracted for these loans. Over the course of one and a half year, the programme has been popular among farmers: by the end of November 2011, 483 loans in the amount of LVL 15 million have been granted, including loans issued in the amount of LVL 14.2 million.

The Regulations of the Cabinet of Ministers *Procedure for Administration and Control of the State and European Union Support to Agriculture, Rural and Fisheries Development by Establishing the Credit Fund* were approved in July 2010, envisaging the issue of loans for financing the projects[1] approved by the Rural Support Service. Loans for a period of up to 15 years are planned to be allocated for investments in agricultural enterprises – for construction, purchasing stationary devices and equipment, purchasing construction materials, and preparing technical projects. By the end of November 2011, the Mortgage Bank has granted 36 loans in the amount of LVL 11.3 million, but the amount of isseued loans reached LVL 6.5 million.

**LLC "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 three financial instruments to improve competitiveness:

- 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.

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 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 and the Ministry of Economics signed an agreement on implementation of the project *Guarantees for improving enterprise competitiveness* of the activity 2.2.1.3 *Guarantees for improving enterprise competitiveness* of the measure 2.2.1 *Access to financial resources* of the priority 2.2 *Access to finances* of the supplement to the OP *Entrepreneurship and Innovations*. The ERDF funding available within the activity is LVL 60 million.

In October 2010, the Cabinet of Ministers approved the *Regulations Regarding Guarantees for Improving Competitiveness of Merchants and of Conforming Agricultural Service Cooperative Societies,* stipulating that 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 Activity 2.2.1.3 *Guarantees for Improvement of Enterprise Competitiveness for the Loan Guarantee Programme* since launching the activity until April 31, 2011:

- number of applications – 1219 applications from 343 enterprises;
- amount applied for – LVL 208 million;
- number of issued guarantees – 536 guarantees to 194 enterprises;
- amount of issued guarantees – LVL 88 million;
- amount of guaranteed credits – LVL 187 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 Activity 2.2.1.3 *Guarantees for the Improvement of Enterprise Competitiveness for the Export Loan Guarantee Programme* since launching the activity until November 28, 2011:

- number of applications – 136 applications from 44 enterprises;
- number of issued guarantees – 73 guarantees to 22 enterprises;
- amount of issued guarantees – LVL 4.27 million

All enterprises which signed the agreement represent the processing industry (for example, production of communication equipment, production of household appliances, production of plywood

[1] Measures of Rural Support Service: Modernization of Farms, Creating Value Added to Agricultural Products, Support to Establishment and Development of Enterprises (Including Diversification of Activities not Related to Agriculture), Promotion of Tourism Activities, Investments in Aquaculture Enterprises, Processing of Fishing and Aquaculture Products)

sheets and wooden panels, production of soap, washing, cleaning and polishing agents, production of food products, etc.). 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 support in a form of mezzanine loans for improving competitiveness of economic operators. The minimum amount of a mezzanine loan is LVL 100000 and the maximum amount is LVL 700000. The amount of loan does not exceed 40% of the total costs of an investment project. The total amount of the loans is LVL 17.7 million.

The activity 2.2.1.4 *Loans for Improving Enterprise Competitiveness* has been 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.

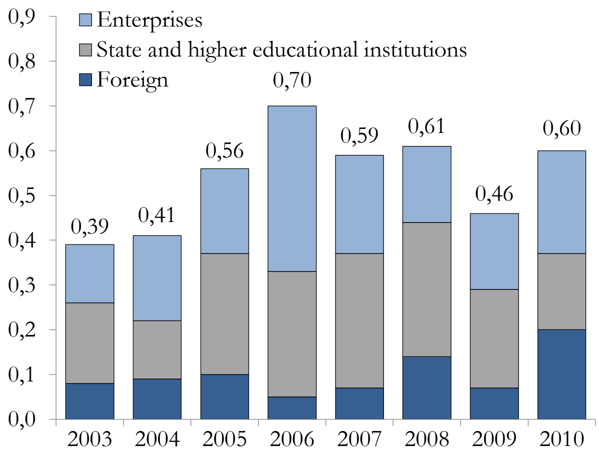
## 6.8. Innovation and New Technologies

In 2010, the total funding for research and development in Latvia was 0.6% of GDP or LVL 77 million which is by 22.2% more than in 2009. An analysis of investment structure and dynamics in research and development leads to a conclusion that growth is observed for entrepreneurship and foreign financing however decrease is observed for state and higher educational institutions' funding for research work. State and higher educational institutions' funding for research and development in 2010 constituted 0.17% of GDP or LVL 21.4 million, while foreign funding, including funding from the EU Structural Funds, was LVL 25.7 million or 0.2% of GDP. Private sector investments in research and development in 2010 according to actual figure has increased most rapidly – by almost 26%.

Figure 6.9

**Funding for research and development 2003-2010**

(% of GDP)




At the same time, it should be noted that Latvia's indicators for investments in research and development are considerably behind the objective set in the *National Reform Programme of Latvia for the Implementation of the EU 2020 Strategy* (see Section 6.1.2) envisaging that the total Latvian investments in research and development should constitute at least 1% of GDP by 2015.

In 2011, the key innovation activities were implemented according to the main directions for fostering innovations until 2013 set in the *National Reform Programme of Latvia for the Implementation of the EU 2020 Strategy*:

- developing scientific activity potential;
- establishing a platform for long-term co-operation between enterprises and scientists;
- supporting development of innovative enterprises.

**Developing scientific activity potential**

In 2011, implementation of several measures were continued to foster scientific activities in order 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.

The Ministry of Education and Science continues implementing important activities in this field, for example, by supporting cross-sectoral scientific research within five priority scientific directions of the State research programme commissioned by the state.

In 2011, the Ministry of Education and Science continued implementing the EU Structural Funds activity *Development of Science Infrastructure* aimed at improvement of scientific and research equipment and creation of state-of-the-art materially-technical base for research activities in leading research centres of national importance.

The activity is implemented in two selections stages with 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 world-class scientific facilities and equipment, reconstructing and renovating buildings and premises, as well as creating state-of-the-art materially-technical base for research. A decision on supporting 9 research centres of national importance until 2015 for EU funds support in the total amount of LVL 56.3 million was adopted as a result thereof.

In 2011, the second selection stage of project applications submission was launched intended for both enterprises and scientific institutions to apply for support in project implementation aimed at development of research infrastructure that fosters development of research in the private sector and research service rendering to the private sector. The EU funds funding available in the second selection stage of project applications submission is LVL 46.3 million.

In 2011, the Ministry of Education and Science continued implementing the EU Structural Funds activity *Support to Research and Development* thus supporting implementation of practical research projects in the state priority science directions. Overall, decisions on approval of 122 projects for total EU funds funding in the amount of LVL 36.6 million have been adopted in the activity.

**Establishing a platform for long-term co-operation between enterprises and scientists**

The key activity in this field is the *Competence Centre Programme* which supports six projects envisaging to carry out joint industrial researches and project development by scientists and entrepreneurs in such sectors important to national economy of Latvia as 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 total public support to activities of 6 Competence centres until 2015 is LVL 37.4 million and additional co-funding in the amount of LVL 22 million are 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 promote technology transfer, IDAL continues supporting the activity of 8 technology transfer contact points at higher educational institutions (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). The task of the technology transfer contact points is to establish a practical link between researchers in state scientific institutions and higher educational institutions and entrepreneurs by actively participating in identifying the results of commercially accomplished researches, including provision of services of industrial property rights protection. The EU Structural Funds support available for the activity of technology transfer contact points until 2013 constitutes LVL 1.9 million.

In 2011, the Ministry of Economics continued implementing 7 approved cluster projects within the framework of the *Cluster Development Programme* thus promoting cooperation between industrial enterprises and enterprises of related sectors, as well as cooperation of these enterprises with educational and research institutions in identifying and implementing joint projects to increase competitiveness of enterprises involved in the cluster. The cluster projects are implemented in sectors of electronics, chemistry and pharmacy, metal processing, light industry, logistics and related sectors, as well as space technology development cluster project is implemented. State budget funding for implementation of these projects in 2011 is LVL 0.2 million. As of 2012, the EU Structural Funds funding in the amount of LVL 2 million is planned to be attracted to the Cluster Programme.

In 2011, the Ministry of Education and Science supported implementation of projects within the *EUREKA Programme* which is a European scale programme for mutual cooperation between enterprises and scientific institutions to foster development and introduction of technologies and new and competitive products and services. At the same time, on September 9, 2011, the Ministry of Education and Science signed an agreement with the EUREKA Secretariat on implementation of the European scale joint programme EUROSTARS thus giving small and medium-sized research and development enterprises of Latvia an opportunity to receive a support for implementation of projects aimed at developing innovative and market-demanded products, technologies, and services.

**Supporting development of innovative enterprises**

In 2011, IDAL within the framework of the programmes *Development of New Products and Technologies* and *Introduction of New Products and Technologies into Production* continued to grant funding to those projects of enterprises aimed at developing new or significantly improved products or technologies, as well as introducing the new product, services, or technological processes in production, including purchase of equipment and technologies.

In 2011, the Investment and Development Agency of Latvia continued to support 24 projects approved within the framework of the activity *High Added Valued Investments Programme* aimed at developing large scale production plants and creating new workplaces, including purchase of equipment, construction and reconstruction of buildings. The EU funds funding granted to implementation of the 24 projects is LVL 52.9 million. From December 12, 2011 until April 2, 2012, IDAL is organizing the second call for project applications submission, and the total public funding available in the second selection stage of project applications of the activity is LVL 26 million.

On October 11, 2011, the Cabinet of Ministers approved the new support programme *Development*

*Programme of New Products and Technologies of Micro-, Small and Medium-Sized Enterprises*. Within the framework of the activity micro-, small- and medium-sized enterprises will receive support for research, development of new products and purchase of intellectual property protection services. The total funding available within the framework of the activity is LVL 2 million. The EU funds co-funding per one project will be available in the amount of 60%, and the maximum amount thereof is planned to be LVL 10 thousand. The reception of the project applications is expected to be launched in the first half of 2012.

The Ministry of Economics also continues developing a new support instrument for fostering eco-innovation 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 2011, IDAL continued implementing a range of measures to educate the society and raise awareness, as well as to encourage people to start a business and focus on development and application of innovative solutions. The key measures organized within the framework of the activity *Measures to Encourage Innovations and Business Start-ups* are the annual Latvian innovative idea competition *Idea Cup* in which almost 500 ideas were submitted in 2011. The winner of the competition was the author of the idea *HugLock* who developed a new type of connection mechanism allowing easy and quick connection of different elements. Within the framework of the activity, IDAL also organized training course *Become an Entrepreneur in 5 days*, series of seminars *Innovative Business Start-up*, mentoring programme for new entrepreneurs, as well as measures aimed at educating pupils, students and teachers about innovation and entrepreneurship and their practical involvement in implementing activities. The total funding available within the activity until 2013 is LVL 2. 1 million.

# 6.9. 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 6.13).

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 – according to the *EU 2020 Strategy* to gain economic and social benefit from the digital single market based on fast and particularly fast Internet. *A Digital Agenda for Europe* includes 101 legislative initiatives and a number of EU, regional, and Member States' measures of horizontal level in seven areas in three dimensions of the *EU 2020 Strategy* development: social, environmental, and global dimension.

Development of information society in Latvia is regulated by the *Information Society Development Guidelines for 2006-2013* approved by the Decree of the Cabinet of Ministers on 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", State 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.

[1] The ICT sector is defined in accordance with the OECD definition which specifies inclusion of the following economic activities (NACE 2nd rev.): ICT manufacturing (manufacture of electronic components; manufacture of electronic boards; manufacture of computers and peripheral equipment; manufacture of communication equipment; manufacture of consumer electronic equipment; manufacture 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 rendering 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)

**Box 6.13**

**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 import amounting to LVL 370.8 million exceeded export with LVL 270.4 million. It should be noted that in 2010 import of the ICT products increased by 43% while export – 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%[1]), 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 professional 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 professional education institutions had an Internet connection.

Funding from the European Union 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 6.14)) funded from different sources, but mainly by the European Regional Development Fund. The amount allocated for project implementation for 2009-2012 constitutes LVL 97.9 million.

**Box 6.14**

**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 funding 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*, 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*, promotion thereof, development of other institutions information systems, the 2nd stage of *Development of Digital Library*, development of *Unified Welfare information system (WellIS)*, information system of the sectors centralized functions ad centralized ICT infrastructure, *Development of the Information System of the Register of Enterprises*, development of *Unified financial and management accounting system of state institutions* and linking thereof with the *Unified State Human Resources Management System*, development of *Client-Guided Service 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*, 2nd stage for updating the *General catalogue of the National Holdings of Museums (GCNHM),* 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*, 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.

[1] 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

**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 is 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*).

On January 12, 2010, the Cabinet of Ministers supported the *Concept on Electronic Identification Cards* envisaging introduction of electronic identification cards. The card will be a person's identification and travel document in the EU, as well as the mean for a person's electronic identification and authentication for electronic services, and also a carrier for creating (using) an e-signature. The Office of Citizenship and Migration Affairs plans to launch card issuing as of March 1, 2012.

On December 28, 2010, the Cabinet of Ministers approved the *Regulations Regarding Centralized Electronic Procurements* which envisage that starting from February 1, 2011, state institutions are obliged to make procurements in the centralized e-procurement system or e-catalogue office equipment, computers, paper, software, and specified medical products, for which the contractual price in 12 months for the respective goods or services group is LVL 100 or more.

According to the data of the State Regional Development Agency, the total sum of general agreements on procurement in 2011 reached LVL 11.5 million (in 2010 – LVL 6.8 million), the number of goods in the e-catalogue reached 63.5 thousand. The majority were procurements of computer technologies, printing equipment, and medicaments.

**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 Internet speed measurement website *speedtest.net* of the Internet research company "Ookla Net Metrics", at end of December 2011, Latvia with the download speed of 25.6 Mbit/s and upload speed of 15.5 Mbit/s takes the 4th place among 174 world countries. Such results are reached owing 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. That will give the citizens and enterprises an opportunity to use high-quality Internet with speed from 30 to 100 Mbit/s, thus eliminating the digital gap between urban and rural territories.

**Combating computer piracy**

According to the data of the international software copyright protection organisation "Business Software Alliance", the level of computer piracy in Latvia remained at 56% in 2010 (the level has not changed since 2006), while the losses to Latvian economy caused by piracy have reached almost LVL 15 million.

The level of computer piracy will be reduced by the possibilities to use free-of-charge and open code software. Already 25.4% of all enterprises used such software in 2010.

**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 2009, 3.7% of Latvian population used Internet for selling goods and services online, for example, in internet auctions (the EU average – 10.2%).

In 2010, 72% of Internet users had used Internet banking over the last three months (the EU average – 52%), but 76% – in 2011.

In 2010, 23.6% 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 goods and services purchased this way constitute 5.2% of the total purchases of enterprises. However, 8.9% of all enterprises (except financial sector) with 10 and more employees had sold goods or services over the Internet or other computer networks in 2010. The turnover of these transactions constituted 6.2% of the total turnover of these enterprises.

## 6.10. Competition Policy

The Competition Council (CC) is responsible for implementing 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, thus ensuring a choice of various goods and services of good quality to all consumers. 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 not to tolerate such violations, CC carries out public information measures and other measures promoting competition

The work of CC is performed in compliance with the *Competition Law*, other legal 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. CC also controls mergers of enterprises.

The priority of CC is identification and prevention of the most serious breaches of the *Competition Law* – prohibited agreements and dominant position abuse.

In 9 months of 2011, control of 6 merger enterprises, 7 inspections regarding failure to observe prohibition against abuse of dominant position in retail, as well as 17 investigations of the most serious breaches of the *Competition Law* – prohibited agreements and abuse of dominant position – were carried out.

The *Competition Law* defines several situations, in which agreement between market participants is prohibited, because its purpose or consequences hinder, restrict, or distort the competition, including market sharing depending on territory, customers, suppliers, or other conditions. The Competition Council identified a breach of this particular norm in the activities of 5 providers of construction supervision and designing services (see Box 6.15).

**Box 6.15**

**CC penalises five construction supervision and designing enterprises for prohibited agreement**

On November 4, 2011, the CC adopted a decision identifying a prohibited agreement between five providers of construction supervision and designing services, which appeared in a form of information exchange and market sharing. JSC "VCI", LLC "Projekts 3", LLC "PRO VIA", LLC "Pk 19+93", and JSC "Ceļu inženieri" were imposed a fine for the total amount of LVL 23 320.

The abovementioned five enterprises established a general partnership "Latroad" at the beginning of 2010 for the purpose of carrying out joint commercial activities. However, the Memorandum of Association contained provisions violating allowed cooperation limits. For instance, the enterprises agreed that they will participate in procurements for design, project management, and construction supervision organized by the Ministry of Transport and nine largest Latvian cities and funded by the ERDF and the Cohesion Fund as a general partnership thus prohibiting the members to participate individually in the procurements without the consent of other members. Thus, the Memorandum of General Partnership basically provided market sharing and information exchange instead of allowed agreement on joint participation in implementation of a project.

During the investigation of this case, CC came to a conclusion that the members of "Latroad" have agreed on participation also in other public procurements in which they were not supposed to participate under the Memorandum of General Partnership, and some of the members have participated in procurements in which "Latroad" was supposed to participate.

One of the significant factors concluded in the investigation of the particular case by CC was that in general the members of "Latroad" could have participate individually in the procurements because applications of the procurement were submitted by the general partnership but the actual work was done by one or two of its members, and the rest of members participated only formally. Thus, the general partnership served as a platform of information exchange and market sharing for the enterprises, not as an opportunity to jointly participate in procurement, for which they alone are not able to qualify.

CC emphasizes that establishment of a general partnership itself is not a breach; it is a way for enterprises to jointly participate in procurement. Yet, the establishment of general partnership prohibits its members – mutually competing enterprises – to violate the *Competition Law*. Therefore, CC urges enterprises establishing general partnerships to take the responsibility for own actions and carefully consider conditions thereof to ensure compliance with principles of fair competition.

SIA "PRO VIA" has been imposed a fine in the amount of LVL 6602, AS "Ceļu inženieri" – a fine of LVL 5815, LLC "Pk 19+93" – a fine of LVL 3821, JSC "VCI" – a fine of LVL 2860, and LLC "Projekts 3" – a fine of LVL 4222.

The *Competition Law* stipulates that any market participant being in the dominant position is prohibited to abuse it in any way within the territory of Latvia. Abuse of the dominant position may be also direct or indirect enforcing or applying unfair purchase or sale price or other trade conditions. CC has received complaints of several electronic communication service providers regarding breach of this particular norm (see Box 6.16).

**Box 6.16**

**CC has dismissed a case against LLC "Lattelecom" due to lack of facts and points out shortcomings in implementation of digital terrestrial television project**

SIA "Lattelecom" is assigned to provide implementation of digital television broadcasting in Latvia by the end of 2013. In March 2010, CC brought an action based on applications of LLC "TV3 Latvia", "VIASAT AS Latvia", "Baltkom TV LLC", and LLC "IZZI", in which the enterprises expressed their concern that LLC "Lattelecom" applies excessively high prices to broadcasting of broadcaster channels which are available free of charge for the public, besides it uses the profit gained in such way (cross-subsidizes) to strengthen its position in pay-TV and other electronic communication services markets where it competes with other pay-TV operators).

On August 25, 2011, CC made a decision to dismiss the case. Having examined the currently available data, CC did not detect application of unfair prices, while data required for analysis of potential cross-subsidization will be available only after the end of 2013 when the date of implementation of digital terrestrial television project will expire. As, in compliance with the *Competition Law*, the period of case investigation may not exceed two years, CC made a decision to dismiss the case. Yet, in case the CC will have access to data on project implementation in a longer period that might indicate possible breaches, the institution may reinitiate the investigation.

During investigation of the violation case, CC made sure that no diligent planning of current costs was carried out before such resource-based project as implementation and provision of digital terrestrial television.

By imposing an obligation on LLC "Lattelecom" to provide free TV channel digital broadcasting to public and setting no regulation on formation of payment for broadcasting service television channels, in effect a situation was created when relevant market participants irrespective of the number thereof are forced to cover the costs of free broadcasting services to an unlimited amount.

The hasty time schedule of project implementation probably is the reason why the financial plan of LLC "Lattelecom" and forecasted costs of partners thereof were set rather approximately and lacked cost-amount-profit analysis to the required extent, depending on possible changes in some indicators and influence thereof on costs (for its turn, adjustments are made on a regular basis mainly directed to the rise in costs). Also, no requirement has been originally set for the project implementer to separate financial flow related to the project from other costs, thus facilitating control opportunities.

At the same time, CC points out that conditions and criteria for implementation and provision measures of digital terrestrial television project contained no cost minimisation and alignment of costs and prices, as well as a profit limit was defined, thus allowing a situation when broadcasters are subjected to unexpected costs which have negative influence on business activity of electronic mass media and planning thereof, besides endangering viability of the project.

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 CC.

The CC 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 competition, the CC adopts a decision permitting the merger. Two enterprises providing construction services received such CC permit to merge (see Box 6.17). However, in order to prevent negative consequences regarding the competition in the market, the CC may permit the merger, determining binding provisions for the relevant merger participants.

**Box 6.17**

**The CC permits a merger of LLC "ENERGO HOLDINGS" and LLC "LATVIJAS ENERGOCELTNIEKS"**

On October 13, 2011, the CC made a decision to permit a merger, as a result of which LLC "ENERGO HOLDINGS" will gain decisive influence over LLC "LATVIJAS ENERGOCELTNIEKS".

As a result of the transaction, a natural person having indirect decisive influence over LLC "ENERGO HOLDINGS" will gain indirect decisive influence also over LLC "LATVIJAS ENERGOCELTNIEKS".

CC made the decision permitting the merger because, having surveyed the particular market, CC concluded that such a merger will have no negative impact on competition in directly influenced construction market of residential and non-residential buildings, where both merger participants are operating. No damage will be caused also to competition in indirectly influenced markets – labour market of power supply system construction and telecommunication system construction in which LLC "LATVIJAS ENERGOCELTNIEKS" is operating and engineering construction market in which LLC "SKONTO BŪVE" – associated company of LLC "ENERGO HOLDINGS" – is operating.

As after the merger, these particular enterprises will be able to offer different mutually related construction services, the merger may result in improved competitiveness thereof and potential to provide their services outside Latvia.

At the same time, the ability of the merger participants to provide a wider range of related services will have no negative influence on sub-contractors because the particular enterprises are not able to simultaneously implement sufficient number of projects to overtake the market, besides, both large and small enterprises may participate in projects by involving larger sub-contractors as general contractors.

In this case, a merger report will be submitted upon CC's request because the requirement under the law to notify about the merger before its completion was infringed. CC has initiated a case of merger for violation of Section 15 of the *Competition Law*. At the same time, it should be noted that market participants should more carefully consider whether the merger complies with the criteria for notification under Section 15 of the *Competition Law* and consult with the CC if necessary.

**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 CC is a work focused 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, 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*.

CC recognizes the necessity to ensure legal environment for development of entrepreneurship, as well as to timely detect distortion of competition in the sectors affecting a wide range of consumers. Therefore, a wide range of market supervision activities is carried out for several years, allowing to obtain and analyse information about the competition situation in markets relevant for consumers, as well as to find solutions for improvements thereof. In 9 months of 2011, CC has completed 10 market supervision cases in such fields as fuel retail, sale of sugar, sale of fruits and vegetables, cooking oils, electrical installation materials, electricity and telecommunication wires and cables, professional activity of locksmiths, distribution of medicinal products etc.

Some supervision activities resulted in cases initiated due to violation of competition provisions. Dairy and bread market supervision carried out in daily consumption goods retail supermarkets within the framework of market supervision should be mentioned among the supervision activities that affects a wide range of consumers (see Box 6.18).

**Box 6.18**

**The Competition Council has summarized its conclusions about the dairy and bread market gained during the supervision**

Within the framework of wide daily consumption goods retail market supervision, CC has summarized conclusions about dynamics of dairy and bread market – price formation, competition situation, and market structure.

Information obtained during the supervision has enabled the institution to initiate four cases of violation in framework of which CC investigated whether the large retail chains have not abused their dominant position in retail concerning producers. Two of these cases contained violation; one of the two cases contained application of unfair discounts while the other one – of too long settlement periods. One case contained no prohibited actions, while another was dismissed due to lack of facts because the potential victim enterprise did not provide information necessary to investigate the case.

At the same time, the supervision carried out by the CC gives insight in development trends of the particular market.

The role of supermarkets has continued growing from 2008 to 2009 – over 75% of total food, beverages and tobacco retail volume are sold in supermarkets, besides, two companies – LLC "RIMI Latvia" and LLC "MAXIMA Latvija" take more than 60% of the supermarket chain market. At the same time in 2009, the total turnover of stores focusing on sale of food, beverages and tobacco has decreased by 17% in comparison with 2008. Such market situation increases the risk that producers being in dependent positions might suffer from abuse of supermarket dominant position in retail trade.

In autumn of 2010, Latvian producers/suppliers significantly increased prices for a range of food products, indicating rise in price for raw materials, packaging materials, energy resources and delivery costs as the main reasons for the increase. For example, producer price for dairy products increased by 10% to 17%, for oil – by 4% to 38%, for bread products – by 5% to 18%, for grain products – up to 155%, for juices – by 6% to 20%. In most cases, prices in stores have increased by the same percentage in comparison with the previous retail price. It means that retailers have increased the price not only according to the rise in purchase costs of the product but also applied the rise to other costs (sale-related) which are not affected by the rise in producer prices. Thus, the rise in price for goods in absolute values (in lats) in retail exceeded the rise in purchase costs, and traders benefited the most of it. Correspondingly, the competitive constraints were insufficient for traders to consider application of a lower mark-up.

At the same time, market supervision led to a conclusion that long-term price level substantially depends on efficiency of producers' work. Most milk processing enterprises have old equipment, and on average, 30-50% of production capacity is left unutilized and therefore the share of production costs (raw materials and other direct costs) in sold amount is considerably higher than in production of bread products. Besides, in 2009 it was tended to increase, for different enterprises reaching total 70-99% of turnover. Larger bread producers, for their turn, have managed to reduce the share of costs in turnover to 60-70% in 2009 by making the cost structure more efficient.

For example, examination of the price structure of white bread and rye-bread baked by three producers revealed that producer's share in the final price has exceeded the trader's share. The average producer's share (prime cost of the bread + profit) reached 50% to 70% for white bread and 50% to 80% for rye-bread while the trader's share (costs + profit) reached correspondingly 30% to 50% for white bread and 20% to 50% for rye bread.

Traders' action of not applying a lower price than a competitor has applied in cases when bread from the producer has been purchased at a lower price indicates insufficient competition. Also, the share of producers' profit and high amount of traders' gross profit indicate lack of competition at production and retail level despite the fact that bread is a product of intense circulation and may be sold at a lower price.

In order to promote information exchange among national competition supervising authorities within the European Union, in cases when the European Commission does not evaluate merger of market participants, however issue of a permit is required in several Member States, good practice guidelines have been approved for evaluation of cross-border mergers. The European Commission in cooperation with

European competition authorities has developed the abovementioned document to reduce difficulties caused by the requirement to notify several authorities about such merger. It identifies the evaluation stages requiring closer cooperation of supervising authorities and defines information to be exchanged between the authorities.

By decision of the Supreme Court Senate of October 4, 2011, the decision of the CC adopted on October 30, 2009, on imposing a fine on five traders of Samsung household appliances for a prohibited agreement has entered into full force. According to the decision of the Senate to refuse initiation of an appeal proceeding, the decision of the Administrative Regional Court of May 6, 2011, finding the decision of the CC legal and reasonable, may not be appealed. This is the first decision of the CC that has entered into full force after legal proceedings in which along with violations of the *Competition Law* of Latvia the decision also deals with violation of Article 101 of the *Treaty on the Functioning of the European Union* or prohibited agreement affecting cross-border trade.

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 CC home page (*http://www.kp.gov.lv/?object_id=522*) and the European Commission home page.

## 6.11. Regulation of Public Utilities

The Public Utilities Commission is a multi-sector regulator performing 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 interests of users, and fostering development of public utility providers, setting tariff calculation methodologies and approving tariffs in accordance with the laws of each sector, issuing licenses and registering electronic communications and mailing service entrepreneurs, promoting competition in the regulated sectors, settlement of disputes, and supervising 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 correspondingly in Daugavpils, Saldus, and Cēsis.

**Box 6.19**

**Amendments to the law *On Regulators of Public Utilities***

The amendments entered into force on August 11, 2011. According to the amendments, as of July 2012, the Commission will no longer carry out control of operation of energy supply enterprise objects and other energy supply objects and supervision of safety and operation conformity monitoring of hydrotechnical structures of hydroelectric power plants.

The amendments to the law stipulate that the Commission is institutionally and functionally independent, lawful, self-governing subject of public law and may independently use its budget under the law thus the requirement of *3rd package of the EU Energy Law* on independence of regulating authority was introduced in the legislation of Latvia.

According to the amendments to the law *On Regulators of Public Utilities* and the *Civil Procedure Law*, regulating norms of law regarding disputes arising out of public utilities rendering relationships and consideration thereof has been defined more precisely, particularly regulating the procedure for considering disputes arising out of public utilities rendering in the Commission. These amendments entered into force on September 30, 2011.

The law no longer defines the Commission as a compulsory preliminary out-of-court instance, thus allowing the parties involved in a dispute to choose on their own to assign examination of the dispute to the Commission or a court of general jurisdiction. The amendments to the Law prescribe a procedure for cases when a party involved in the dispute objects to the decision of the regulator in case of dispute consideration. In such case the involved party with the subject of the dispute may go to the court of general jurisdiction in accordance with the procedure specified in the *Civil Procedure Law*, and the court adjudicates such dispute on the merits, thus avoiding situation when a regulator's decision on dispute consideration is appealed in accordance with the procedure specified in the *Administrative Procedure Law*, and instead of repeated adjudication of the dispute on the merits, the regulator becomes the defendant in administrative procedure thus becoming the representative of interest of the other party to the dispute, who, on the other hand, participates in the administrative procedure only as a third party.

On July 14, 2011, the Saeima adopted amendments to the law *On Regulators of Public Utilities* introducing significant changes in the status of the Commission and procedure for assessing and publishing tariffs, defining the procedure for payment and use of state fee, imposing an obligation on a service provider to respond to user complaints and defining a precise procedure for voting in the council meetings (see Box 6.19).

**Situation and policies of the regulated sectors**

**Electricity (see also Chapter 6.3.)**

A significant role in power supply is played by the JSC "Latvenergo" generating more than 90% of power produced in Latvia and ensuring power supply, as well as delivery to users, who have not chosen another supplier. As from September 1, 2005, all functions of electricity transmission system operator are fully carried out by JSC "Augstsprieguma tīkls" fully owned by JSC "Latvenergo", but as from July 1, 2007, the functions of a distribution system operator are carried out by the JSC "Sadales tīkls" fully owned by the JSC "Latvenergo".

Electricity is also generated by 140 small hydropower stations, 30 wind power stations and 69 cogeneration power stations. About 30 other enterprises have received licences to distribute or sell electricity.

Latvian electricity market is fully open to competition from July 1, 2007, and since the second half of 2008, when the largest electricity users buy electric power at an agreed price, several electricity users have changed their power supplier.

Amendments to the *Electricity Market Law* and the *Energy Law* have been made in relation to introduction of requirements set in the *3rd package of the EU Energy Law* into the legislation of Latvia. The laws above envisage separating a transmission system operator, providing conditions for power exchange functioning, and simplifying enterprise licensing.

Amendments to the Regulations of the Cabinet of Ministers *Regulations regarding the Licensing of Public Utilities* are being developed in the second half of 2011 in connection to transition of electricity and heat energy producers and traders from licensing to registration as of January 1, 2012. On November 23, 2011, the Commission approved the *Regulations of General Authorisation* in energy sector setting specific requirements for production and trade of energy which are binding to all electricity and heat energy producers and traders, as well as the *Regulations Regarding Registration of Energy Producers and Traders* setting the requirements for registration of energy producers and traders, procedure for submission of notification on registration or termination of activity and forms of notifications, data to be included in enterprise registers, as well as the procedure for excluding an enterprise from register in case of breaching regulations of general authorisation in energy sector.

With respect to the conditions of the *Directive 2009/72/EC* of July 13, 2009, Latvia has chosen to implement the model 2 for unbundling an electricity transmission system operator which envisages setting up an independent system operator. As of April 1, 2011, JSC "Latvijas elektriskie tīkli" fully owned by JSC "Latvenergo" and owning transmission assets began its operation.

As JSC "Latvenergo" is the holder of both shares of the electricity system owner (JSC "Latvijas elektriskie tīkli") and shares of the distribution system operator (JSC "Sadales tīkls"), then, in order to comply with the requirements of the *Electricity Market Law*, it is necessary to alienate the shares of the transmission system operator JSC "Augstsprieguma tīkls", thus discontinuing participation of JSC "Latvenergo" in JSC "Augstsprieguma tīkls". Once shares of JSC "Augstsprieguma tīkls" are transferred to the ownership of the state, the Ministry of Finance is expected to be appointed the holder of state shares of JSC "Augstsprieguma tīkls".

**Gas supply**

Supply of natural gas in Latvia is ensured by a vertically-integrated enterprise JSC "Latvijas Gāze".

As of July 1, 2011, the excise duty was applied to natural gas used as fuel or petrol. According to the amendments to the *Law on Excise Duties* adopted on April 14, 2011, the excise tax rate for natural gas used as fuel was reduced from LVL 15.6 to LVL 12 per 1000 $m^3$. On April 14, 2011, amendments to the *Law on Value Added Tax* were also adopted envisaging application of the standard tax rate of 22% to natural gas supply as of July 1, 2011.

Amendments made on September 22, 2011 to the *Energy Law* stipulate that energy supply is a commercial activity to be performed in the energy sector which requires licensing or registration and includes the generation of electricity or heating energy, the purchase, conversion, storage, transmission, distribution, or trade of electricity, heating energy or natural gas. Hereby, service rendering in liquefied petroleum gas sector has been excluded from the types of regulated public utilities.

**Heating energy supply**

In accordance with amendments of June 11, 2009 to the *Law on Regulators of Public Utilities*, the Commission took over the regulatory functions in heat supply from local government regulators or local government councils (boards) by November 1, 2009. The amendments to the Regulations No 1227 *Regulations on Types of Regulated Public Utilities* of the Cabinet of Ministers of October 27, 2009 entered into force on March 19, 2011, and according to them, the heating energy production, transmission, distribution, and trade need to be regulated in the heat energy supply, if the total amount of delivered, transferred and distributed heating energy or amount of heating energy trade exceeds 5000 megawatt hours per year. 88 heat supply enterprises are providing public utilities in the heat supply sector.

Applying excise duty to natural gas as of July 1, 2011, raises the costs of heating energy supply enterprises and affects tariffs of heating energy supply. Such rise is being gradually included in tariffs of heating energy supply according to assessing procedure of the tariffs.

**Electronic communication and postal services**

394 enterprises were registered and actively operated in the sector of electronic communication as of November 24, 2011. In the postal sector, SJSC "Latvijas Pasts" provides general postal services, while 55 service providers operate actively in the sector of express mail.

On August 10, 2011, the Commission adopted a decision on setting maximum limits of interconnection tariffs or the so-called tariff cap envisaging application of common interconnection tariffs to fixed networks as of March 2012. The Commission has also decided that the maximum limit of terminating connection (excluding value added tax) will be LVL 0.0054 per call and LVL 0.005 per call minute; however, the tariff mentioned by LLC "Lattelecom" will be applied as of January 1, 2012. The common interconnection tariff for fixed networks has been calculated based on costs of efficient service rendering and comparison to average EU tariffs.

Taking into account that since 2009, LLC "Lattelecom" is the only fixed network operator who has been subject to these obligations imposed by the Commission, while interconnection tariffs applied by other fixed electronic service providers were not regulated at all, a range of enterprises took advantage of their power in the market and refused to reduce the interconnection tariff and some of them even increased the tariff. Therefore, the Public Utilities Commission has set a tariff cap defining the maximum value of interconnection tariff but providing no minimum value. Thus equal competition is ensured to all market participants developing also the electronic communication market.

Decisions of the Commission are related to EU recommendations and the objective to implement symmetrical tariffs of terminating the connection both in fixed and mobile networks by December 31, 2012.

**Railway**

In the railway sector, JSC "Latvijas Dzelzceļš" ensures maintenance of the public railway infrastructure. Domestic passenger transportation is carried out by JSC "Pasažieru vilciens" and LLC "Gulbenes-Alūksnes bānītis". In the sector of cargo transportation, there are also several operators, such as LLC "LDz Cargo", JSC "Baltijas ekspresis", and JSC "Baltijas tranzīta serviss". LLC "LDz Cargo" carries out also international passenger transportation.

On September 23, 2010, the amendments to the *Railway Law* entered into force, according to which from January 1, 2011, the company performing main functions of manager of public railway infrastructure JSC "LatRailNet" sets a charge for using the public railway infrastructure, while the Commission considers complaints on conformity of the charge for using the public railway infrastructure to the methodology, as well as complaints on the application of increased charge for using the public railway infrastructure and allowances thereof. The amendments stipulate that the Commission is the body responsible for the enforcement of the ***Regulation (EC) No 1371/2007*** **of the European Parliament and of the Council of 23 October, 2007 on rail passengers' rights and obligations** mentioned in Article 30 of this Regulation, **as well as that the Commission performs market supervision functions in railway passenger traffic sector**.

On June 16, 2011, the Commission approved the *Procedure for Applying the Charge for Using the Public Railway Infrastructure* and the *Procedure for Payments of the Charge for Using the Public Railway Infrastructure*. On September 21, 2011, the Commission approved the new edition of the *Methodology for Calculating the Charge for Using the Public Railway Infrastructure for Traffic*. The *Procedure for Applying the Charge for Using the Public Railway Infrastructure* and the *Procedure for Payments of the Charge for Using the Public Railway Infrastructure* were also defined precisely in relation to changes in the Methodology.

**Water supply and sewerage, waste management and disposal**

In accordance with amendments of June 11, 2009, to the *Law on Regulators of Public Utilities*, the Commission took over the regulatory functions in the sectors of heat supply, municipal waste management and water management from local government regulators or local government councils (boards) before November 1, 2009.

A total of around 164 enterprises have been licensed in the water management sector and 10 enterprises – in the waste disposal sector.

In the second half of 2011, the Commission issued 8 licences, amended licence conditions in 11 licences (mainly in relation to change of licence validity area) and annulled 4 licences in the water management sector. No licence was issued, amended or annulled in the waste disposal sector.

In the second half of 2011, the Commission approved water management service tariffs of 10 enterprises and municipal waste disposal service tariffs of 3 enterprises.

# 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;
– access to support instruments;
– contractual security.

Particular measures in these directions of action are implemented in compliance with 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* that envisages 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 institutions.

The *Coordination Council for Large and Strategically Important Investment Projects established in 2010* ensures harmonized interagency cooperation for successful implementation of investment projects; the Council is composed of the Ministers for Economics, Traffic, Finance, Foreign Affairs, Environment, Agriculture, Regional Development and Local Governments, Education and Science, as well as involved representatives from state and municipal institutions, infrastructural enterprises, non-governmental organizations and other experts.

The Council has held 7 meetings within 11 months of 2011. The Council meetings deal with issues of investment attraction strategy and activities to be carried out; problematic issues that hinder investment project progress have been identified, for example, improvement of electricity connection and its quality in industrial area, 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 present tax stimuli, at the beginning of 2012, in order to promote making of investments and develop business-friendly environment in Latvia, the Cabinet of Ministers plans to approve a new support programme co-financed by the EU Structural Funds for creation of new workplace projects aimed at increasing the number of well-paid jobs and growth of added value and export. But since the 4$^{th}$ quarter of 2011, entrepreneurs, as well as investors have an opportunity to apply for co-funding in the framework of the EU Structural Funds programme *High Added Value Investments* for making investments.

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. In 9 months of 2011, 1293 consultations on export-related issues including foreign markets, specific trade requirements and search for business partners have been provided, 13 export skills and informative seminars about external markets have been organized, as well as 27 sectoral market reports have been prepared. Also 21 trade missions (the number of entrepreneurs – 169) and 44 individual business visits at potential cooperation partners abroad have been organized. Identification and fostering of export and investment projects is carried out as well.

In 2011, the available state support has been broadened and the Investment and Development Agency of Latvia has arranged national stands of Latvian enterprises in 9 international sectoral exhibitions abroad in fields of engineering industry and metal processing, food industry, wood processing, publishing, textile industry, construction, interior and design by attracting the funding of the EU Structural Funds.

Essential contribution to the export promotion of Latvian merchants and attraction of foreign investments is rendered by Foreign Economic Representative Offices of Latvia located in Germany, Great Britain, Sweden, France, Russia, the Netherlands, Denmark, Norway, Japan, and Poland. In June 2011, the Foreign Economic Representative Office of Latvia was opened in Lithuania and in November 2011 – in Ukraine. Thus, in November 2011, there are 12 actively operating Foreign Economic Representative Offices of Latvia abroad.

The representations support Latvian commercial companies in developing and maintaining business contacts, as well as in implementing external marketing measures and provides information about requirements of particular foreign markets. Services of the Foreign Economic Representative Offices of Latvia and IDAL are provided to the merchants 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.* In 9 months of 2011, the Representative Offices have organized 37 individual business visits of entrepreneurs, supported participation of enterprises in 15 international exhibitions abroad, as well as provided 736 consultations about foreign markets and search for business partners, processed 369 export requests/projects in fields of construction, metal processing, wood processing, publishing, textile industry, food industry, etc. 122 consultations provided/information applications processed in the field of foreign investment attraction.

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 until November 28, 2011, 700 contracts for the total amount of LVL 4.6 million have been concluded.

**Box 6.20**

***Export and Innovation Award 2011***

Already for seventh year, the Ministry of Economics in cooperation with IDAL organize the competition *Export and Innovation Award* evaluating the most successful merchants and their products in the following categories:

– Best exporter in large/medium commercial companies group;
– Best exporter in small commercial companies group;
– Import substitute product;
– Innovative product;
– Industrial design.

The title *Leading Exporter* is defined by evaluating the largest Latvian exporters based on data and contribution to provision of sustainable growth.

This year, 106 applications were submitted for participation in the competition *Export and Innovation Award 2011*, most of them – 31 applications – were for award category *Innovative product.*

The winners of the *Export and Innovation Award 2011* are:

– category *Best exporter in large/medium commercial companies group*:
  1. *CEMEX, LLC* (Portland cement CEM I 42.5 N, CEM I 42.5 R, CEM I 52.5 N; composite Portland cement CEM II AM (S-L) 42.5 N);
  2. *Dobeles dzirnavnieks, JSC* (flour and other food products, animal feed, bran);
  3. *Severstaļlat, JSC* (various types of steel products);

– category *Best exporter in small commercial companies group:*
  1. *AmberCRO, LLC* (clinical research on medicaments, medicines, and other products);
  2. *PAA, LLC* (baths, sinks, and shower pans);
  3. *Latlaft Norge, LCC* (handmade wooden log cabins);

– category *Innovative product*:
  1. *Grandeg, LLC* (granule heating boiler GD TURBO);
  2. *BF-esse, LLC* (food supplement "Fitesten");
  3. *Rišon Inter, LLC* (passenger platform of glass fiber composite);

– category *Import substitute product*:
  1. *Karšu izdevniecība Jāņa sēta, LLC* (JS GPS Tracking system);
  2. *NP Foods, LLC* (AS „Laima" candy products);
  3. *ROTONS, LLC* (thermo-insulated water gauge wells);

– category *Industrial design*:
  1. *Computer Hardware Design, LLC* (CHD electronic cash register);
  2. *Ameri, LLC* (school uniforms; collection "Ameri by Leikis");
  3. *Dizaina papīrlietas, LLC* (candlestick "Signs of Light", collection of diaries "fLUXbook").

The *Leading Exporter* in 2011 is *JSC "Valmieras stikla šķiedra"*.

In order to increase the total export volume of enterprises (especially to countries with 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 in more detail in Section 6.7 of the Report.

## 6.13. Protection of Consumer Rights and Market Surveillance

The consumer rights protection system in Latvia is in a constant process of becoming stronger and more developed in order to ensure efficient market surveillance and consumer rights protection.

**Supervision of Consumer Rights**

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, the activity of which is 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 consumer 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.

In the 10 months of 2011, the CRPC, within the framework of its operation, has rendered 29310 consultations to consumers and legal entities. 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.

In the 10 months of 2011, the **CRPC has received 1795 consumer complaints and applications**. A decrease by 13% is observed in the number of submitted complaints in comparison with the corresponding period of 2010; that might be explained with the improved awareness of consumers and entrepreneurs about consumer rights, as well as reducing economic activity of the population. Most often, consumers have made complaints concerning services incompliant with contract provisions, purchased goods incompliant with contract provisions, and failure to observe the principle of legal equality of the contracting parties. Out of all complaints received about goods, the majority has been about footwear, electric appliances, and mobile phones. In the field of services, the majority of complaints have been about aviation, electronic communications, rent, and public utilities services. Consumer crediting-related issues are still topical. Also in 2011, the most complaints concerning failure to observe the principle of legal equality were received in relation to consumer crediting contracts and action of creditors. The dynamics of submitted complaints content have not significantly changed over past few years.

CRPC **for supervision of consumer rights** in 2011 has set such **priority areas** as protection of collective interests of consumers, supervision of consumer crediting contracts, supervision of electronic communication service contracts, supervision of security guarantees issued by complex tourism service providers to consumers, as well as considering amendments to the legal framework, launch licensing of creditors non-compliant with the status of a credit institution.

Since November 1, 2011, only capital companies having received a special permit (licence) for consumer crediting services are allowed to provide crediting services to consumers. By November 1, 2011, the CRPC as the responsible institution for licensing and supervision of consumer creditors has received 42 licence applications and issued 17 licences. The state duty for the issue of a licence is LVL 50000, and the state duty for extending the validity of licence – LVL 10000.

In the field of protection of collective interests of consumers and contract supervision, implementation of the project *Supervision of Contract Provisions and Commercial Practice / Advertisement in the Field of Electronic Services* has been launched in 2011, and within the framework of the project, contract provisions of 10 largest electronic service providers are currently being evaluated and/or draft contracts are being harmonized, as well as commercial practice is being evaluated in the field of electronic communication services (Internet, television, telephony, mobile communication, and other services). Within the field mentioned above, implementation of the project *Supervision of Contract Provisions and Security Guaranty of Money Paid by a Client in the Field of Complex Tourism Services* is launched by carrying out inspections at places where tourism services are rendered.

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 aviation services that constitute almost 40% of the total number of received complaints and rendered consultations, as well as questions about goods or services purchased remotely (ordering on Internet or choosing from a catalogue).

In 2011, the CRPC in the field of **market surveillance** has identified such priority directions as safety of toys and children's products, safety level of playgrounds, safety, and conformity to the set provisions for machines, electric appliances, personal protective equipments, conformity of transportable pressure equipment and construction products to the set requirements, surveillance of dangerous equipment at the place of its use (control of rope tows (lifts) intended for skiers).

The following surveillance projects have been launched and implemented in 2011:

- market surveillance of transportable pressure equipment;
- market surveillance of LED (light emitting diodes) modules and products;
- market surveillance of toys – children's books and board games;
- surveillance of children's products;
- surveillance of rope tows (ski lifts) intended for skiers.

The surveillance project of rope tows (ski lifts) intended for skiers implemented by the CRPC, as well as the CRPC activities regarding market surveillance of toys – children's books and board games have received wide public response and interest of entrepreneurs regarding their liability.

In the field of **state metrological supervision,** the CRPC has carried out inspections for evaluating conformity of measurement equipment to the normative requirements at the place of use in 2011. 3892 measurement equipment (including non-automatic scales at trading enterprises, fuel filling equipment) were subjected to metrological monitoring in 253 manufacturing, trading, and service rendering enterprises. The control measures of pre-packed goods included in the CRPC action plan are being implemented by carrying out control of content amount and conformity of labelling of pre-packed goods intended for distribution at manufacturing and wholesale enterprises, including priority product group – juices and other non-alcoholic beverages.

**Improvement of the Legal Framework**

On July 8, 2011, the Saeima approved the *Amendment to the Law on Procedures for the Coming into Force of the Commercial Law* thus continuing improvement of the non-banking market sector of consumer crediting. The given amendments set the requirement for minimum equity capital to be paid in the amount of LVL 300000 for a capital company which provides crediting services to the consumer and which pursuant to Section 8 ($1^1$) of the *Consumer Rights Protection Law* should receive the licence for provision of such service after November 1, 2011. Determination of minimum equity capital to be paid will promote long-term development of stable non-bank crediting market that the consumers can rely on protecting them from creditors with short-term operation goals, from deteriorating solvency of creditors that may result in debt recovery from the clients, and also would ensure compliance with laws and regulations regarding consumer crediting and data protection, as well as foster provision of qualitative services to consumers.

In 2011 the legal framework of out-of-court recovery (*Draft Law on Debt Recovery)* was under development to ensure fair, proportionate 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, 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 the debt recovery process. On November 8, 2011, the draft law was approved in the Cabinet of Ministers and submitted for further consideration to the Saeima.

On November 17, 2011, two draft laws – amendments to the *Advertising Law* and the *Unfair Commercial Practice Prohibition Law* – were submitted for interinstitutional consideration aimed at making the surveillance system of consumer rights and economic interest protection more efficient in order to reduce the influence of unfair commercial practice and advertising on consumers and economic operators, as well as to reduce the risk of restricting the choice for consumers to make economically reasonable and informed decisions in relation to purchases. Both draft laws envisage to optimize and to improve the work of supervising institutions by defining precisely the institutions' rights and obligations related to assessment of commercial practice and advertising conformity to the requirements of laws and regulations. Based on the existing surveillance experience, the draft laws stipulate that further the supervising institution will supervise the commercial practice and advertising in accordance with the surveillance priorities set by the institution, by assessing the influence of potential violation on collective interests of consumers. In case the supervising institution has received a complaint on potential violations of the law, the reported violation will be assessed and information will be used in planning further activities, thus focusing resources of the institution on the most important matters. The draft laws specify the cooperation mechanism between the supervising institution and entrepreneurs thus fostering voluntary work, stipulating new provisions for voluntary prevention of violations, and ensuring no further violations and elimination of consequences thereof, for example, by reimbursing the damage incurred to consumers.

Upon evaluating the practice of law application, it was concluded that the present framework in force is not effective enough to encourage violators to abstain from or terminate prohibited commercial practice because sometimes it is more beneficial to pay the imposed fine than fulfil the decisions of the supervising institution. In order to deal with this situation, the Ministry of Economics has incorporated into the draft law several additional coercive measures both in a form of a fine to be imposed depending on the severity of the violation, as well as taking into account the cooperation of the entrepreneur with the supervising institution and steps taken to eliminate the damage incurred to consumers. In case of material violations when the decision made by the supervising institution has not been fulfilled, institutions are authorized to temporarily terminate the economic activity of such entrepreneurs. During the elaboration process both draft laws were highly supported by organizations of consumer interest protection.

On October 25, 2011, the ***Directive 2011/83/EU of the European Parliament and of the Council*** **on consumer rights** was approved aimed at ensuring equal level of consumer rights protection in all EU Member States, as well as promoting development of the EU internal market. As soon as the Directive comes into force, all 27 EU Member States will be subject to common consumer rights in relation to signing distance contracts or off-premises contracts, at the same time giving more opportunities to entrepreneurs providing goods or services in the EU market as they no longer will be required to conform to different requirements for consumer rights protection of the EU Member States. The Directive specifies the information to be included in a distance contract (for example, contracts signed on Internet or via TV, or catalogue) and an off-premises contract (contracts signed during a trader's presentation at the consumer's home), as well as the information to be provided by the consumer prior to signing such contracts. Whenever such contracts are signed, a single 14-days withdrawal period is applied to all EU Member States during which the consumer has the right of withdrawal without specific reason.

The Directive also sets certain requirements for contracts signed in the premises of a company, for example, when goods are considered to be delivered, as well as delivery terms. In addition to the abovementioned, the Directive ensures more transparent prices by prohibiting hidden payments, use of previously marked boxes or so-called "marks", as well as prohibiting any additional charges for the use of credit cards and special phone lines and ensures a more detailed regulation of consumer rights protection in the field of digital item purchases. Requirements of the Directive are to be implemented in Latvia by the end of 2013.

In the second half of 2011, discussions were continued on the proposal for the *Directive of the European Parliament and of the Council on consumer credit agreement relating to immovable property* creating an EU level legal framework regarding credits granted to consumers and secured by a mortgage on immovable property or intended for the purchase of immovable property. 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 the 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 given service providers. An agreement on the draft project with the European Council is expected to be achieved by the end of 2011 prior to launching discussions on comments of the European Parliament at the beginning of 2012.

## 6.14. Quality Assurance

### 6.14.1. Quality Structural Policy

The main task in the field of quality assurance is to promote adequate application and observance of requirements 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 system in Latvia is regulated by the *Law on Conformity Assessment*, the *Standardisation Law*, as well as the *Law on Uniformity of Measurements* and other related laws and regulations.

The main policy directions are as follows:

– maintenance and improvement of the conformity assessment infrastructure (including testing and calibration laboratories, inspection and certification institutions, environmental verifiers) in accordance 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 protect the society from inaccurately performed measurements;
- encouraging introduction of environmental quality management and other voluntary quality systems in enterprises in order to ensure manufacturing of high-quality production, service rendering, and competitiveness of Latvian merchants in international markets;
- promotion of effective 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, 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 LLC "Standardization, Accreditation, and Metrology Centre" as 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 in 2011 was 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 November 1, 2011, 34878 standardization documents have been registered in the LVS, including 29181 European standards adapted to the status of a Latvian standard. In 10 months of 2011, 50 standardization technical committees and 4 working groups coordinated by the LVS have adapted 1206 European standards, and 26 mandatory applicable standards have been translated into Latvian. Standardization information services have been provided to 2900 legal and natural persons.

Continuing the improvement of the electronic sales system of standards, more than 49% 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 Status and Cancelled Latvian Standards in fields that interest clients for* 530 regular clients.

In order to link legislation with standards and to facilitate information searching, 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*.

Within the promotional programme of entrepreneurship and knowledge-based economy, the LVS continues developing technical infrastructure to provide convenient access to standardization information to enterprises and to promote broader application of European and international standards in entrepreneurship.

**Accreditation**

The Latvian National Accreditation Bureau (LNAB), which is a structural unit of LLC "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. Increasing number of new institutions want to prove their competence by accreditation. Many of the institutions are extending their field of activities. At the moment, the status of accreditation is maintained for 214 accredited institutions. New accreditations have been awarded to laboratories for calibrating and testing explosive gas equipment, medical laboratories, inspecting authorities for inspection of tachographs and speed-limiting devices and dangerous equipment and certification of forest management. The conformity of one institution is maintained in compliance with the *Principles of Good Laboratory Practice*. LNAB continues providing accreditation services in Ukraine, where one institution for personnel certification has been accredited.

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, meetings of the *Multilateral Recognition Agreement* Committee and General Assemblies.

In the framework of international cooperation, collaboration is maintained with accreditation institutions of Belarus, Ukraine, and Uzbekistan. Additionally, cooperation with the accreditation institution of Georgia has been launched 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 for conformity evaluation institutions are organized.

**Metrology**

Since July 1, 2009, the Metrology Bureau of LLC "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*.

The National measurement standards are calibrated and standard maintaining procedures are fulfilled according to the schedule in the national metrology institutes of the European Union (NMI).

Calibration of the standard load of 500 kg mass was carried out in the Czech NMI. Having calibrated the standard load, the LATMB carried out post-calibration works, stability and drift control of the calibration results and update of uncertainty budget. In July 2011, the standard load of 10 kg mass was calibrated at the Danish NMI. In November, calibration of standard length of 1 m, a set of end-measurements and glass scale was carried out at the Finnish NMI. Stability analysis and drift assessment of national electric measurements and length standards were carried out over a period of the calibration. 7 reliability validation procedures for calibration results have been fulfilled in the field of CMC (Calibration and Measurement Capabilities).

During 2011, conformity of 25 measurement equipment types was evaluated by certifying them, including re-evaluated conformity of measurement equipment types and extended certificates for 17 types. The list of approved types available on the website of the Metrology Bureau is updated on a regular basis. A list of standards applicable to technical and metrological requirements for vehicle speed control systems has been developed and prepared for publishing. 23 consultations on regulated metrology issues have been provided, among them 4 to foreign enterprises. The German enterprise *BARTEC Benke GmbH* received explanations regarding implementation of requirements in Latvia set in the *Directive 2004/22/EC*.

The annual quality management system report of the 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 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 2011, the LATMB continues cooperation with the EURAMET, as well as the International Organization of Legal Metrology (OIML) and the European cooperation in legal metrology (WELMEC). The LATMB has analysed the materials of the EURAMET conference of April 2011 about the International Mutual Recognition Arrangement (CIPM MRA) and proposals on new terms and definitions considered therein. The LATMB personnel have become acquainted with the decisions of the WELMEC 27$^{th}$ Committee Meeting (May 2011) and with the supplements to the documents of WG series discussed in the meeting.

Cooperation with metrology institutions of Lithuania – the national metrology institution (NMI) VMT and the Institute of Metrology of Kaunas University of Technology – has been expanded. Issues of regulated metrology in terms of approval of measurement equipment types, application of harmonised standards, and development of measurement equipment testing programmes were discussed during the business visits.

Cooperation with Latvian metrology institutions still continues. 74 reference standards, as well as 3 mass comparators of LLC "National Metrology Bureau of Latvia" have been calibrated.

## 6.15. Privatisation

The goal of privatisation 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 Latvian national economy development and to narrow the activity performed by the state and local governments in capacity of entrepreneurs.

As the goal of mass privatisation in Latvia is principally achieved, the *Law on the Completion of Privatisation of State and Local Government Property and Use of Privatisation Certificates (Law on the Completion of Privatisation*) came into force on September 1, 2005, prescribing the procedure of completing the privatisation process and land reform and ensuring completion of the use of privatisation certificates (see Box 6.21).

**Box 6.21**

***Law on the Completion of Privatisation of State and Local Government Property and Use of Privatisation Certificates***

The *Law on the Completion of Privatisation* prescribes:
- the deadline, August 31, 2006, by which any legal or natural person could propose to bring any state or local government property to privatisation;
- the procedure, by which a privatisation proposal submitted by a person is reviewed, and a decision on bringing the state or local government property to privatisation is adopted;
- that privatisation 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 could adopt decisions regarding the bringing a state or local government property to privatisation by December 30, 2010;
- that decisions on bringing the state or local government property involved in dispute regarding property rights to privatisation 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””, “Latvian Railway”, “Latvijas gaisa satiksme” and “Latvijas valsts meži” are not subjected to privatisation 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 privatisation certificates before conclusion of the land redemption contract has to be submitted to the State Land Service (September 1, 2008), as well as for the application for decision with respect to 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 privatisation certificates do not have an expiry term, but may be only used within the framework of the privatisation process;
- the procedure for completion of the issuance of privatisation certificates. The final deadline by which persons could submit an application for granting privatisation certificates was December 28, 2007.

In order to ensure successful and open progress of privatisation completion processes, the Cabinet of Ministers has set the procedure on how the institutions implementing privatisation and land reform have to establish publicly available registers of privatisation proposals and land property buy-outs.

**Privatisation of state property and land**

Privatisation of state property or land is carried out and privatisation proposals are summed up by the state joint stock company Latvian Privatisation Agency under the *Law on Privatisation of State and Local Government Property.*

A decision to bring a state property object, including capital shares and vacant land to privatisation 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 privatisation is taken by the Latvian Privatisation Agency. The decision is made on the basis of a privatisation proposal submitted by any natural or legal person.

From September 1, 2005, when the *Law on the Completion of Privatisation* came into force, until October 31, 2011, 628 proposals for privatisation of real estate, 57 proposals for privatisation of state capital shares and 4343 proposals for privatisation or privatisation continuation of land have been registered in the Register of Privatisation Proposals of the Latvian Privatisation Agency. After August 31, 2006, those privatisation proposals were registered in the Register of Privatisation Proposals, which were submitted by mistake to other state and local government institutions up to that date and later according to the competence were transferred to the Latvian Privatisation Agency. A natural or legal person eligible to acquire movable or real property in Latvia can be the subject of privatisation of state-owned property (real estate, capital shares, land). Payments for the property objects have to be made in lats and/or privatisation certificates.

From April 17, 1994 until October 31, 2011, the privatisation provisions in compliance with the statutory procedure have been approved for 2485 state property objects (excluding land). 94 companies were transformed to public joint stock companies, thus releasing 439.14 million shares into public circulation. During this period, income obtained from privatisation 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 1.665 billion, of which LVL 398.778 million was in cash and LVL 1.266 billion in nominal values was for privatisation certificates. New owners took over obligations of privatised 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 Privatisation Agency carries out privatisation of state-owned land since 1997. By October 31, 2011, 5011 state land lots were privatised (purchase agreements signed). The total sales price for the privatised state land constitutes LVL 199.4 million, of which LVL 96.1 million was in cash and LVL 103.3 million in property compensation certificates. On October 31, 2011, income from privatisation of these land lots amounted to LVL 184.77 million

**Privatisation of local government property objects and land**

A decision concerning privatisation of local government real estate is made by the municipality (city) council. The decision is made on the basis of a privatisation 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 privatisation can be the subject of privatisation 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 and/or privatisation certificates.

Privatisation of local government property in the municipality area is ensured by the property privatisation commission of the respective municipality (city, district).

Compliance of privatisation projects, regulations, and announcements approved by a municipality with the provisions of the *Law on Privatisation of State and Local Government Property* and the *Law on the Completion of Privatisation* is ensured by the Ministry of Economics.

From February 17, 1994 until October 31, 2011, the Ministry of Economics has reviewed and accepted for information 3296 privatisation projects for the total estimated price of LVL 159.2 million (*inter alia* payments in certificates for the nominal value of LVL 58.2 million).

From January 1, 1997 until October 31, 2011, the Ministry of Economics has reviewed and accepted privatisation provisions in respect to 1671 building land lots and vacant local government land lots (separate announcements of privatisation of building land lots – as from September 1, 2005) with 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).

Article 41(2) of the *Law on Privatisation of State and Local Government Property Objects* imposes an obligation that the municipality council submits a decision on approval of a privatisation project of a local government property object, and the approved privatisation project to the Ministry of Economics. The submission of a decision on approval of provisions (an announcement) regarding privatisation 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 Privatisation*, after August 31, 2006, the local governments on a quarterly basis must provide the Ministry of Economics with data regarding the received privatisation proposals for local government property objects and building land and vacant land, decisions on bringing these property objects and land to privatisation, the sale price and the amount of privatisation certificates to be used for payment.

**Privatisation process of residential houses**

Privatisation of residential houses in Latvia was initiated in 1995. It was implemented by the Central Privatisation 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 Privatisation Agency), as well as by the local government residential building privatisation commissions in compliance with the procedure stipulated by the *Law on Privatisation of State and Local Government Residential Houses*.

On October 31, 2011, 522 residential buildings with 987 non-privatised state apartment properties and 967 non-privatised state apartment properties placed in residential buildings that are handed over to management of 380 apartment owners were in the possession of the Privatisation Agency.

**The privatisation process of the state residential houses** – by October 31, 2011, decisions on bringing 5108 residential houses to the privatisation have been made. The Board of the Latvian Privatisation Agency has to make a decision on bringing to privatisation another 96 state residential houses being in possession of the Agency. By October 31, 2011, privatisation announcements have been sent to 50 126 state apartment tenants. 44277 state apartments have been privatised by October 31, 2011, and 49 apartments have been privatised in 2011.

**The privatisation process of local government residential houses** – data on the privatisation process of local government residential houses 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 Privatisation Agency does not reflect the actual situation.

By October 31, 2011, 3874 state residential houses were transferred to the **possession of apartment owners**. 25 state residential houses have been transferred to the possession of apartment owners in 2011.

**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 privatisation (alienation) of land owned by the state or local government. Redemption (purchase) of land allocated for permanent use and restoration of ownership rights are carried out with regard to the rural and urban land reform being implemented in the country.

In cities, allocation of land for the use to residential building owners or orchard users, who have received the land for setting up an orchard with building rights, has been completed. The city land commissions have reviewed opinions concerning the rights to acquire land ownership for payment. In accordance with the Regulations of the Cabinet of Ministers of August 25, 2008, *Procedure on the Conclusion of Land Redemption (Purchase) Agreement* the Mortgage Bank by November 30, 2011, has concluded 73024 agreements.

*Amendments to the Law on Completion of State and Local Government Property Privatisation and Utilisation of Privatisation Certificates* came into force on June 1, 2011, envisaging that those redeemers of rural and urban lands who have not managed to conclude a land redemption (purchase) agreement with the Mortgage Bank of Latvia will be able to do that until December 30, 2011.

The amendments to the *Law on Completion of Privatisation* envisage that those owners of residential buildings and orchard users in towns, who had submitted a land boundary plan with an application for decision-making regarding the allocation of land property for payment and had received the decision by August 31, 2009, can conclude a land redemption (purchase) agreement with the Mortgage and Land Bank of Latvia until December 30, 2011.

According to the amendments to the *Law on Completion of Privatisation*, city land commissions on June 1, 2011 resumed 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.

Allocation of land for use has been completed in rural areas, however, the decision-making process is still in progress regarding the termination of rights to use land and conclusion of land rent agreements with persons.

By December 30, 2010, about 6530 persons have failed to pay for the land and to conclude an agreement with the Mortgage and Land Bank of Latvia on 9860 land units requested for redemption in rural areas, however, almost 670 persons having made the pre-payment have failed to submit the application for a decision on allocation of the cadastral-surveyed land to the State Land Service.

According to the amendments to the *Law on Completion of Privatisation,* persons may 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 privatisation 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, correspondingly 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.

Allocation of land in rural areas for payment, as well as conclusion of redemption (purchase) agreements with the Mortgage Bank was resumed on June 1, 2011.

By December 30, 2011, all those land redeemers having received a decision on allocation of land for payment before making the amendments to the *Law on Completion of Privatisation* of June 1, 2011, were also entitled to conclude the land redemption agreement with the Mortgage Bank. According to the information available to the State Land Service, only 9 % of 6530 land redemption (purchase) agreements were concluded with the Mortgage Bank within the time period from June 1, 2011 until November 2011.

If a land redemption (purchase) agreement with the Mortgage Bank is not concluded before the prolonged term in the *Law on Completion of Privatisation* – until December 30, 2011, both urban and rural land redeemer loses the opportunity to redeem the land at its cadastral value, as well as loses the pre-payment already made with privatisation certificates before the cadastral survey.

With the abovementioned amendments, the term was prolonged until March 31, 2012, by which the Mortgage Bank of Latvia will provide the State Land Service and the corresponding city municipalities with information on the concluded land redemption (purchase) agreements.

Article 16(1) of the *Law On Completion of Land Reform in Rural Areas* envisaged that 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 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 No 1030 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 local governments examine 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 at 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 performance of 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 commenced the purchase (concluded an accessory contract) of real estate left in Latvia by German emigrants from the General Agricultural 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 land reform are constituted by 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 per cent.

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 SLS regional branches, as well as a state level commission for the completion of land reform has been established in the central structure of SLS. The commissions established by 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 land reform established by the State Land Service has examined claims of the 90 first priority claimers.

Examination of claims of the fist priority claimers in commissions for completion of land reform of local government and regional level, as well as in state level was completed in January 2011.

After receiving the CLC statement on restoration of ownership rights, the first priority claimers carries out cadastral survey of land units. After the cadastral survey the CLC makes decisions on restoration of ownership rights, and the claimer thereby obtains rights to enter the property in the Land Register.

On 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 will be offered an opportunity to select land units at state level in all 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 Ludza region, Valka region, Cēsis region, Preiļi region, and Balvi region. Boundary schemes were selected and signed for a total of 37 land units in an area of 155.5 ha. 30% of second priority claimers refused to select 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, correspondingly 36% in Latgale, 20% in Zemgale, 19% in Vidzeme, 16% in Kurzeme, and 9% in Riga. Zemgale and Tukums local government and regional level commissions for completion of land reform examined claims of the third priority claimers by December 2011. Land units for a total area of 41.52 ha were selected in the territory of former Bauska district, while 39.1 ha were selected in the territory of former Dobele district and 76 ha – in the territory of former Jelgava district. The third priority claimers have selected land units for a total area of 104 ha in the territory of former Tukums district.

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, the third priority claimers will be offered an opportunity to select land units in all territory of Latvia. Examination of claims of the third priority claimers at local government and regional level are expected to be completed at the beginning of 2012. Thus, the state level commission for the completion of land reform of the State Land Service plans to start working in the spring 2012.

According to the *Law on Completion of Land Reform in Rural Areas*, the CLC must complete the restoration of ownership rights by December 30, 2012.

**Privatisation certificates**

A privatisation 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 privatised.

Privatisation certificates are issued and used according to the *Law on Privatisation Certificates*. By October 31, 2011, a total of 104.4 million privatisation certificates have been issued to 2.45 million people for the time they have lived in Latvia, including 794.7 thousand privatisation 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 privatised specialized state agricultural enterprises, 4896.4 thousand for land in rural areas, 969.3 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.

In 2011 by October 31, 499.62 property compensation certificates have been issued to 4 former owners or their heirs.

As from December 1, 2007, in accordance with Article 27 of the *Law on Completion of Privatisation*, 58 thousand persons have lost their rights to transfer 1.64 million privatisation certificates to their accounts.

Table 6.6

**Use of Privatisation Certificates**

(until October 31, 2011)

| Type of property | Amount | Number of privatisation certificates | including property compensation certificates |
|---|---|---|---|
| | | (million) | (thousand) |
| Residential buildings | 446 thousand apartment privatisation 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 | 820.0 |
| Land | 317.1 thousand land lots | 17.2 | 5152.4 |
| **Total:** | | **106.9** | **6805.8** |
| % of total certificates issued | | 95.1% | 85.0% |

According to the *Law on Privatisation of Land in Rural Areas*, 11076 decisions on payment of cash compensations for former land ownership in rural areas have been made by October 31, 2011. Compensations for the total amount of LVL 17.5 million have been paid to 8411 persons, thus cancelling 0.62 million property compensation certificates.

Cash compensations for the total amount of LVL 4.7 million were paid to 26.2 thousand politically repressed persons by October 31, 2011, thus cancelling privatisation certificates. According to the provisions set in Article 27 of the *Law on Completion of Privatisation,* 3.2 thousand persons have lost their rights to cancel 15 thousand certificates.

By October 31, 2011, 106.9 million privatisation certificates or 95.1% of the total number of granted certificates have been used for privatisation of state and local government property (see Table 6.6). From April 1, 2008 until October 31, 2011, 517.1 thousand privatisation certificates have been used instead of 419.1 thousand property compensation certificates.

On October 31, 2011, 2.16 million privatisation certificates or 1.9% of the total number of granted certificates, including 0.127 million property compensation certificates were stored on the accounts of 382 thousand natural persons.

On October 31, 2011, 0.87 million privatisation certificates or 0.8% of the total number of granted certificates, including 0.006 million property compensation certificates were stored on the accounts of legal entities.

In October 2011, holders of privatisation certificates could use services of 10 licensed intermediary capital companies for transactions in the market of privatisation certificates. The total amount of monthly transactions with privatisation certificates (buying from natural persons and selling) performed by intermediary capital companies by October 31, 2011, varied from 8.57 thousand privatisation certificates in February to 50.56 thousand privatisation certificates in July and from 0.16 thousand property compensation certificates in February to 2 thousand property compensation certificates in June.

## 6.16. National Economy Council

The National Economy Council of the Ministry of Economics (NEC) 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 Bylaw 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, the NEC invites Sectoral Associations, representing entrepreneurs of the respective sector and their interests, as well as independent experts – economists, representatives of education and science.

**Box 6.22**

**The NEC personnel and work organization**

Based on the decision of the Managing Committee, the NEC personnel is approved by the Minister for Economics.

The NEC Managing Committee is a consulting and coordinating institution that takes part in settlement of business policy related issues and is responsible for assessment and approval of issues of the agenda of the NEC meetings and action plan of the NEC, as well as for ensuring and improving efficiency of the NEC activity.

The personnel of the Managing Committee are approved by the Minister for Economics. The Managing Committee is composed of five representatives of the NEC founders, which are simultaneously the 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.

NEC consists of 26 NEC experts designated by the NEC Managing Committee.

A representative from the Foreign Investors Council in Latvia participates in the NEC meetings as an observer, as well as a representative from the Riga Technical University.

Decisions on changes or additions to the composition of the NEC are made by the NEC founders in the meetings of the NEC Managing Committee.

NEC is managed by the Council Chairman elected by the members of the NEC Managing Committee from among its members in a rotation procedure for a term of office of one year.

NEC meetings are held on average once per month.

The work of NEC is ensured by the Secretariat of the National Economy Council, activity of which is ensured by the Ministry of Economics.

During the time in between NEC meetings, recommending decisions of NEC are made by the NEC Managing Committee.

The objective of the 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 preventing entrepreneurship and to perform all necessary activities to eliminate them, to participate in developing laws and regulations, and policy programming documents that promote commercial activity, and to promote innovations and external trade.

The 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. The NEC prepares proposals and adopts recommending decisions on these issues. The NEC carries out a dialogue between the entrepreneurs and the Ministry of Economics, as well as other state institutions and public organizations.

The decisions adopted by the NEC are of recommending nature.

NEC cooperates with the Cabinet of Ministers, ministries, and other state institutions to achieve inclusion of the proposals suggested by NEC necessary for improving the business environment into 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 the 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 introduction of sustainable strategy of Latvia.

In order to represent professionally the interests of economic sectors in an effective dialogue with the Ministry of Economics, NEC, and other business organizations and state institutions, the Ministry of Economics has set up a model for cooperation with the national economy sectors.

**Box 6.23**

**NEC about priorities on economic policy**

NEC believes that Latvia should continue work on development of stable macroeconomic environment and promotion of competition. Latvia should form a balanced budget, approve competition monitoring and promote development of competition in all economic sectors for the public benefit by timely identifying the risk sectors to be subject to violation of competition rights and limiting administrative and other barriers to 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.

Also the normative acts must be assessed, already during their drafting process, in order to identify and prevent possible violations of the 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 facilitating co-operation of education, research, and national economy sectors by ensuring transfer of knowledge and technologies must be elaborated and implemented.

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 improving the legislation submitted by the institutions-associations representing the entrepreneurs. Sectoral Associations evaluate draft legislation and give opinions on them. The Ministry of Economics informs the drafters of the laws and regulations about proposals for improving of legislation submitted to NEC. NEC carries out other measures for implementing programmes of development of national economy and 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 implementing the programmes for 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.

10 National Economy Council meetings have been held in 2011, considering the following main issues:

- establishment of a *Single EU patent system;*
- *Action Plan to Improve the Business Environment for 2011/2012*;
- *implementing activities of the Action Plan of Combating Shadow Economy and Ensuring Fair Competition;*
- establishing development financial institution;
- *National Reform Programme of Latvia* and its planning system;
- *Guidelines on Cohesion Policy for Programming Period 2014-2020*;
- Public management of enterprises;
- *Informative Report on Medium-term Forecasts of Labour Force Demand and Supply*;
- Development of the *National Development Plan*;
- *Convergence Programme of Latvia*;
- Entrepreneurs poll regarding administrative process and barriers.

# 7. Recommendations

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 because of huge 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 Latvian economy, in which exports are the key driver of growth, along with the ability to compete in internal and external product markets and the ability to be competitive in attracting capital to increase productive potential of Latvia. Along with the change of 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.

Similarly, structural issues of the labour market must be dealt with by supporting efforts to obtain higher qualification based on labour market requirements and improving regional and professional labour mobility. Employment policy should be developed taking into consideration that the share of the long-term unemployed increases the risk of cyclic unemployment turning into structural unemployment.

Although the economic imbalances which developed during the years of rapid growth have decreased during the crisis, the so-called *balance sheet effect* still continues due to the remaining budget imbalance of public and private sectors (households and enterprises), including debt restructuring. The EU debt crisis is major risk to the Latvian economic development. Therefore the budget should be developed by a realistic assessment of the economic development possibilities and by avoiding the development of an overly optimistic budget. Financial stability of the public sector in the future might be endangered by worsening demographic situation as according to the forecasts, the number of working population will continue decreasing.

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 funding 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 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;
  - to ensure sustainability of public finance including raise of retirement age;

- **for improving business environment and ensuring competitiveness:**
  - to restructure the tax system by making it socially fairer and business-friendlier. Reduction of the tax burden on entrepreneurship and employment must be attained;
  - to reduce the time required for dealing with tax administration by simplifying report forms and avoiding repeated request of information;
  - 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 in respect to availability of the state and local government services;
  - to implement fully operating electronic registration of enterprises by reducing the number of documents to be submitted and the time required for this 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 introduce the one-stop shop agency principle for real estate data registration, by providing data exchange between 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 ensure maximally complete and quick updating of information stored in the registers in order to prevent discrepancy of the information in the registers from the actual situation, as well as to avoid repeated request of information from respondents;
  - to actively address the most severe violations of the *Competition Law* – prohibited agreements and dominant position abuse. As regards the abovementioned violations, particularly identification of cartels, preventive measures are of great 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 continue the work on improving efficiency of the licensing system of non-bank creditors, at the same time ensuring increased supervision thereof;
  - 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 support entrepreneurship with high value added;
  - to facilitate cooperation between 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 the production;
  - to ensure access to financing at all business development stages, especially at an early (business start-up and pre-seed and seed) stage;
  - to support development of scientific potential more actively by focusing it on the fields in which Latvia has comparative advantages;
  - to improve laws regulating scientific activity stipulating 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 acquisition of new markets;
  - to develop and expand the network of Latvian foreign economic representation offices thus ensuring to Latvian entrepreneurs a range of state export support services broadly and easily accessible abroad;
  - 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 a 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;
  - the adult lifelong learning system must take into account the currently existing nonconformities in profession groups, i.e. large part of population is employed in a profession which is not related to their acquired education;
  - 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 improving 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 professional higher education (colleges) – reduced training period, saved public and private funding;
  - to review the regulation of legal labour relations by expanding the flexibility among the employer and employee;
  - to promote conformity of training to the requirements of the labour market – consider the opportunity to improve (change) the existing planning system of labour training by reviewing the former methodology of short-term labour market forecasting and the 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 national economy;

- **for improving energy efficiency:**
  - to continue improving energy efficiency in multi-apartment buildings;
  - to set requirements regarding construction of low energy consumption buildings;
  - to reduce heat energy losses in centralized heat supply by reconstructing the existing heat sources and heat networks, and by setting energy efficiency requirements for centralized heat supply systems;
  - to promote production of energy in high-efficiency cogeneration stations by developing a new heat supply infrastructure;
  - to develop unified public transportation route network (ban of awarding grants for parallel routes, coordinated schedules, improved route planning system), replace the passenger traffic (electric trains and diesel-engine trains) rolling stock with more effective rolling stock;

- **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 develop the base-load power station projects by choosing the types of energy resources, which will ensure resource supply guarantees and sustainability, as well as increase the state energy subsistence;
  - to develop energy infrastructure projects by implementing the *Baltic Energy Market Interconnection Plan* in the framework of the EU Baltic Sea Region Strategy;
  - to foster possibilities to diversify energy sources by implementing the creation of a regional liquefied natural gas terminal;

- **for managing residential buildings:**
  - to ensure development of Register of residential building managers and methodological management thereof;
  - to prepare 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 the 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.**