

**Ministry of Economics
Republic of Latvia**

**ECONOMIC
DEVELOPMENT
OF LATVIA**

REPORT

**RIGA
JULY 2006**

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Dear reader,

Experts of the Ministry of Economics have prepared the 24th **Report on the Economic Development of Latvia**. The first Report was published in September 1994 and the following Reports since 1995 were published traditionally twice a year in June and December. The present Report, just like the previous ones, provides evaluation of economic situation in Latvia and progress of reforms as well as offers economic development forecasts.

I note with satisfaction that in recent years Latvia has demonstrated very fast rates of economic growth. In the period of 2001-2005 Latvian GDP has increased annually by 8.1% on average and in 2005 it went up by 10.2%. Such indicators of development are the highest in the European Union. The fast increase of GDP reduces our country's backwardness from the old member states of the European Union.

The rapid economic development of Latvia indicates that the economic policy implemented by the country is right and that we, by re-orienting the national economy from planned economy to market economy, have taken the right decisions and were able to implement them consistently.

Also 2006 has started successfully for Latvian national economy. GDP in the 1st quarter increased by 13.1% in comparison with the respective period of the preceding year. Investment continued growing and increased by 16% in the 1st quarter, while the received foreign direct investment reached 158.9 million LVL that is a quarterly record amount of the recent years. Stability of business environment is indicated by the number of newly founded companies, which reached 6625 in the 1st half of 2006 (record number of the last 12 years) and is by 25.9% more than in the respective period of the previous year. Taking into account the fast growth rate in the 1st quarter, in the whole 2006 GDP in Latvia may grow faster than forecasted and its growth rate may exceed 10 per cent.

The priority for operation of the Ministry of Economics is promotion of business activity and knowledge-based economy. 3 million LVL have been granted from the state budget in 2006 for such activities as support to operation of technology transfer contact points, establishment and operation of innovation incubators, and development of applied research infrastructure. In addition, resources from the EU Structural Funds in the amount of 3.46 million LVL have been available in the period of 2005-2006 for implementation of innovation measures. Development of knowledge-based economy will be the priority also in the EU Structural Funds financing during the next planning period lasting from 2007 till 2013.

At the same time, the Ministry of Economics continues the started activities to ensure attractive business environment and development of small and medium-sized enterprises in Latvia, promote export and entry in new markets and consolidation in the current ones, foster safe, balanced and high-quality supply of energy to consumers, ensure completion of the privatisation and land reform process, and improve protection of consumer rights.

Purposeful and efficient utilisation of the EU Structural Funds is essential for economic development of Latvia, which will lay foundations for success story of Latvia in the future. Hence, our priorities for work of the next seven years are clear – they are the raising of competitiveness of Latvia in the world and development of knowledge-based national economy.

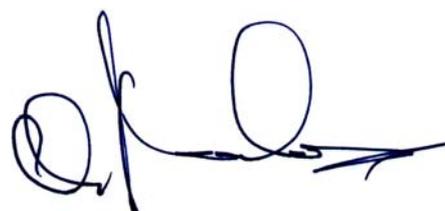
I am sure that successful implementation of structural reforms will ensure stable growth also in the next years.

In the Report you will find information on both the development of main economic and social indicators, growth of national economy sectors and external economic environment, and government's economic policy for promotion of growth and employment, foreign trade policy, utilisation of the EU Structural Funds and the Cohesion Fund, innovative and entrepreneurial policy and other economic reforms. In the conclusion the authors of the Report give recommendations for improvement of the national economic policy.

The Cabinet of Ministers has not assessed all issues addressed in the Report hence many conclusions on development of the national economy and proposals for further action reflect purely the opinion of experts of the Ministry of Economics.

I hope that the Report will be useful to economists and entrepreneurs and everyone interested in the issues of economic development of Latvia and will encourage exchange of opinions between public institutions, various organisations and interest groups, economists and other stakeholders.

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



Aigars Štokenbergs,
Minister of Economics

July 2006

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Abbreviations

Abbreviations

CEE	Central and Eastern Europe
CEES	Common European Economic Space
CHP	Thermal power station
CIS	Commonwealth of Independent States
CRPC	Consumer Rights Protection Centre
CSB	Central Statistical Bureau
CSMEC	Council of the Small and Medium-Sized Enterprises and Crafts
DDA	Doha Development Agenda
DPI	Producer price index for products sold in the domestic market
EC	European Community
ECB	European Central Bank
EDIS	External Decentralised Implementation System
EEA	European Economic Area
EMU	European Monetary Union
ERDF	European Regional Development Fund
ERM II	European currency rate mechanism
ESA	European System of National Accounts
ESF	European Social Fund
EU	European Union
EU-15	European Union before enlargement on May 1, 2004
EU-25	European Union after enlargement on May 1, 2004
FCMC	Financial and Capital Market Commission
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
FTA	Free Trade Agreement
GDP	Gross domestic product
GVA	Gross value added
HPS	Hydroelectric power station
ICT	Information and communication technologies
IMF	International Monetary Fund
ISPA	Instrument for the Structural Policies for Pre-accession
IT	Information technologies
IUVI	Import unit value index
JSC	Joint stock company
LEPP	Latvian Export Promotion Programme
LGA	Latvian Guarantee Agency
LIDA	Latvian Investment and Development Agency
LLC	Limited liability company
ME	Ministry of Economics of Latvia
MLBL	Mortgage and Land Bank of Latvia
NATO	North Atlantic Treaty Organisation
NEC	National Economy Council

NGO	Non-governmental organisation
OECD	Organisation for Economic Co-operation and Development
PHARE	The Economic assistance programme of European Union for countries of Central and Eastern Europe
PIP	Public Investment Programme
PPI	Producer price index
PPP	Public and private partnership
R&D	Research and Development
ROA	Ratio of profit against losses to assets
ROE	Ratio of profit against losses to capital and reserves
RSE	Riga Stock Exchange
SAPARD	Special Assistance Programme for Agricultural and Rural Development
SJSC	State Joint Stock Company
SME	Small and medium-sized enterprises
SOLVIT	Efficient Solving of Internal Market Problems
TSO	Transmission System Operator
UN	United Nations
USA	United States of America
VAT	Value added tax
WTO	World Trade Organisation
XPI	Producer price index for exported products

Measures

EUR, EURO	Euro, single currency of the EMU
GBP	British pound
LVL	Latvian lats (national currency of Latvia)
SDR	Special drawing rights, IMF approved currency
USD	US dollar

Conventional designations

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

1. Economic Situation: Brief Overview

Reforms implemented in Latvia and integration in the EU left a positive impact on economic development of the country. **Latvia has shown the highest economic growth rates in the EU.** Since 2000 the average annual growth of gross domestic product (GDP) in Latvia was 8.1%, in 2005 GDP increased even faster by 10.2%. Rapid economic growth of Latvia continues in 2006 as well. GDP in the 1st quarter of this year has increased by 13.1% in comparison with the respective period of 2005. The high growth rates are achieved due to the stable dynamics of domestic demand and increase in exports.

Economic activity increases in all major sectors of the national economy. Manufacturing contributes substantially to the growth. In the period from 2001 to 2005, output in manufacturing has grown by 7.6% on average every year. In these years, the biggest contribution to industrial growth was made by wood industry, machine building and metalwork production. In 2005 manufacturing output grew at a slightly slower pace (by 6.3%), mainly due to the negative impact of the storm in January, which had a negative impact on the biggest export sector – production of timber and articles of wood. However, since the 3rd quarter of 2005 the quarterly growth rate of manufacturing is 8-9%. Modernisation and reconstruction of production as well as utilisation of EU funds will raise productivity and competitiveness of the sector, therefore it is expected that industry will continue developing dynamically.

Growth in agriculture was 6.9% in 2005. Further development of agriculture will depend on adjustment of agricultural production facilities and products to EU standards and quality criteria and on the external demand. Latvia's accession to the EU ensures more equal competition opportunities for farmers in the EU internal market, while support from EU funds facilitates modernisation of agriculture and diversification of agricultural activities.

Rapid rise in investment has a favourable influence of development of construction. The construction sector grew by 15.5% in 2005. Construction of streets and roads, residential and commercial buildings, hotels, industrial and other objects grows fast. The construction sector is expected to maintain high development rates also in the future due to development of mortgage lending, increased economic activity and investment as well as implementation of projects financed from EU funds.

Increased domestic demand promotes development of services, especially those concerning wholesale and retail trade (this sector grew by 17.4% in 2005). It must be noted that growth of the trade sector is mostly determined by the domestic demand but slightly more than one-tenth is also linked to trade intermediary services that are provided to non-residents. This share increases every year.

The dynamics of domestic demand is steady and ensured by the growth of income, stability of the financial system, expansion of credit opportunities, accession to NATO and EU, and formation of positive future expectations. It is expected that increased household income and spread of consumer loans will foster further growth of domestic trade (especially non-food consumer goods) and other market services, but the growth rates will be lower than up to now, because of market saturation. Big opportunities for growth lie ahead for the tourism sector that has developed very fast in the recent years.

Transit services are of great importance for the national economy of Latvia. They constitute approximately 15% of the revenues from Latvian exports of goods and services or about 5% of GDP. Even though transit services are growing by volume, their share in the national economy in general and in the transport and communications sector is diminishing. This can be explained by the fact that the domestic use of transport sector services has grown faster than their external use in the last years. Two-thirds of the growth in the transport and communications sector depends on the domestic demand (development of communications, warehousing, parking services, tourism, etc.) and only one-third depends on the external demand (transit).

On the whole, the transport and communications sector grew by 16.2% in 2005. After accession to the EU, cargo transportation increased especially fast and passenger transport services are growing, including air transport services.

The Ministry of Economics forecasts that the **GDP growth in Latvia will exceed 10% in 2006.**

The economic growth in Latvia is achieved in conditions of stable macroeconomic environment. The Bank of Latvia implements *de facto* policy of fixed national currency exchange rate. This reduces uncertainty, eliminates exposure to currency risk and gives entrepreneurs a stable base for planning and price determination. As from January 1, 2005 the national currency lats (LVL) is re-pegged from the SDR currency basket to the euro at the rate 1 EUR = 0.702804 LVL. Change of the

LVL peg was determined by Latvia's plans to join the European Exchange Rate Mechanism II (ERM II) and, after fulfilment of required criteria, to join the Economic and Monetary Union (EMU).

Since May 2, 2005 Latvia has joined ERM II with already existing exchange rate of lats against the euro, namely, 1 EUR = 0.702804 LVL. Latvia will have to participate in ERM II at least for two years, fulfilling the Maastricht criterion on exchange rate stability. When the EU Council decides that Latvia is ready to take part in the EMU, the Latvian national currency will be substituted by the euro and the Bank of Latvia will discontinue implementing an independent monetary policy. Timetable for introduction of the euro, which is approved by the Cabinet of Ministers, envisages Latvia's joining the EMU on January 1, 2008. Taking into account that the target set by the government has become practically unachievable due to high inflation, situation is assessed at present and a new date for joining the EMU will be set.

Table 1.1

Latvia: Key Indicators of Economic Development

	2002	2003	2004	2005	2006 f
	(growth against the preceding year, %)				
Gross domestic product	6.5	7.2	8.6	10.2	11.0
Private consumption	7.4	8.2	9.5	11.4	11.0
Public consumption	2.2	1.9	2.1	2.7	3.0
Gross fixed capital formation	13.0	12.3	23.8	18.6	18.0
Exports	5.4	5.2	9.4	20.7	7.6
Imports	4.7	13.1	16.6	13.5	8.4
Consumer prices	1.9	2.9	6.2	6.7	6.5
	(in % of GDP, unless indicated otherwise)				
Central government budget fiscal balance	-2.3	-1.6	-1.1	-1.2	-1.5
Central government debt	13.1	13.2	13.2	10.7	10.5
Current account balance	-6.6	-8.1	-12.9	-12.4	-12.5
Foreign direct investments (flows)	2.8	2.6	5.1	4.0	6.0
Unemployment rate (15-74 years)	12.0	10.6	10.4	8.7	8.0

f – forecast

Relatively high inflation rate has been observed in the last years. Faster growth of inflation in 2004 was mainly due to a combination of several one-time factors (rise of administratively regulated prices, harmonisation of indirect tax rates, inflation expectations related to Latvia's accession to the EU, and high world oil prices). High rate of inflation remained in 2005 mostly due to increased world fuel prices and second-round inflation (spiral). In 6 months of 2006 inflation increased at a more moderate pace than in the respective period of the previous 2 years. It is forecasted that inflation will decrease gradually in the following years due to diminishing impact of the mentioned factors that are raising prices.

Due to the growing domestic demand and in order to hold down credit growth rate, the Bank of Latvia raised the refinancing rate by 0.5 percentage points in March and November of 2004 and in July 2006 to 4.5% and increased the reserve requirement from 3% to 4% in July 2004, to 6% in August 2005 and to 8% in December 2005. In order to unify conditions of mutual bank competition and slow down the rapidly growing borrowing by Latvian banks from foreign banks, the Bank of Latvia included bank commitments to foreign banks and central banks of foreign countries with a fixed term or warning term for withdrawal over 2 years in the base of compulsory reserves as from January 24, 2005. On March 14, 2006 the Board of the Bank of Latvia took decision to expand the base of compulsory reserves, maintaining the norm of reserves at the previous level of 8%. As from May 24, 2006 the requirements of compulsory reserves are also applied to bank commitments with a fixed term exceeding 2 years.

However, the impact of such measures in Latvia is limited by the fixed exchange rate regime and several specific factors such as low share of loans granted to residents in GDP, relatively easy access by banks to foreign resources, and relatively big share of loans granted in foreign currencies in the credit structure.

Since 2000 the fiscal deficit of the general government consolidated budget in Latvia has been below the maximum 3% of GDP permitted by the Maastricht Treaty, and gradual improvement of the

fiscal situation has been observed. The budget deficit in 2005 was lower than planned, i.e., in the amount of 105.2 million LVL or 1.2% of GDP (according to the methodology of the ESA 95 European System of National Accounts, in 2005 Latvia had a budget surplus in the amount of 0.2% of GDP). Decrease in the fiscal deficit of the general government consolidated budget in the last years took place mostly due to surplus in the social security budget.

The Saeima approved the state budget for 2006 with a deficit in the amount of 145.2 million LVL or 1.5% of GDP. General government budget revenues in 5 months of 2006 were by 27.6% higher than in the respective period of the previous year, while expenditures were by 17.4% higher. The budget had a fiscal surplus in the amount of 248 million LVL.

The central government debt in Latvia is among the lowest in the EU. At the end of 2005 it amounted to 955 million LVL or 10.7% of GDP.

One of the main economic development risks in Latvia is a relatively high current account deficit caused by high domestic demand and steep growth of investment in particular. Strongly negative trade balance is the main reason for the current account deficit. Slightly less than one-third of this balance is covered by the positive balance of services, because there is a high share of transit services in the economy.

In 2005 the current account deficit amounted to 12.4% of GDP and was by 0.5 percentage points lower than in 2004. It was caused by improvement of trade balance by 1.4 percentage points and improvement of revenue balance by 0.9 percentage points. At the same time, worsening of services balance by 0.6 percentage points and decrease in positive balance of net current transfers by 1.3 percentage points have to be noted.

In the 1st quarter of 2006 the negative balance of current account balance worsened by 3.7 percentage points in comparison with the 1st quarter of 2005 and amounted to 14.6% of GDP. The increase in the negative balance of current account was caused by increased ratio of the negative balance of goods and services against GDP, which was not compensated by the increased ratio of the positive balance of services and current transfers against GDP.

Even though the current account deficit is at a relatively high level, it should not be regarded as critical at present, because it is covered by foreign direct investment and long-term loans. Net foreign reserves of the Bank of Latvia fully cover the reserve money.

It is forecasted that faster growth of exports promoted mostly by structural reforms will gradually bring down the current account deficit in the medium term. However, the demand for imports will remain relatively high due to further modernisation of the national economy and its growing openness. It should be noted that, after accession to the euro zone, the risks related to negative current account deficit (risk of a currency crisis) will almost completely disappear, as stability of the currency and keeping of foreign currency reserves will become the competence of the European Central Bank.

EU is the main trading partner of Latvia. Trade with EU member states has been constantly expanding since restoration of Latvia's independence, and currently 75% of Latvian exports and imports are linked to the EU. In 2005 most of Latvia's foreign trade turnover was made up by trade with Lithuania (12.7%), Germany (12.6%), Estonia (9%), Russia (8.3%), Sweden (6.1%) and Poland (5.9%).

The exports of Latvian goods in current prices grew annually by 11-12% in 2000-2002, by 17% in 2003, 30% in 2004 and 34% in 2005. In 2004 and 2005 the exports of goods were favourably affected by rapid increase in export unit value.

Exports increase to all sales markets for Latvian goods – to EU member states, CIS and other countries of the world. After accession to the EU, trade of Latvia with Lithuania and Estonia as well as other new EU member states grows very fast. Latvian trade with other Baltic states in two years has increased more than twice in comparison with the period before the accession to the EU.

In 2005 the fastest growth rates were observed in exports of mineral products, foodstuffs, transport vehicles and machine building products. Also imports in 2005 considerably exceeded the volume of the previous year (by 28% in current prices).

In the first 5 months of 2006 the value of exported products exceeded the level of the respective period of the previous year by 11.8%, while imports increased considerably faster by 26.4%. This was mostly due to increased imports of investment goods and rise of fuel prices.

With the economic growth, income of the population is also growing. The real income of employees in the period from 2000 till 2005 has increased by 36%, but in 2005 alone – by 9.7%.

By implementing a socially responsible policy, as from January 1, 2006 the minimum monthly wage has been increased from 80 LVL to 90 LVL, the monthly non-taxable minimum was increased from 26 LVL to 32 LVL, and monthly tax allowance for dependent person was raised from 18 LVL to 22 LVL.

It should be noted that the growth of population's income is uneven. Growth of old age pensions is slower than growth of the income of employees. The Gini index measuring inequality in distribution of income within the country has gone up from 0.34 in 2000 to 0.36 in 2004.

The employment and unemployment indicators are gradually improving. However, it should be noted that the growth has been mainly reached at the expense of productivity and less due to increasing number of employees. In 2005 the number of employed persons has increased by mere 10.3% as compared to 2000. The growth trend having little effect on employment remains present in almost all sectors of the national economy. With development and strengthening of the private sector, competition also becomes stronger, forcing companies to look for ways to cut costs. As the corporate management improves, one of the main cost items to be downsized are labour costs, which often results in reduction of the number of employees. These processes are objectively determined for the Latvian national economy, given its generally low level of productivity. Therefore the further growth will be mostly based on increase of productivity rather than growth of the number of employees.

The economic activity of the population (participation in the labour market) in Latvia is close to the EU average, while the economic activity of women has already exceeded the average indicators of the EU. In the period from 2000 till 2005 the employment rate in Latvia has increased by 6.1 percentage points. In 2005 it reached 63.4%, that is by 1.1 percentage points higher than in 2004.

According to the data of the Labour Force Survey done by the CSB, the unemployment rate has gone down from 14.4% in 2000 to 8.7% in 2005. The unemployment is the highest in Latgale region (12.8% in 2004). The high unemployment rate is determined by poorly developed business activity, small number of self-employed persons and bad traffic infrastructure. Latgale also has the lowest GDP per capita in the country, which is twice as low as the average in Latvia.

The economic growth potential is best characterised by the growth of investments. In 2005 investments in fixed assets were carried out in twice bigger amount than in 2000. The amount of investments carried out during this period has increased by 15.7% annually.

As regards growth of investments and their share in GDP, Latvia has one of the highest indicators among EU member states. Investments are promoted by several factors, among them stable macroeconomic environment, inflow of foreign investments, reduction of interest rates on loans and strengthening of the banking sector, increase of general economic activities and formation of positive future expectations, etc.

In 2005 a high investment level was retained in the national economy. Investments in the fixed assets increased by 18.6% in 2005. The investment process was favourably affected by the improvement of accessibility of finances and high growth rates.

At the end of 2005, foreign direct investments (FDI) accumulated in Latvia amounted to 2836 million LVL or 40.4% of annual GDP volume. The volume of incoming FDI in the last five years equalled to 3.4% of GDP on average. After Latvia's accession to the EU, their inflow increased. In 2005 they amounted to 4% of GDP and covered almost 15% of investments in fixed assets.

In the sectoral structure of accumulated FDI, investments in service sectors make a bigger share. In 2005 the biggest FDI growth was in the energy sector and financial services.

Three-fourths of FDI are related to EU member states: the biggest investors are entrepreneurs of Sweden (13.9% of accumulated FDI at the end of 2005), Germany (13.3%) and Estonia (9.4%). 8.9% of investments are from Russia. In 2005 the biggest investors in Latvia were Swedish entrepreneurs (16.8% of incoming FDI in a year), but interest of Russian entrepreneurs was considerable as well (15%).

The reforms carried out in the previous decade have strengthened the private sector, macroeconomic conditions favourable for development have been created and the business environment is improving. Investments continue to grow rapidly, encouraging modernisation of production and introduction of new, more productive technologies. Accession to the EU has a particularly positive impact on development of Latvian national economy. This strengthens confidence in sustainable growth also in the following years. If there are no external shocks, the annual GDP growth can be expected to be 6-8% in the medium term.

2. Development of World Economy¹

Development of world economy continued at a high pace in 2005, although prices of oil products increased and several natural calamities took place. Especially fast growth rates were observed in transition economies. Growth was encouraged by the global development of industry, services and interstate trade sectors as well as favourable conditions of labour market development. Very fast growth of development rates was observed at the 2nd half of 2005. Total growth for 2006 is also forecasted slightly faster than in the previous year (see Table 2.1).

Table 2.1

GDP Growth
(percentage against the preceding year)

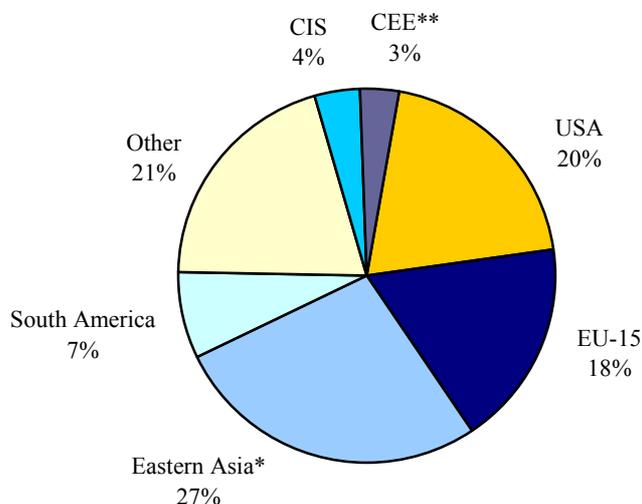
	2003	2004	2005	2006 p	2007 f
World	4.0	5.3	4.8	4.9	5.7
USA	2.7	4.2	3.5	3.4	3.3
Japan	1.4	2.3	2.7	2.8	2.1
EU	1.3	2.5	1.8	2.4	2.3
CIS	7.9	8.4	6.5	6.0	6.1

Source: “The World Economic Outlook April 2006”, International Monetary Fund, <http://www.imf.org>
f – forecast.

Figure 2.1

The World GDP Ratio by Groups of Countries in 2005

(structure, GDP by purchasing power units)



Source: “The World Economic Outlook September 2005”, International Monetary Fund, <http://www.imf.org>

* Japan, China, South Korea, Malaysia, Singapore, Thailand, Philippines

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

At the end of 2005 the economic growth of the **United States** slowed down. Weak private consumption as a result of considerable decline in motor-car trade related to growing oil product prices as well as low export growth are mentioned as causes of this slowdown. However, this stagnation at the end of 2005 is considered as one of short duration, and already at the beginning of 2006, with increased

¹ In this section, data from “World Economic Outlook”, International Monetary Fund, April 2006 and “Economic Forecasts Spring 2006”, European Commission were used, unless indicated otherwise.

industrial output, the economy resumed development and almost reached the growth rate of the previous year.

Increase of growth rates in USA during 2006 are forecasted at the level of 3.4%, which is slightly more optimistic than forecasted in September 2005. Also forecasts of growth for 2007 are a bit reduced to 3.3%.

1st quarter of 2005 was very favourable for the economy of **Japan** and was followed by considerable declines of growth rates in the next quarters; however, this year on the whole is considered successful for Japan, mainly due to increased export rates promoted by growing demand in USA and Asian countries as well as favourable fluctuations of the yen exchange rate. The growth was also encouraged by rising domestic demand, development of the labour market, and increase of loans issued by banks.

The growth of Japanese economy in 2006 is forecasted at the level of 2.8%, which is by 0.8 percentage points more than forecasted in September 2005. The growing domestic demand is mentioned as the main factor of changes. Growth of Japan in 2007 is forecasted as slightly weaker (2.1%).

Table 2.2

Main Macroeconomic Indicators of the Developed Countries
(percentage)

	GDP growth			Consumer price changes			Investment (% of GDP)			Current account deficit (% of GDP)			Budget deficit (% of GDP)		
	USA	EU	Japan	USA	EU	Japan	USA	EU	Japan	USA	EU	Japan	USA	EU	Japan
2004	4.2	2.5	2.3	2.7	2.2	0.0	19.6	19.8	22.7	-5.7	0.2	3.8	-4.7	-2.9	-6.6
2005	3.5	1.8	2.7	3.4	2.2	-0.3	20.0	20.2	23.2	-6.4	-0.4	3.6	-4.1	-2.6	-5.8
2006 f	3.4	2.4	2.8	3.2	2.1	0.3	20.6	20.6	23.7	-6.5	-0.7	3.2	-4.3	-2.6	-5.7
2007 f	3.3	2.3	2.1	2.5	2.2	0.6	20.8	20.8	24.0	-6.5	-0.5	2.9	-4.0	-2.3	-5.4

Source: "The World Economic Outlook April 2006", International Monetary Fund, <http://www.imf.org>
f – forecast.

Economic growth in the **old EU member states** was at a rather good level in the first quarters of 2005 but slightly decreased in the last quarter. External shocks were mentioned as the main hindering factors; as usual, such shocks were the rapid rise of oil product prices and the weak external demand. Growth was unfavourably affected by the low private consumption as well. It is important to note that the investment level at the end of the year was rather high.

In 2006 the growth will be mainly based on the rising external demand and may also be promoted by favourable fluctuations of the euro exchange rate and stability in financial markets. For the year on the whole, the growth is forecasted at the level of 2.4%, which is slightly more than forecasted half a year before.

2005 was not a particularly successful year for the economy of **Germany** and its GDP grew by mere 0.9%, still this is slightly more than forecasted half a year before. This growth was mainly due to the significant external demand. Low rise of wages and decline of employment, which caused decrease of private consumption, have to be mentioned as negative factors.

Growth in Germany in 2006 is assessed as moderate, acknowledging small increase of unemployment as a negative factor, while the confidence indicator is among the highest during the last years. Growth of German GDP is forecasted in the amount of 1.3% in 2006 and 1% in 2007.

Growth in **France** in 2005 was slightly more moderate in comparison with 2004 (2.1%) and reached mere 1.4%, although previous forecasts were even more pessimistic. Negative contribution of exports to GDP is mentioned as the main cause. The growth was affected positively by external demand and private consumption as well as increase of the minimum wage.

In 2006 the growth in France was forecasted as slightly faster in the amount of 2%, mostly due to domestic demand, and the influence of negative exports to the growth may diminish as well. However, it is believed that the stable private consumption will play the main role in the growth. Growth in 2007 is forecasted a bit faster than in 2006 (by 2.1 per cent).

In 2005 the growth in the **United Kingdom** was considerably below the potential level and reached mere 1.8%, which was by almost a half less than in 2004. The following main causes for this were mentioned: decreased output of manufacturing, and low growth rates of the service sector. Growth was also hindered by unstable domestic demand and low private consumption.

Growth forecasts for 2006 and 2007 in the United Kingdom are 2.5% and 2.7% respectively, mostly due to growing domestic demand, and increase of private consumption is forecasted.

Although growth rates in the **new EU member states and candidate countries** have slightly decreased in 2005 compared with 2004, they still are at very high level in comparison with the old EU member states. Strong domestic demand still exists and, despite unfavourable currency exchange rate fluctuations, high export growth rates are maintained.

Like in the previous years, inflation is high, based on the negative influence of oil price growth and the growing domestic demand. Forecasted domestic demand rise in the old member states and rapid increase of loans mostly issued in foreign currencies are also mentioned as factors that may affect further growth in the future.

According to IMF calculations, the growth in 2006 on the whole will remain the same as in 2005, while in 2007 it will slightly stabilise, reaching 4.8%.

Table 2.3

Main Macroeconomic Indicators of the New EU Member States and Candidate Countries
(percentage)

	GDP growth				Consumer prices				Current account deficit (% of GDP)			
	2004	2005	2006 f	2007 f	2004	2005	2006 f	2007 f	2004	2005	2006 f	2007 f
Total	6.5	5.3	5.2	4.8	6.1	4.8	4.1	3.4	-5.7	-5.2	-5.5	-5.4
Estonia	7.8	9.8	7.9	7.1	3.0	4.1	3.6	3.2	-12.7	-10.5	-10.1	-9.6
Latvia	8.5	10.2	9.0	7.0	6.3	6.7	6.4	5.5	-12.9	-12.5	-12.8	-12.0
Lithuania	7.0	7.3	6.5	6.0	1.2	2.6	3.2	2.7	-7.7	-7.5	-7.5	-7.3
Czech Republic	4.7	6.0	5.5	4.5	2.8	1.8	2.8	3.0	-6.0	-2.1	-2.3	-2.3
Hungary	4.6	4.1	4.4	4.2	6.7	3.5	2.0	2.7	-8.8	-7.9	-8.2	-7.5
Poland	5.3	3.2	4.2	3.8	3.5	2.1	1.3	2.3	-4.1	-1.6	-2.5	-3.1
Slovakia	5.5	6.0	6.3	6.7	7.5	2.8	3.6	2.5	-3.5	-7.2	-6.4	-5.5
Slovenia	4.2	3.9	4.0	4.0	3.6	2.5	2.4	2.4	-2.1	-0.9	-0.3	0.1
Cyprus	3.9	3.7	4.0	4.0	2.3	2.6	2.0	2.0	-5.7	-5.1	-5.6	-4.6
Malta	1.0	1.0	1.2	1.5	2.7	3.1	2.8	2.4	-10.4	-6.7	-6.5	-6.3
Turkey	8.9	7.4	6.0	5.0	8.6	8.2	6.5	4.4	-5.2	-6.3	-6.5	-6.1
Bulgaria	5.7	5.5	5.6	5.8	6.1	5.0	7.2	4.1	-5.8	-11.8	-10.2	-9.1
Romania	8.4	4.1	5.2	5.6	11.9	9.0	7.9	4.8	-8.4	-8.7	-8.3	-8.1

Source: "The World Economic Outlook April 2006", International Monetary Fund, <http://www.imf.org>
f – forecast.

The highest growth rates among EU member states are still maintained in the **Baltic States**, which is stimulated by successful macroeconomic policies and broad structural reforms. Like in the previous periods, domestic demand remains at high level, which is stimulated by rapid increase of loans granted to individuals. Rapid growth is still observed in the market of real estate prices. For these reasons, high

current account deficit of the balance of payments still maintains in the Baltic States. The economic growth in Lithuania and Estonia in 2006 is forecasted in the amount of 6.5% and 7.9% respectively, while in 2007 the growth will slightly diminish to 6% and 7.1% respectively.

Reduction of inflation and limiting volumes of rapidly growing loans are mentioned as the main priorities in order to ensure sustainability of growth of the region.

In 2005 the growth in the group of **Commonwealth of Independent States (CIS)** considerably decreased. Growth of the region was negatively affected by diminishing rates of economic development of Ukraine after the very favourable 2004. Growth of the region was also hindered by comparatively low output in the energy sector and by political and economic uncertainty in particular countries of the region. Investment also remained at low level, while the growth was promoted by stable increase of consumption mainly due to increased wages and pensions and growing credit resources.

Growth rates for 2006 and 2007 are forecasted slightly more moderate but still will remain at high level (6% and 6.1% respectively). It is recommended for the region on the whole to pay bigger attention to consolidation of the monetary policy (in order to lessen inflation) and to arrange the business environment, which would ensure attraction of investment.

Table 2.4

Main Macroeconomic Indicators in the Group of CIS Countries
(percentage)

	2004	2005	2006 f	2007 f
GDP growth	8.4	6.5	6.0	6.1
of which in Russia	7.2	6.4	6.0	5.8
Consumer prices	10.3	12.3	10.4	9.7
of which in Russia	10.9	12.6	10.4	9.5
Current account balance (% of GDP)	8.1	9.1	9.6	8.1
of which in Russia	9.9	11.3	11.8	9.5

Source: “The World Economic Outlook April 2006”, International Monetary Fund, <http://www.imf.org>
f – forecast.

Despite the still rising oil prices, the global growth in 2006 and 2007 is projected rather positively (by 4.9% and 4.7% respectively), due to favourable conditions of financial markets and successfully implemented macroeconomic policies. Influence of the rapid development of Asian countries on the global economy in the future was also stressed; this, in turn, positively affects development of global competition.

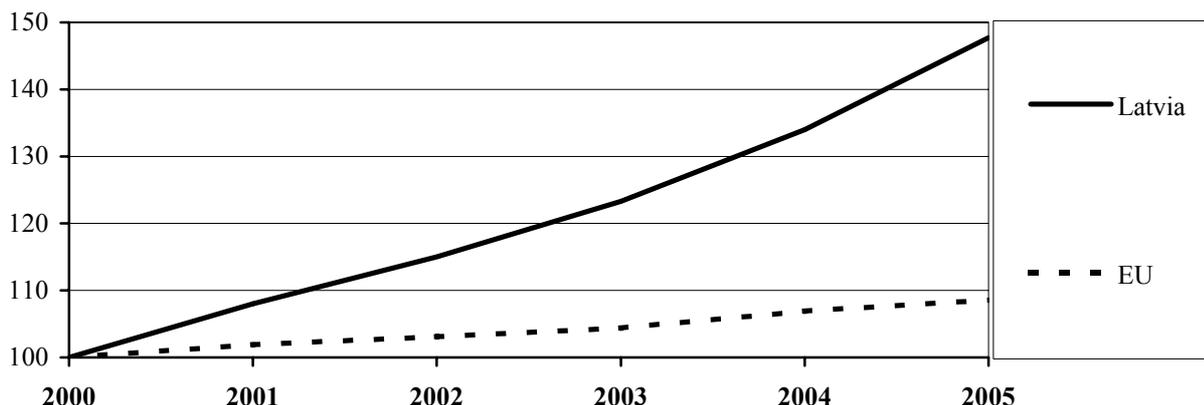
3. Growth and Productivity

3.1. GDP Dynamics and Productivity

Rapid economic growth is observed in Latvia for several years. In the last five years (2001-2005) GDP went up annually by 8 per cent on average.

Figure 3.1

GDP Growth in Latvia and EU
(2000 = 100%)



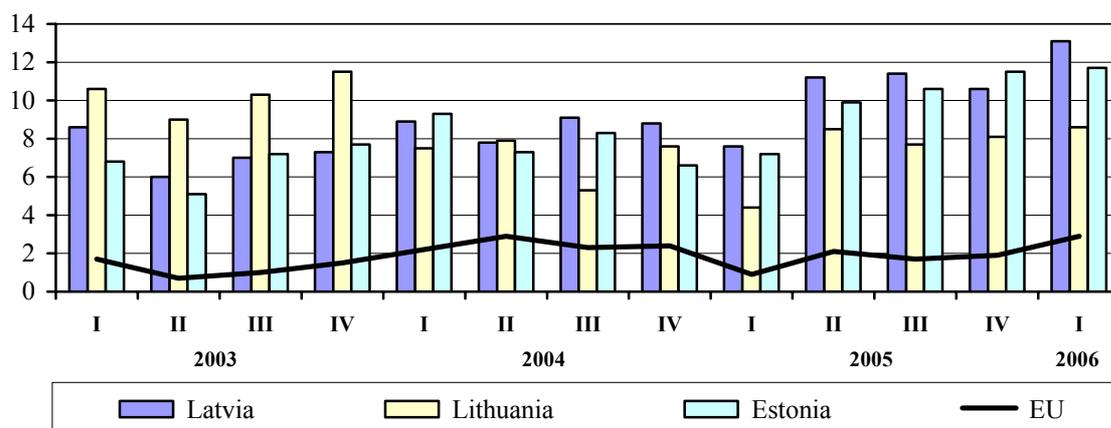
Source: Eurostat

Growth was especially fast in 2004 and 2005 (by 8.6% and 10.2% respectively). The steady growth is ensured by stable dynamics of the domestic demand and ability to expand export markets.

Although the average growth of the EU member states has been rather slow in the last years, the growth rates of the new EU member states are high and steady, especially of the Baltic States, including Latvia. Besides, the GDP growth in 2004 and 2005 was the most rapid in Latvia.

Figure 3.2

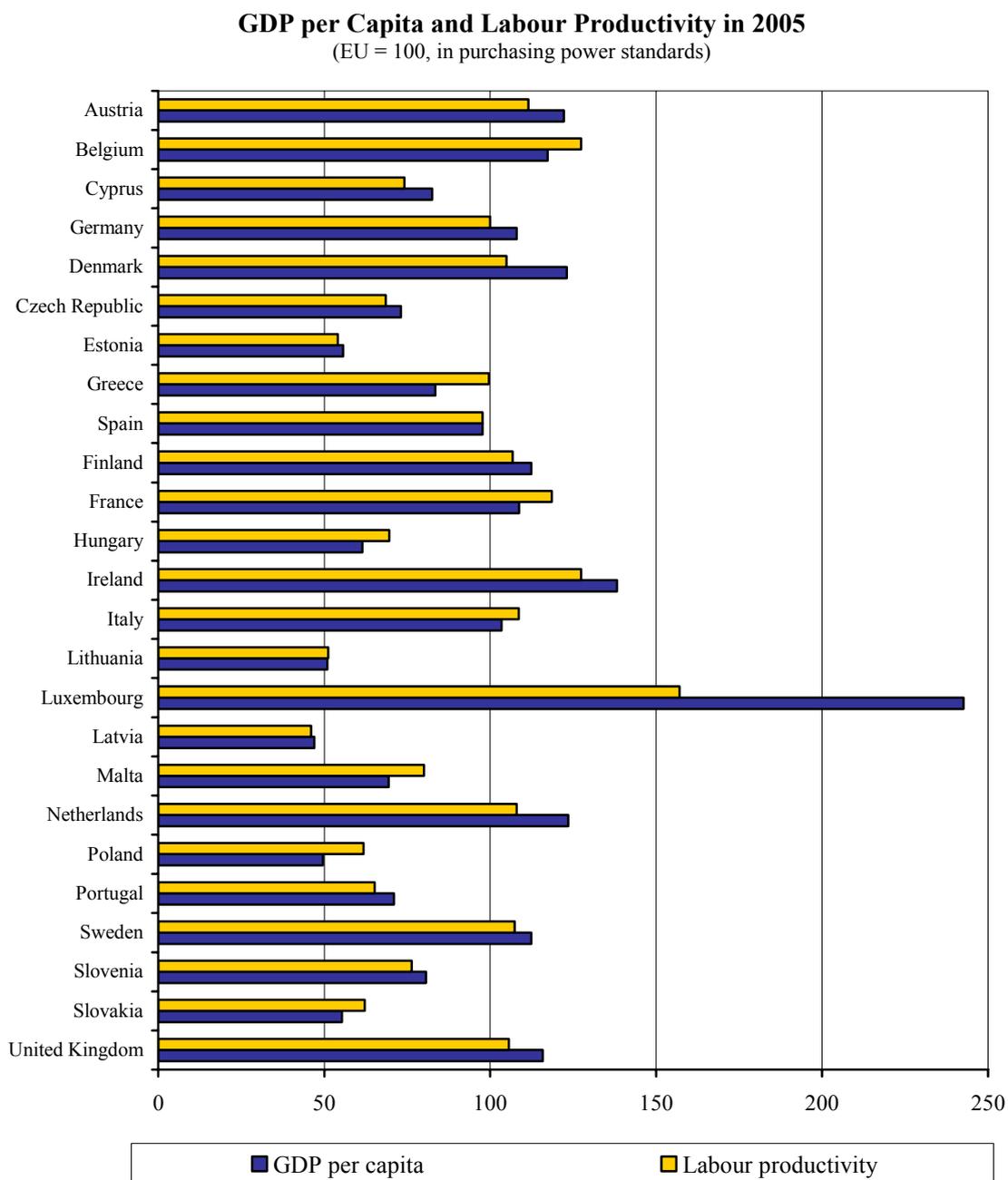
GDP Growth in Latvia, Lithuania, Estonia and EU, Quarterly Profile
(percentage change against the corresponding quarter of the preceding year)



Source: Eurostat

In 2005, Latvian GDP per capita in purchasing power standards was 47% of the EU average (according to the estimation of the Eurostat). In comparison with 2000, the backwardness from the average EU level was reduced by 11.6 percentage points.

Figure 3.3



Source: estimation of the *Eurostat*

In this period, the real volume of GDP per capita has increased by 1.5 times in Latvia and by 8.5% on average in the EU.

Increase of Latvian GDP was mainly fostered by the productivity growth and, to a smaller extent, by the increase of employment. In 2005, the volume of GDP per person employed in Latvia compared to the EU average was almost at the same level as GDP per capita.

The rate of productivity changes has increased in the last two years. Productivity increased by 7.5% in 2004 and by 8.6% in 2005, and by 5% on average annually in the period of 2001-2003.

Table 3.1

Productivity by Sectors of Economy – Value Added per Person Employed

	Annual average real changes in the period of 2001-2005 (%)	Level in current prices (LVL per person employed) 2005
Primary sectors	7.7	2978
Manufacturing	8.6	6276
Electricity, gas and water supply	6.2	13062
Construction	1.6	5543
Trade, hotels and restaurants	9.2	8960
Transport and communications	5.7	12849
Other services	4.8	13141
Public services*	1.7	5288
Total economy	6.5	7751

* Public administration with health care and education

Productivity is increasing faster in manufacturing and trade. However, its level in these sectors still lags behind the indicators of several service sectors. For example, the productivity level in financial services is 3 times higher than in manufacturing and 2.5 times higher than in the economy on average.

3.2. GDP Expenditure

3.2.1. Aggregate Demand

The main impulse to the fast growth in 2003 and 2004 was a stable domestic demand, while export growth played a bigger role in 2005, and considerable increase of domestic demand was maintained at the same time.

Exports of both the goods and services rapidly increased and the export-import balance of Latvia improved in 2005. The volume of private consumption increased, which was favourably affected not only by the annual increase of wages, but also the opportunities for individuals to get consumer credits and loans for acquisition and repair of housing for acceptable interest rates. The private consumption in 2005 exceeded the level of the previous year by 11.4%. The favourable financial situation (low interest rates on loans, development of mortgage crediting) encourages investment as well. Investment in fixed assets in 2005 was considerably bigger (by 18.6%) than in the previous year.

Table 3.2

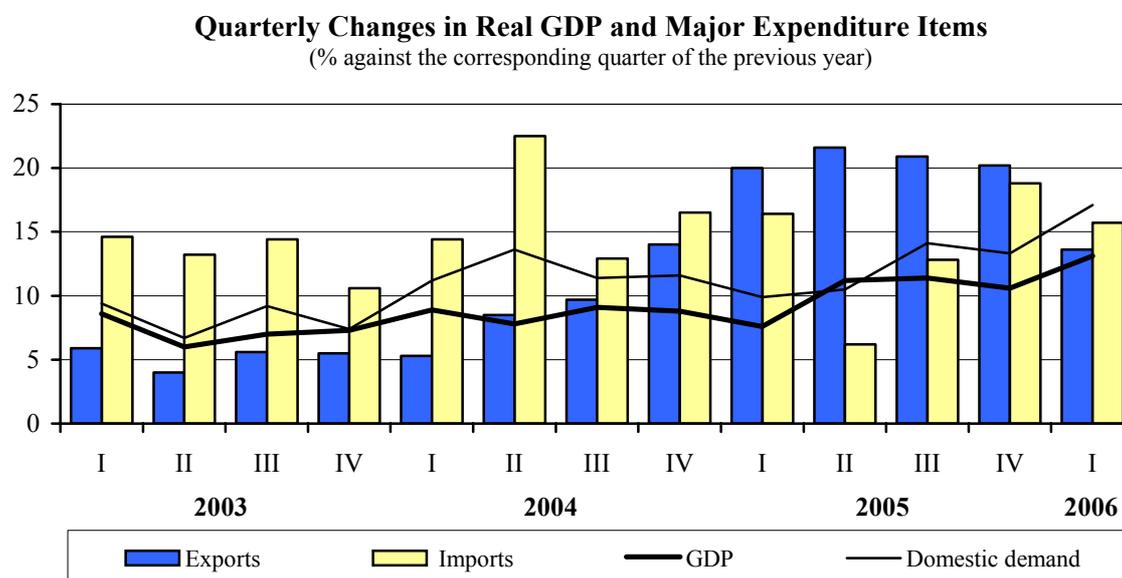
Expenditure of Latvian GDP

(percentage)

	2003			2004			2005		
	structure	growth rates	contribution to growth	structure	growth rates	contribution to growth	structure	growth rates	contribution to growth
Gross domestic product	100	7.2	7.2	100	8.6	8.6	100	10.2	10.2
Private consumption	62.4	8.2	5.1	63.0	9.5	6.0	62.4	11.4	7.3
Public consumption	21.4	1.9	0.4	19.6	2.1	0.4	17.7	2.7	0.5
Gross fixed capital formation	24.4	12.3	3.3	27.5	23.8	6.6	29.8	18.6	5.9
Changes in inventories	4.3	–	2.9	5.6	–	0.7	4.4	–	-4.0
Exports	42.1	5.2	2.1	44.0	9.4	3.8	48.1	20.7	8.4
Imports	-54.6	13.1	-6.6	-59.7	16.6	-8.9	-62.4	13.5	-7.7

High growth indicators are also in 2006. Like in the previous years, the growth was largely stimulated by the domestic demand, but the expansion of export opportunities was important as well (see Figure 3.4).

Figure 3.4



3.2.2. Private and Public Consumption

In the recent years the disposable income of households¹ in Latvia amounts to 60% of GDP on average, but the final consumption expenditures are close to 64%, therefore the net savings are negative and comprise 3-4% of GDP.

Table 3.3

Disposable Income and Final Consumption Expenditures of Households, Net Savings

	2002	2003	2004 e	2005 e
Disposable income of households (changes in % against the preceding year)	10.1	14.1	17.9	20.0
Final consumption expenditures of households (changes in % against the preceding year)	9.7	11.5	17.2	19.2
Net savings in % of disposable income	-4.0	-2.7	-2.8	-3.0
Net savings in % of GDP	-3.2	-2.1	-2.3	-2.3

e – estimation of the Ministry of Economics

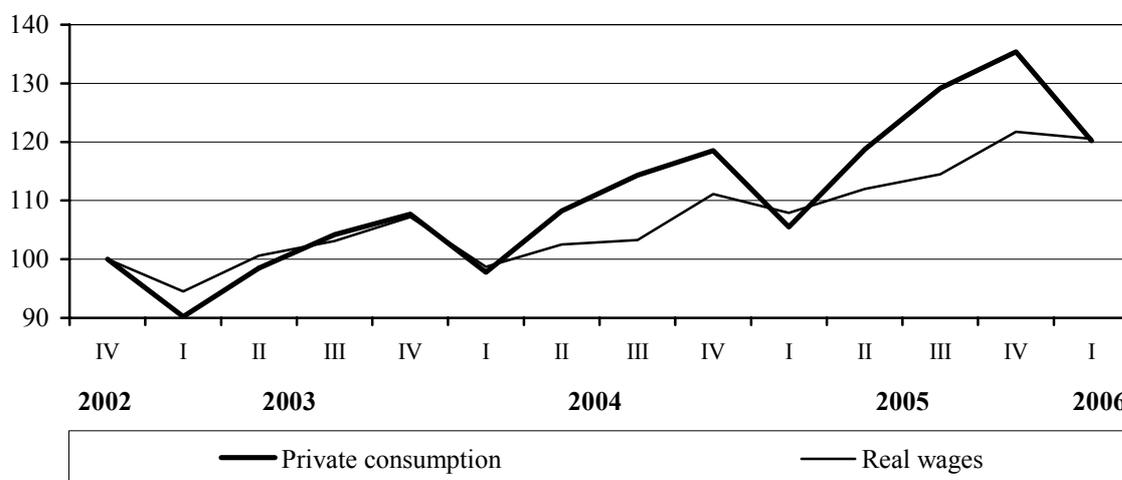
Dynamics of the disposable income and the final consumption (private consumption) expenditures in the last 5 years have been almost equal, with income growing slightly faster. Hence the ratio of the negative savings (debt) of households against the disposable income remains close to 3% with small fluctuations by years.

Real wages grow slightly slower than the private consumption, while the share of pay for work in the total income of households slightly increases due to employment rise.

¹ Disposable income – income in cash and the cash value of goods and services obtained in kind, received in form of wages and salary, other income for work (after deduction of taxes), transfers, net income (income after deduction of production costs) from entrepreneurial activity and agricultural production, income from property, rent, etc.

Figure 3.5

Growth of Real Wages and Private Consumption, Quarterly Profile
(4th quarter of 2002 = 100)



In 2004 the disposable monthly income of households per household member increased by 17% on average in comparison with 2003 and reached 101.23 LVL¹. Growth of the consumer price index in this period was lower (6.2%), thereby the purchasing power of the population rose by 9.7% on average. Higher nominal growth of the disposable income was in the countryside (24%), while the disposable income in cities grew by 14%.

Average household consumption expenditures per household member in Latvia were 114.08 LVL per month in 2004, exceeding the disposable income by 12.58 LVL. The consumption expenditures in urban households were higher (128 LVL), while the consumption expenditures in rural households were considerably lower (84.75 LVL).

On the whole, growth of final consumption expenditures in 2004 was a bit slower than the GDP growth rates both in current and constant prices. Investment is the part of GDP expenditure with the most rapid growth rate.

3.2.3. Investment

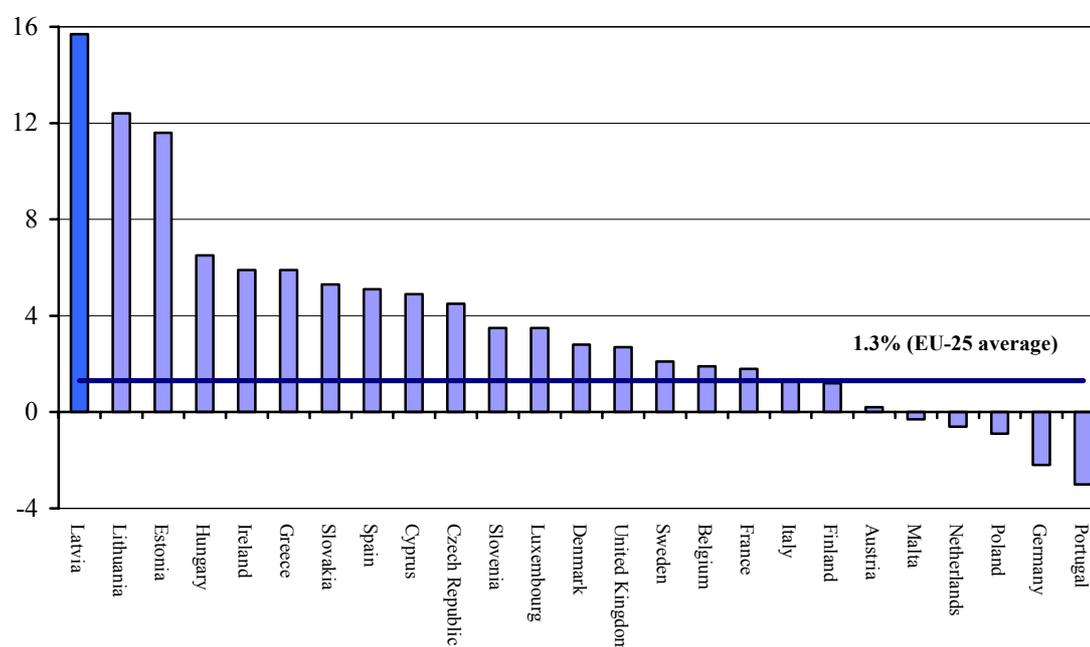
Investment growth rates in Latvia remain steadily high for several years already. This is affected by several factors, especially such as financial stability, continuous improvement of business environment, high domestic demand, rather low real interest rates, inflow of foreign capital, etc. At the same time, relatively low tax burden and increasing product sales due to growing demand positively affected the financial position of companies hence increasing opportunities of investment for own resources.

As indicated by *Eurostat* data, growth of investment (gross fixed capital formation or fixed investment) in EU member states in the last five years has slowed down more than three times (from 4.6% to 1.3%) in comparison with the previous 5-year period, mainly due to the low growth rates or even decrease of investment in the old EU member states. Investment dynamics of almost all new EU member states still exceeds the EU-15 average several times. It should be noted that investment dynamics is the fastest in the Baltic States, including Latvia.

¹ According to the data of household budget survey

Figure 3.6

Investment Growth in EU Member States from 2000 to 2005
(annual average, per cent)



Source: Eurostat, Annual Macroeconomic data base, http://ec.europa.eu/economy_finance

Fixed investments in Latvia in 2005 were twice bigger than in 2000, i.e., they have annually increased by 15.7% on average in this period. Latvia is the leader in investment dynamics among EU member states.

Along with the fast investment growth rates that exceeded GDP growth several times, the share of investment in GDP increased annually as well. In the last five years the share of investment in GDP (gross fixed capital formation against GDP) constitutes 26.5% on average or almost 4 percentage points more than the EU-15 average. So, more than a quarter of the national income is annually used for the gross fixed capital formation, which is one and a half times more than in the first 10 years on average after restoration of Latvia's independence.

Rapid investment dynamics continued in 2006 as well, and the investment in the 1st quarter of 2006 exceeded the level of the 1st quarter of the previous year by 18%.

Table 3.4

Gross Capital Formation

	2001-2005 (average per year)	2004	2005
Real growth			
GDP	8.1	8.6	10.2
Gross capital formation	16.9	22.9	5.1
– gross fixed capital formation	15.8	23.8	18.6
% of GDP			
Gross capital formation	29.8	33.1	34.2
– gross fixed capital formation	26.0	27.5	29.8
– changes in inventories	3.8	5.6	4.4

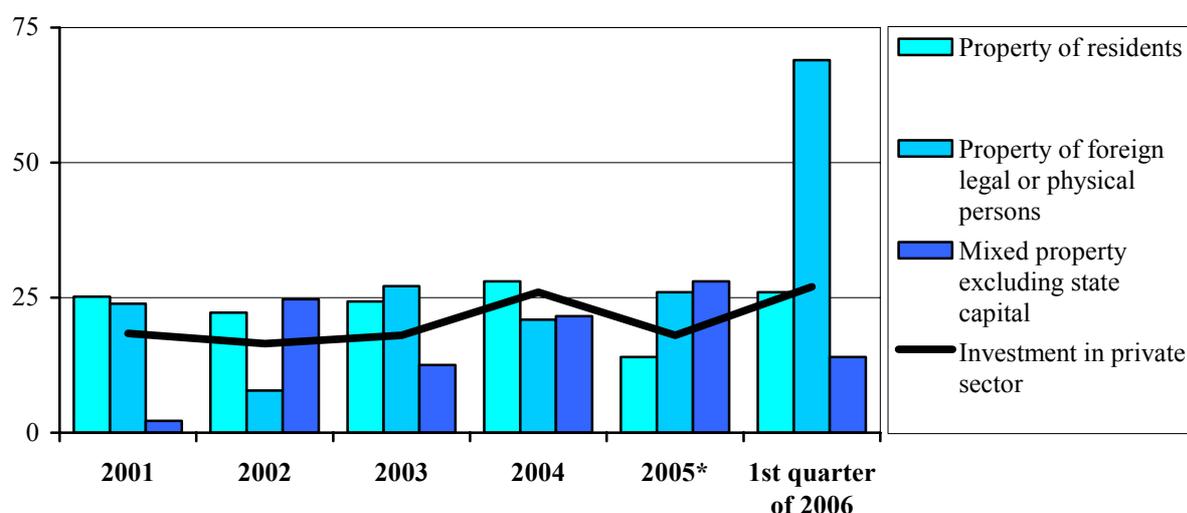
The investment growth is mainly ensured by the investment in the private sector. From 2001 to 2005 the investment in the private sector has doubled (increased on average by 19% annually), while the investment in the public sector¹ has increased by 32% in 4 years (on average by 7.7% annually).

In 2005 the investment in the public sector went up by 6% as compared to 2004, while the investment in the private sector increased by 18%. In the 1st quarter of 2006, the investment in the public sector decreased by 8% in comparison with the respective period of the preceding year, while the investment in the private sector increased by 27% and made 76% of the total volume of investments in Latvian economy.

Investments in companies owned by residents and in companies owned by non-residents increased differently (see Figure 3.7).

Figure 3.7

Fixed Investment Dynamics in Private Sector by Property Forms
(percentage against the preceding year)



* estimated using the quarterly data

Since 2001 the investment in companies owned by residents increased on average by 25.3% per annum and made up 42% of the investment in the private sector or 27.7% of total investment. Investment in companies owned by non-residents reached 17% of the investment in the private sector, growing annually by 19.7% on average. In 2005 faster growth of investment was observed in companies owned by non-residents.

Sectoral structure of investment². Along with the rapid growth of investment, certain changes have also been observed in the sectoral structure of investment. In the last five years (2001–2005) investment dynamics in production sectors was more than one and a half times faster than in services. In this period, investment in production sectors grew by 167% (annually by 21.7% on average), while investment in services sectors increased by 68% (annually by 10.9% on average). In 2005 investment in production sectors grew by 29.4%, i.e., almost seven times faster than in services sectors. These trends determined that the share of production sectors in the sectoral structure of investment is gradually increasing. In 2005 investment in production sectors made 43% of total investment in Latvian economy or one and a half times more than in 2000.

In 2005 positive investment dynamics was observed in almost all national economy sectors. Investment in the “hotels and restaurants” sector almost doubled (increase by 94%), and investment grew especially fast in agriculture (by 53%), mining industry (by 33%), manufacturing (by 31%), construction (by 58%) (see Table 3.5).

¹ The public sector includes enterprises and organisations of the central and local governments, business companies with central or local government or their enterprises’ share in equity capital in the amount of 50% and more, social and religious organisations and enterprises owned by them, and budgetary institutions.

² Investment in distribution by sectors is presented according to non-financial investment statistics that does not include all investment in fixed assets.

Table 3.5

Fixed Investment by Sectors
(excluding investment in individual construction, %)

	Growth			Structure		
	Average 2001-2005	2005*	1st quarter of 2006	Average 2001-2005	2005*	1st quarter of 2006
Primary sectors	36.4	48.2	-8.4	3.9	5.0	3.3
Manufacturing	19.9	31.0	24.0	15.8	19.6	23.2
Electricity, gas and water supply	18.0	14.0	-32.0	9.1	13.1	3.9
Construction	27.0	58.0	9.0	3.1	5.1	4.9
Trade	12.9	15.0	44.0	16.0	15.5	18.0
Transport and communications	0.8	-3.0	-20.0	19.0	15.1	13.3
Other commercial services	18.0	2.8	55.2	19.3	15.0	22.9
Public services	13.1	3.3	22.6	13.9	11.6	10.5
Total	14.6	14.0	16.0	100.0	100.0	100.0

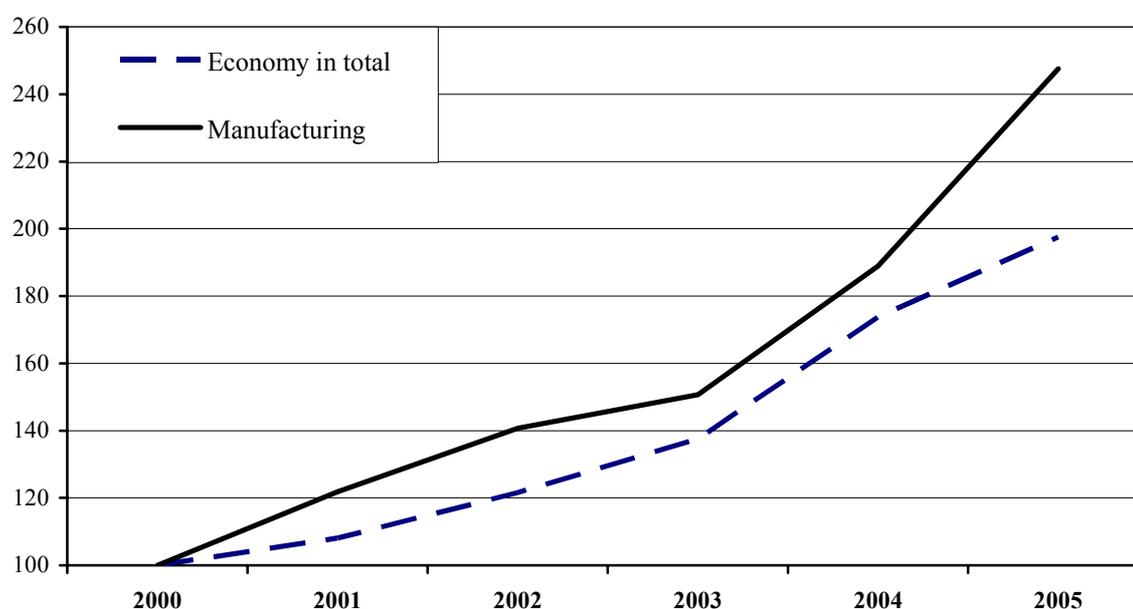
* estimated using the quarterly data

In the 1st quarter of 2006 the investment in services sectors grew slightly faster than in production sectors (by 19.8% and 14.4% respectively). High investment dynamics remained in manufacturing as well.

Since 2000 the average growth of investment in manufacturing is faster than in Latvian economy on average.

Figure 3.8

Fixed Investment in Manufacturing*
(2000=100)



* by statistics of non-financial investment

In 2005 as compared with 2004, the investment in manufacturing grew by 31% and constituted 19.6% of total investment in Latvian economy or 5 percentage points more than in 2000. In the 1st quarter of 2006 the investment in manufacturing increased by 24% in comparison with the respective period of 2005.

Table 3.6

Dynamics and Structure of Investment in Manufacturing
(%)

	Growth rates			Structure		
	Average 2001-2005	2005*	1st quarter of 2006*	Average 2001-2005	2005*	1st quarter of 2006*
Food industry	18.3	22.1	17.1	28.7	20.0	27.4
Light industry	-11.0	-40.3	22.2	6.8	3.7	7.5
Wood processing	20.8	77.0	58.6	28.4	42.0	18.2
Paper industry and publishing	2.7	-16.9	24.1	6.9	4.3	11.3
Chemical industry and related industries	20.7	-14.8	35.5	6.2	2.8	8.6
Production of other non-metallic mineral products	62.8	146.0	71.1	5.2	10.1	3.4
Production of metals and metal articles	40.7	83.3	-8.5	6.7	9.0	8.6
Production of machines and equipment	33.8	83.1	-17.4	6.8	5.1	7.2
Other industries	21.7	-14.6	-38.8	4.2	3.0	7.8

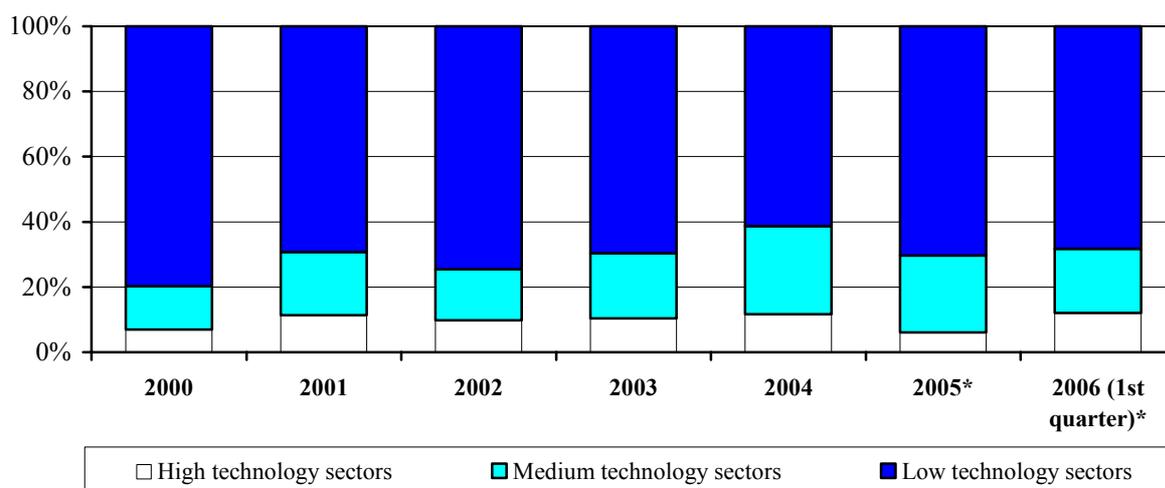
* estimated using the quarterly data

Like in the previous years, food industry and wood processing have leading positions in terms of investment volumes. In 2005 the share of these two sectors in the investment made into manufacturing amounted to 50%. However, the share of the mentioned sectors in investment structure is gradually decreasing, mainly due to faster growth of investment in other sectors. In the last five years, investment grew especially fast in such sectors as metal production (annually by 68% on average), production of other non-metallic products (63%), production of radio, television and communication equipment (61%). Investment in production of machines and equipment was four times bigger than in 2000.

Since 2000 on the whole, investment in manufacturing sectors of high and medium technologies grows the fastest. Investment in these sectors more than doubled in the last five years, while investment in low technology sectors in 2005 has increased by 31% in comparison with 2000.

Figure 3.9

Structure of Investment in Manufacturing
(%)



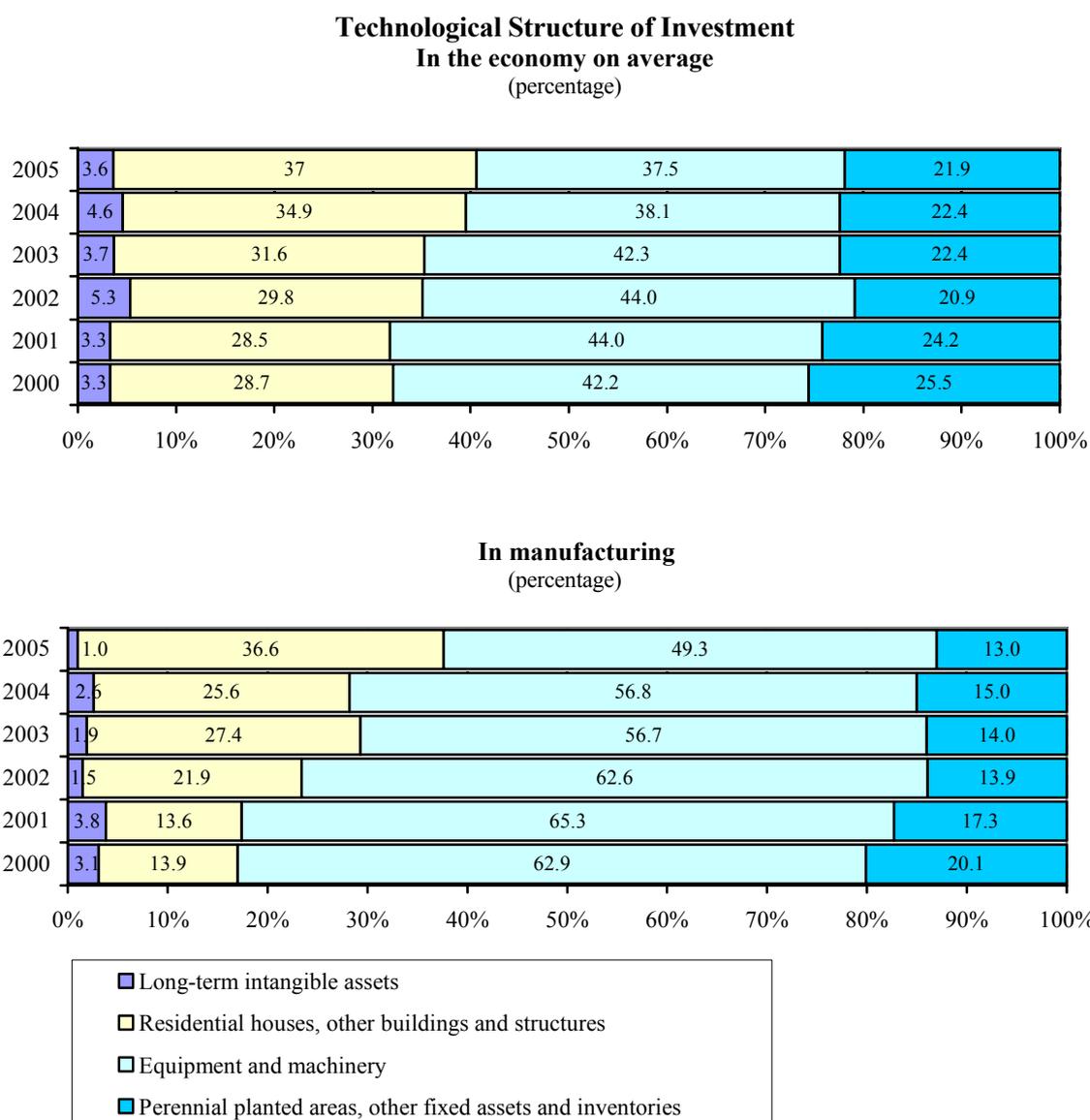
* estimated using the quarterly data

Such trends may indicate certain capital saturation in low technology sectors and drain of their development potential, which is also greatly affected by price competition pressure from Asian producers.

In the last two years the share of residential houses, other buildings and structures in the **technological structure** of investment increased especially fast, which was greatly influenced by development of mortgage crediting in Latvia. The share of the long-term intangible assets in investment is still small.

The share of technological machinery and equipment in the total investment amounts to 41% on average in the last five years, and almost one-fourth of these investments are allocated for acquisition of transport vehicles and are not directly linked with the production process. One-third of the investments are channelled to construction and renovation of buildings.

Figure 3.10



Technological structure of investment is greatly influenced by production specifics and the structure of the existing fixed assets. The average share of equipment and machinery in the manufacturing investment structure is 16.4 percentage points higher than in the economy on average, while the average share of investment into houses and buildings in the manufacturing investment structure during 2000-2005 was 6 percentage points lower than in the economy on average. Entrepreneurs in manufacturing invest increasingly more in buildings during the recent years. New premises are being built and old premises renovated for production needs. This was greatly determined by improved access to financial resources and indicates a new development phase in manufacturing.

As already mentioned, the share of long-term intangible assets in investment is very small in Latvia with a poorly pronounced trend to grow gradually, and their share in manufacturing is even decreasing.

Intangible assets are special kind of costs executed in interests of revenues of next accounting periods. Predominantly, intangible assets are research and enterprise development costs, rights acquired for payment to use patents, licences, trademarks, software, and similar rights. Low share of intangible assets in the technological structure of investment indicates (especially in manufacturing) weak innovation processes and unsatisfactory link between science and the private capital.

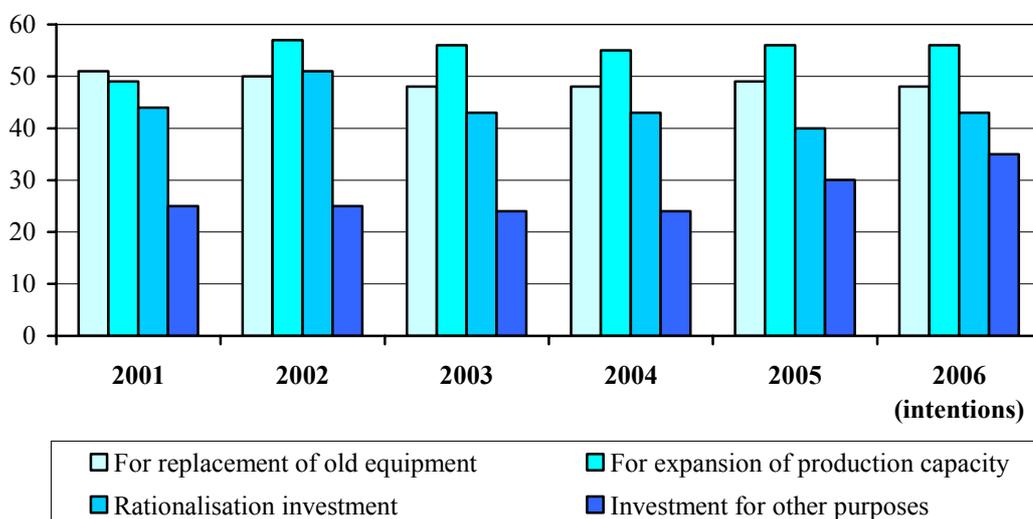
Necessity of investment is determined by increased utilisation rate as well as necessity to restore the existing capacities for retaining and increase of competitiveness. As results of business survey indicate, since 2002 investment for expansion of production capacity dominate rather invariably and significant investment is also channelled for replacement of old equipment. Although investment for rationalisation in 2005 was made by 40% of the surveyed industrial enterprises, this investment tends to decrease.

The utilisation rate in Latvian enterprises is increasing gradually. In 2004 the rate of utilisation (as percentage of full capacity) in industry equalled to 71% on average, exceeding the average rate of 2000 by 11 percentage points. In July 2005 the rate of utilisation reached 79% and was the highest since 1993.

Since 2002 investment in manufacturing is mostly made for expansion of production capacities. In 2005 such investment was made by 56% of the surveyed companies. Big investment is still being made for replacement of old equipment, while the number of companies planning to invest for mechanisation and automation of production has declined since 2002. Investments for increase of labour safety and environmental protection were made in 2005 more than in the previous years. In 2005 such investments were made by 30% of manufacturing companies, but in 2006 such investments are planned by 35% of manufacturing companies.

Figure 3.11

Types of Fixed Investment in Manufacturing Companies
(percentage of surveyed companies)



However, the results of business survey indicate that the demand for products is the determinant factor with the biggest positive influence in all survey years among the factors affecting investment and its importance increased in 2005. It has to be noted that entrepreneurs in Latvian industry on the whole consider technical factors the second most important factor stimulating investment. This factor is more significant than factors of access to financial resources.

The growing domestic and external demand in conditions of high utilisation rate can create additional stimuli for investment also in the future. Results of business surveys indicate that Latvian entrepreneurs plan to increase investment in industry by 23% in 2006, including by 6% in manufacturing.

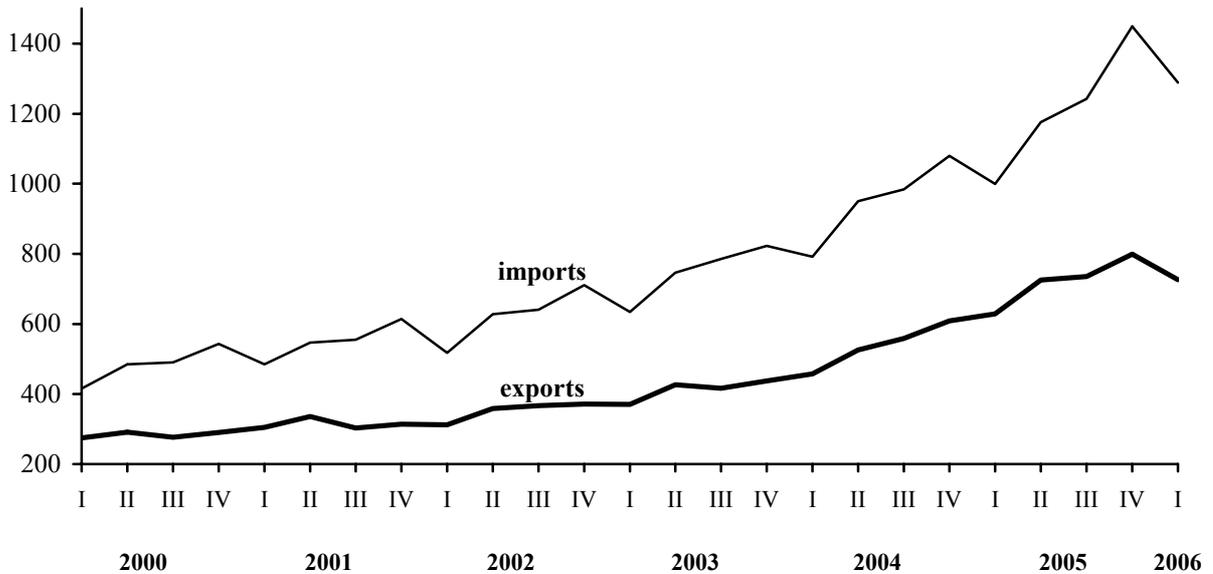
3.2.4. Exports and Imports

Exports and imports of commodities

Exports of Latvian commodities in 2005 grew substantially by 34% in current prices, while imports increased at a slightly more moderate pace by 28%. Especially fast import growth rates were observed at the end of the year (see Figure 3.12).

Figure 3.12

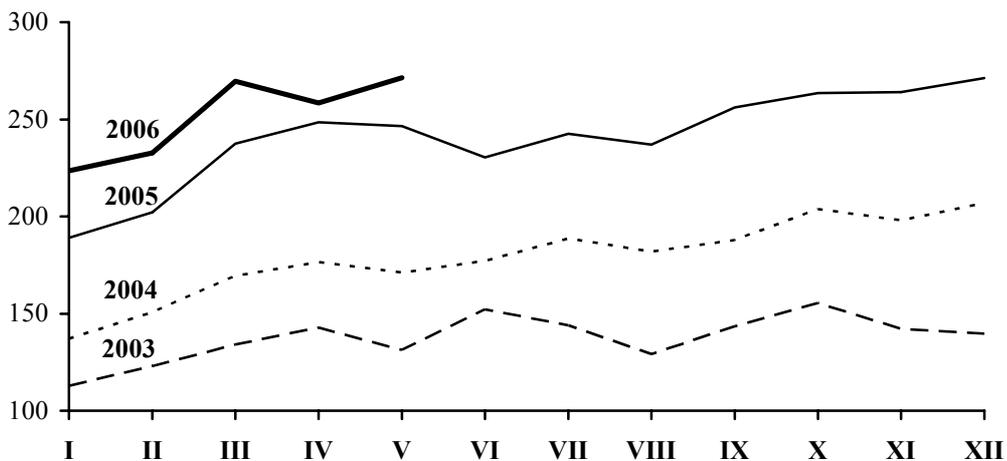
Commodity Exports and Imports by Quarters
(million LVL)



In 2005 the **commodity exports** were favourably influenced by the fast rise of the export unit value that exceeded the value of the previous year by 10%, as the euro exchange rate increased and world prices grew in several groups of goods, especially food products and mineral products.

Figure 3.13

Commodity Exports by Months
(million LVL)



Commodity exports in 2005 went up in all groups of goods, especially mineral products and food products, which accounted for respectively 21% and 19% of the total growth of exports (see Table 3.7). At the beginning of 2006 the export growth was more moderate as the exports of mineral products decreased (mostly to the EU member states).

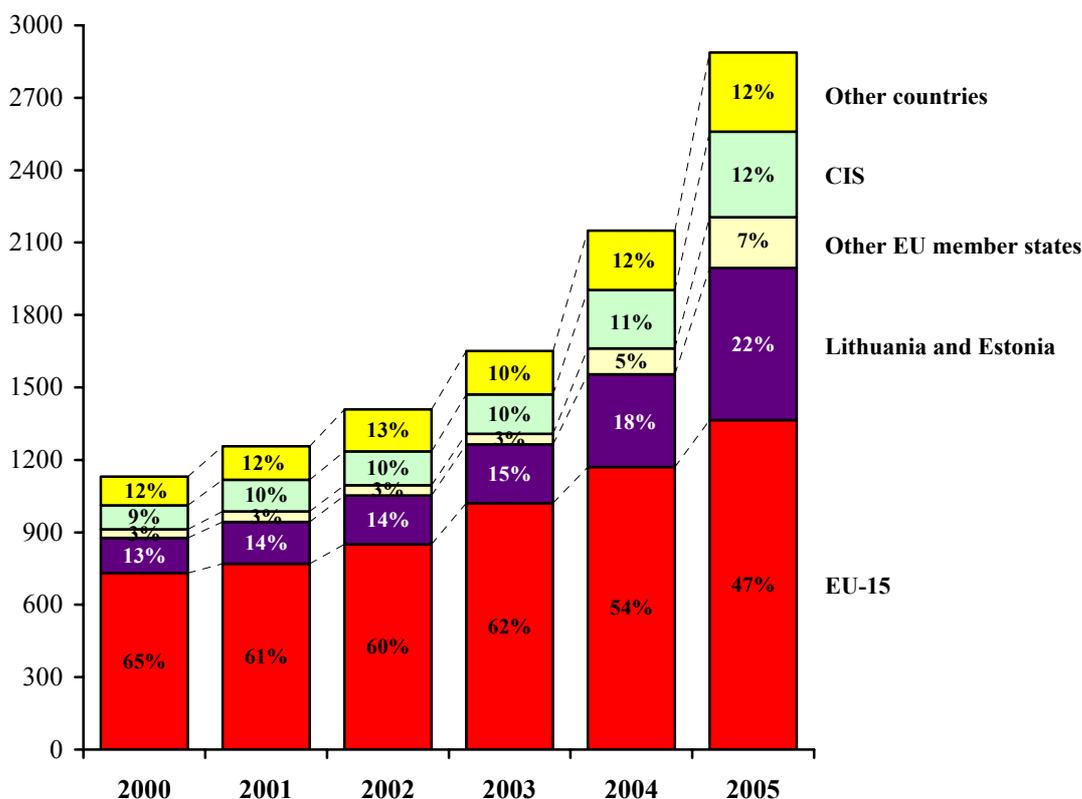
Table 3.7

Exports by Main Groups of Commodities
(FOB prices)

	2004			2005		
	million LVL	structure (%)	increase against 2003 (current prices, %)	million LVL	structure (%)	increase against 2004 (current prices, %)
Total	2150.0	100	30.3	2888.2	100	34.3
including:						
wood and wood products (IX)	655.3	30.5	12.4	717.6	24.8	9.5
metals and metal articles (XV)	303.3	14.1	46.2	379.3	13.1	25.1
light industry products (VIII; XI-XII)	244.6	11.4	8.5	269.8	9.3	10.3
agricultural and food products (I-IV)	209.3	9.7	40.9	352.6	12.2	68.5
products of chemical industry and allied industries, plastics (VI-VII)	196.8	7.9	33.7	233.6	8.1	39.6
machinery (XVI)	196.2	7.9	44.8	269.4	9.3	59.2
mineral products (V)	114.1	5.3	331.9	265.2	9.2	132.4
transport vehicles (XVII)	54.4	2.5	58.9	111.2	3.9	104.4
other commodities (X; XIII-XIV; XVIII-XXII)	250.0	10.7	26.0	289.5	10.0	25.9

Figure 3.14

Exports by Groups of Countries
(percentage)



Exports to the **EU member states** in 2005 were by 32% bigger than in the previous year. Exports increased in all groups of commodities, and the biggest contributions to the growth and the total exports were made by exports of mineral products and food products (22% and 19% respectively of the total growth of exports to the EU member states). More moderate growth rates were observed in the export groups of machinery and metal articles, which accounted for 25% of the total exports to the EU-25.

In January-May 2006 exports to the EU member states increased by 8%, and the biggest contributions were made by the export groups of transport vehicles and agricultural and food products.

Exports to the **CIS countries** in 2005 continued increasing at especially rapid pace (by 46%), mainly due to increased exports of chemical industry products and machinery (20% and 24% respectively of the total growth of exports to the CIS countries). Only exports of wood and wood products decreased (by almost one-half).

Exports to this group of countries grew very fast also in 5 months of 2006 (by 32%), mostly due to the increased exports of agricultural and food products and chemical industry products.

Commodity imports in 2005 increased by 28% (see Figure 3.15 and Table 3.8). Imports grew in all groups of commodities, and the biggest growth was observed in the group of mineral products, which accounted for 26% of the total increase of imports, and in the group of machinery (20%). In January-May 2006 the rapid growth of imports reached 26%, mainly due to the groups of transport vehicles and machinery.

Figure 3.15

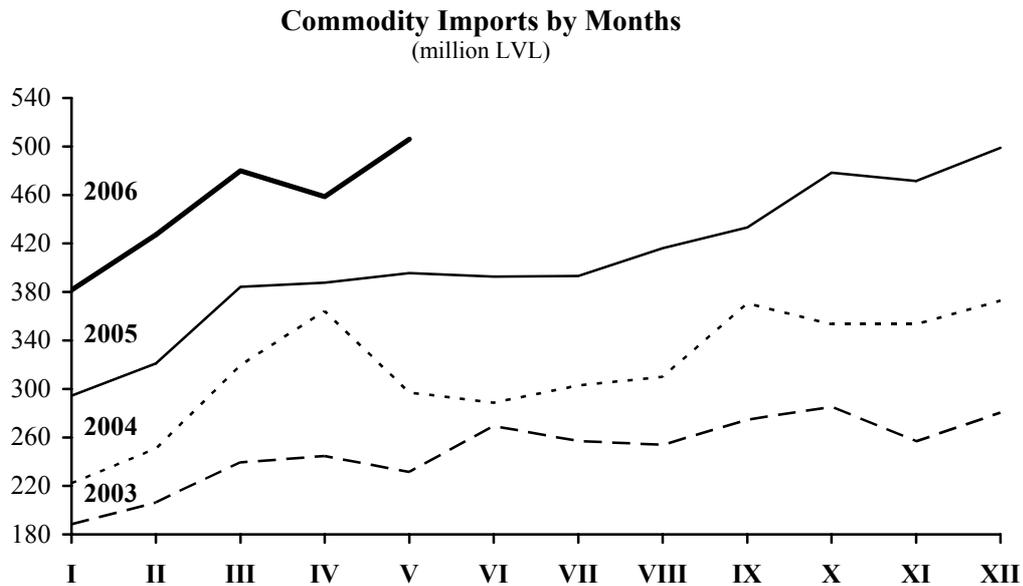


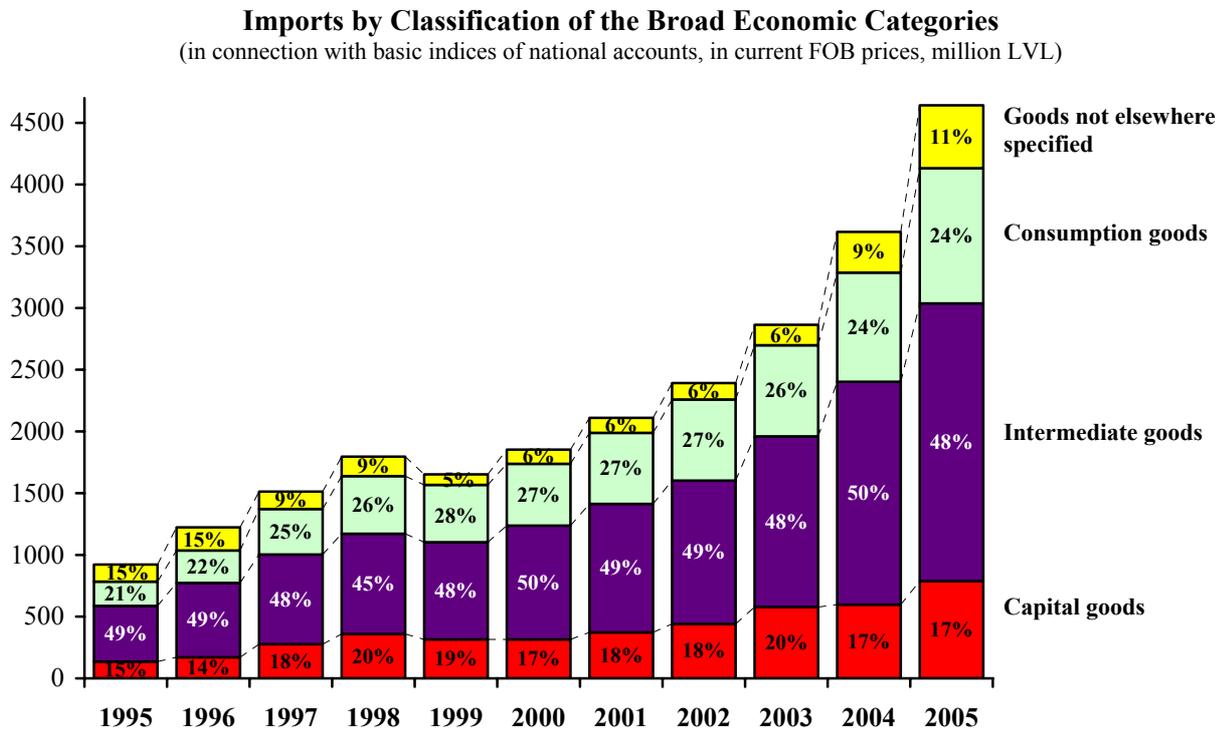
Table 3.8

Imports by Main Groups of Commodities
(CIF prices)

	2004			2005		
	million LVL	structure (%)	increase against 2003 (current prices, %)	million LVL	structure (%)	increase against 2004 (current prices, %)
Total	3805.3	100	27.3	4866.9	100	28.0
including:						
wood and wood products (IX)	114.8	3.0	63.5	142.0	2.9	24.5
metals and metal articles (XV)	388.4	10.2	40.1	447.6	9.2	15.2
light industry products (VIII; XI-XII)	261.5	6.9	12.6	293.4	6.0	12.2
agricultural and food products (I-IV)	445.3	11.7	23.3	566.4	11.7	27.2
products of chemical industry and allied industries, plastics (VI-VII)	540.3	14.2	19.0	659.6	13.6	22.1
machinery (XVI)	755.7	19.9	20.0	967.7	19.9	28.1
mineral products (V)	481.6	12.7	62.2	752.8	15.5	56.3
transport vehicles (XVII)	413.7	10.9	31.9	523.1	10.7	26.4
other commodities (X; XIII-XIV; XVIII-XXII)	404.0	10.6	14.3	513.4	10.5	27.1

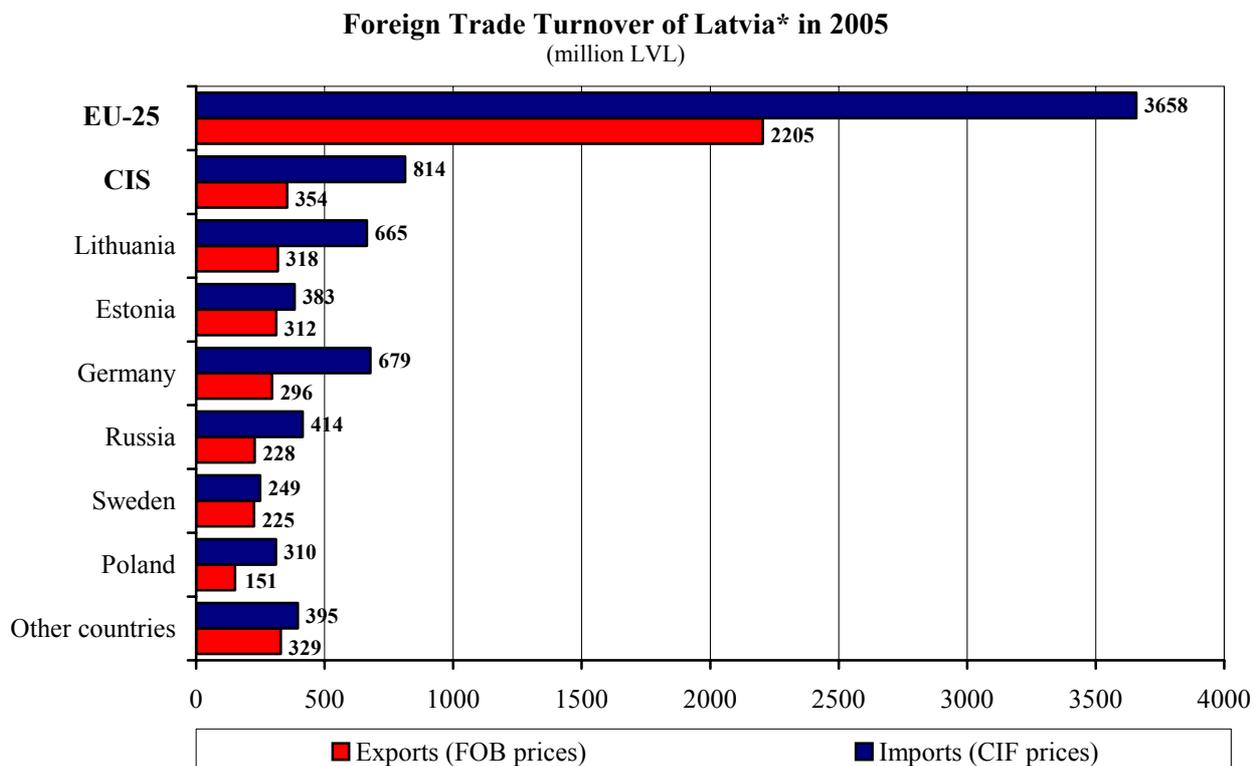
As viewed by classification of broad economic categories, the imports have not changed substantially during the last four years (see Figure 3.16).

Figure 3.16



The biggest **trading partners** of Latvia in 2005 were Lithuania (13% of the total foreign trade turnover), Germany (13%), Estonia (9%), Russia (8%), Sweden (6%) and Poland (6%).

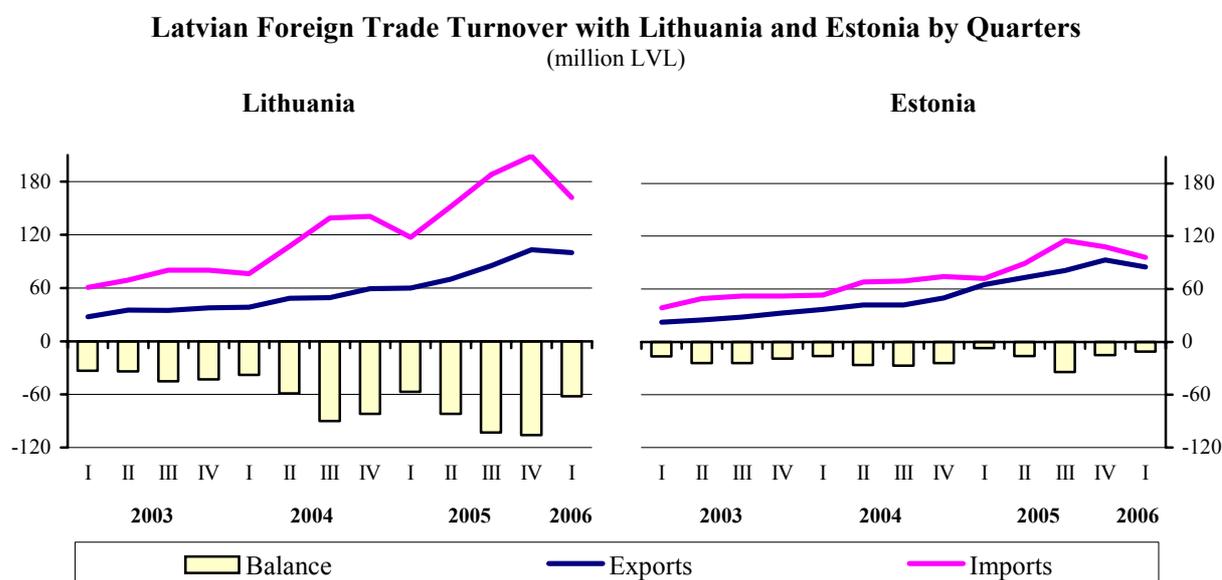
Figure 3.17



* with countries, where foreign trade turnover with Latvia is not less than 5%.

After accession to the EU, foreign trade of Latvia with **Lithuania** and **Estonia** is increasing very rapidly. In comparison with the period before accession to the EU, Latvian foreign trade with these countries has increased more than twice during two years. However, a considerable negative balance still remains, although the share of the negative balance slightly diminishes, considering the rapid increases of the trade volumes (see Figure 3.18).

Figure 3.18



As the figure shows, the negative balance of foreign trade with Lithuania (in 2005 the ratio of imports against exports made 109%) is bigger than with Estonia (23%). The main groups of commodities exported to Estonia and Lithuania are food products, chemical industry products, metals and metal articles, while the main imported commodities are mineral products, transport vehicles and food products.

In January-May 2006 exports to Lithuania increased rapidly (by almost 70%), and the biggest contributions were made by the groups of transport vehicles, mineral products, agricultural and food products. Imports from Lithuania in this period grew at a more moderate pace by 37 per cent.

Growth rates of exports and imports in trade with Estonia in January-May 2006 were similar (33% and 29% respectively). Transport vehicles dominate in exports, while chemical industry products dominate in imports.

Exports and imports of services

The clearly negative balance of commodity trade of Latvia is partly covered by the positive balance of services (see Table 3.9). According to the data of the balance of payments, the balance of services in 2005 has deteriorated, as exports of services went up by 27%, but imports increased faster by 39%.

Table 3.9

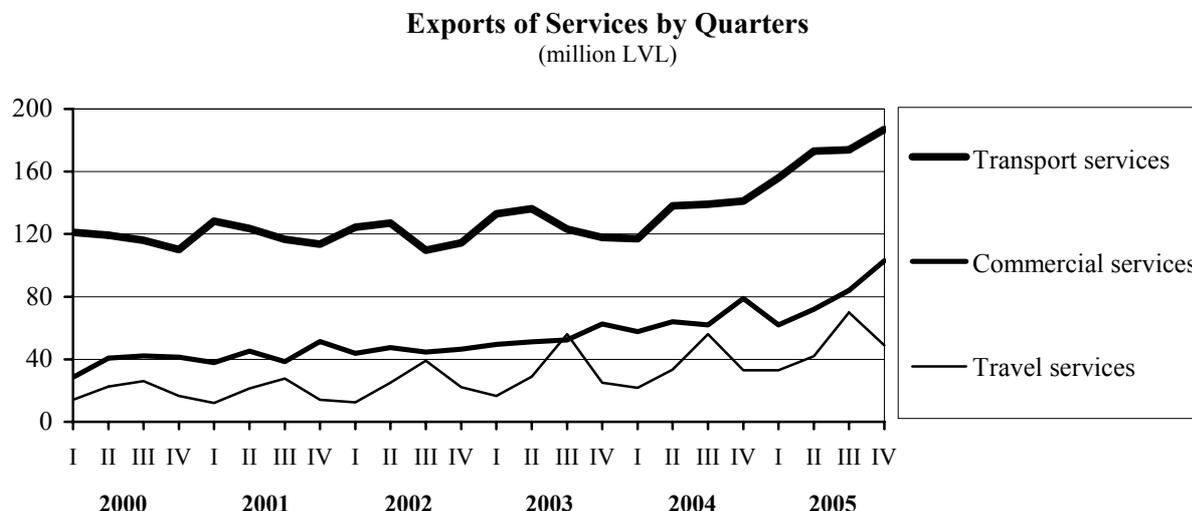
Exports and Imports of Services in 2005

	Million LVL			Structure (%)		Changes against 2004 (%)	
	exports	imports	balance	exports	imports	exports	imports
Services – total	1223.2	-881.7	341.4	100.0	100.0	27.2	38.7
including:							
Transport services	689.8	-283.6	406.2	56.4	32.2	28.7	27.1
– sea transport	292.7	-61.0	231.7	23.9	6.9	25.7	4.1
– air transport	77.0	-99.9	-22.9	6.3	11.3	38.8	48.1
– other transport	320.1	-122.7	197.4	26.2	13.9	29.4	26.4
Travel	193.9	-330.9	-137.0	15.9	37.5	34.2	62.4
Commercial services	320.7	-250.9	69.8	26.2	28.5	21.2	29.5
Other services	18.8	-16.4	2.4	1.5	1.9	13.9	7.1

More than half of the exports of services are made by the revenues from transit haulage. 2005 was a rather successful year for the transit business, as cargo turnover in ports increased and volumes of rail transport services and road transport services grew.

Growth of revenues from incoming tourists and increase of commercial services are significant. Latvian travellers still, as usual, have spent much more money abroad than foreigners in Latvia.

Figure 3.19



3.3. Contribution of Sectors

3.3.1. Structure and Dynamics of the Economy

The structure of Latvian economy in sectoral profile has changed in favour of service sectors in the last years. The share of service sectors in value added has increased to 73.8% in 2005 from 71.8% in 2000. Construction, trade services, transport and communications have grown faster than other sectors of economy in terms of both the value added and the number of employees.

Table 3.10

Structure of the Economy
(%)

	By value added		By number of employees	
	2000	2005	2000	2005
Primary sectors	4.8	4.4	14.5	11.5
Manufacturing	13.7	12.8	17.9	15.8
Electricity, gas and water supply	3.6	2.6	1.9	1.6
Construction	6.1	6.3	5.9	8.8
Trade, hotels and restaurants	17.9	22.1	17.7	19.1
Transport and communications	14.0	15.6	8.3	9.4
Other commercial services	23.0	22.0	12.4	13.0
Public services	16.9	14.2	21.4	20.8
Total	100.0	100.0	100.0	100.0

The structure of the economy in terms of employment differs considerably from the structure by value added due to the marked difference between productivity levels in various sectors of economy.

The rapid economic growth in the recent years has been ensured by both increased domestic demand and wider export opportunities. Increase of domestic demand had a direct impact on the fast growth of several service sectors, while increased volumes of industrial production were mainly based on rising exports.

In the last five years (2001-2005), increasing trade (wholesale and retail) contributed to almost one-third of growth. The contribution by manufacturing is by one-half less and also lags behind the contribution by the transport and communications sector.

The growth of *trade* as an economic sector has been driven mostly by the domestic demand, but a little over one-tenth is related to the trade mediation services provided to non-residents. This share is growing every year.

Table 3.11

GDP Growth
(%)

	Growth rates		Contribution to growth	
	2005	Average 2001-2005	2005	Total 2001-2005
Primary sectors	6.8	4.6	0.3	1.1
Manufacturing	6.3	7.6	0.9	6.0
Electricity, gas and water supply	2.3	4.4	0.1	0.8
Construction	15.5	11.9	1.1	4.6
Trade, hotels and restaurants	17.2	12.7	3.5	14.4
Transport and communications	16.2	10.2	2.3	8.6
Other commercial services	8.0	7.5	1.8	9.8
Public services	2.7	2.8	0.4	2.4
GDP	10.2	8.1	10.2	47.7

Two-thirds of the total demand of the *transport and communications* sector is determined by the domestic demand that is stable and has increased faster than the external demand in recent years. This refers especially to communications as well as supporting and auxiliary types of transport activity, such as warehousing, parking services, operation of travel agencies. The external demand for transit services is unstable. Due to the discriminatory attitude of Russia since 2002 as regards the transit of oil products through Ventspils port, total amount of cargo sent to ports declined. From 2004 the situation improved mostly due to increased cargo turnover of other Latvian ports.

The significant growth rates in the transport and communications sector in 2004-2005 were ensured by increased transportation of both cargo and passengers as well as development of the communications industry. In cargo transportation, the amount of cargo transported by motor vehicles grew substantially and contributed most to the overall growth. Contributions by railway transport and port services to the growth of the sector were smaller. Passenger transport services increased substantially, especially in air transport.

Rapid growth of investment has had a favourable impact on the development of *construction* industry that is growing at a rate much higher than the average growth in the economy.

Table 3.12

GDP Growth in the 1st Quarter of 2006
(% against the respective quarter of the preceding year)

	Growth rates	Contribution to growth
Primary sectors	4.1	0.2
Manufacturing	8.8	1.3
Electricity, gas and water supply	10.7	0.4
Construction	17.5	1.0
Trade, hotels and restaurants	17.3	4.3
Transport and communications	6.0	1.0
Other commercial services	17.5	4.4
Public services	2.9	0.5
GDP	13.1	13.1

In the 1st quarter of 2006 growth was even faster than in the previous year, as high growth rates remained in most service sectors and industrial production volumes increased more rapidly than in the

previous year. High growth rates are in almost all sectors of economy, especially in construction, transport and communications, and trade services.

High growth rates in the 1st quarter of the year allow to forecast, that the average growth will exceed 10% in 2006.

3.3.2. Manufacturing

Manufacturing has shown stable growth in the last years (2001-2005), but this growth still lags behind the average growth of economy.

Table 3.13

Growth of Manufacturing* (per cent)

	Average annual growth in 2001-2005	Growth in 2005	January-March 2006 / January-March 2005
Manufacturing – total	6.9	6.5	8.8
Food industry	5.7	5.1	7.6
Light industry	1.7	8.7	11.2
Wood processing	7.6	2.7	9.0
Paper industry and publishing	3.7	11.7	16.0
Chemical, rubber and plastic industry	11.3	15.4	18.6
Manufacture of other non-metallic mineral products	13.5	24.1	-9.0
Production of metals and metal articles	7.7	2.7	5.6
Production of machinery and equipment	14.0	3.1	12.1
Production of electrical and optical equipment	17.5	6.5	28.6
Production of transport vehicles	-3.7	6.5	-19.6
Other industries	9.4	4.2	10.6

* according to operational statistics

In majority of sectors most of the output is being exported, therefore their growth largely depends on expansion of export opportunities.

Immediately after Latvia's accession to the EU the growth rate of manufacturing decreased, as certain time passed until companies accommodated themselves to the new trade conditions. Considerable growth resumed in May 2005.

Table 3.14

Structure of Manufacturing

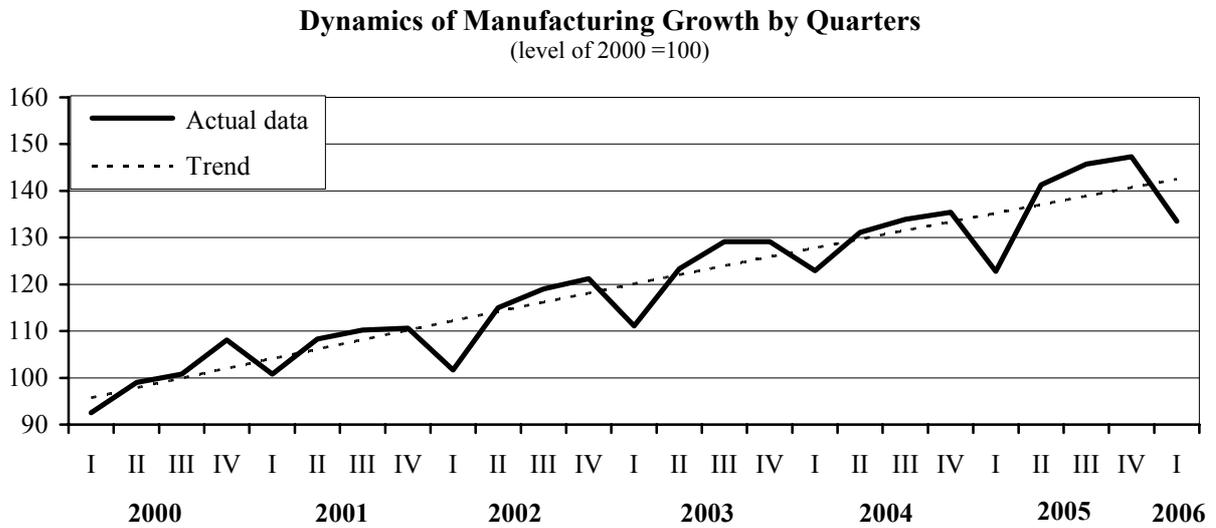
	By value added 2005 (%)*	By number of employees 2004 (%)	Share of exports in sector's sales, 2005 (%)
Manufacturing – total	100	100	51.5
Food industry	20.0	21.4	24.2
Light industry	7.7	14.5	78.9
Wood processing	19.9	19.9	67.5
Paper industry and publishing	8.3	7.8	21.1
Chemical, rubber and plastic industry	7.0	4.9	53.2
Manufacture of other non-metallic mineral products	6.1	3.2	26.1
Production of metals and metal articles	12.3	7.3	71.7
Production of machinery and equipment	3.8	4.4	73.4
Production of electrical and optical equipment	4.7	4.0	63.2
Production of transport vehicles	3.8	4.2	78.3
Other industries	6.4	8.3	62.5

* evaluation by the Ministry of Economics

In 2005 growth was faster in sectors where sales markets are relatively less linked to export, with the exception of food industry. Manufacturing inputs increased by 6.5% on average in this year, as

considerably more moderate growth was observed in wood processing that is one of the principal Latvian export sectors.

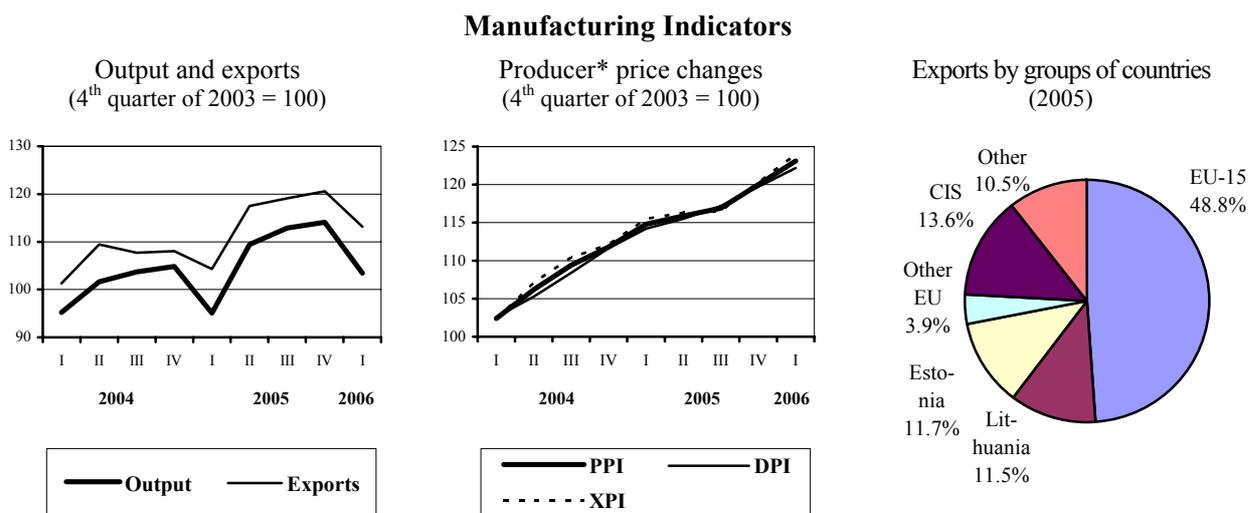
Figure 3.20



Manufacturing growth trend on the whole is equable without marked accelerations or declines. Decreased growth of particular sectors is compensated by increased growth rates in other sectors. In almost all sub-sectors of manufacturing industry the results of 2005 in comparison with 2000 show increased volumes of production (with the exception of production of transport vehicles). After accession to the EU, growth rates increased in paper production and publishing, chemical industry, production of construction materials, and production of electrical and optical equipment. In other sectors, growth rates remained at the previous levels or slightly decreased.

In the period after accession, exports to Estonia and Lithuania expanded most substantially and the growth of exports to these countries was bigger than to the other EU member states. Exports of manufacturing products to CIS countries also increased rapidly.

Figure 3.21

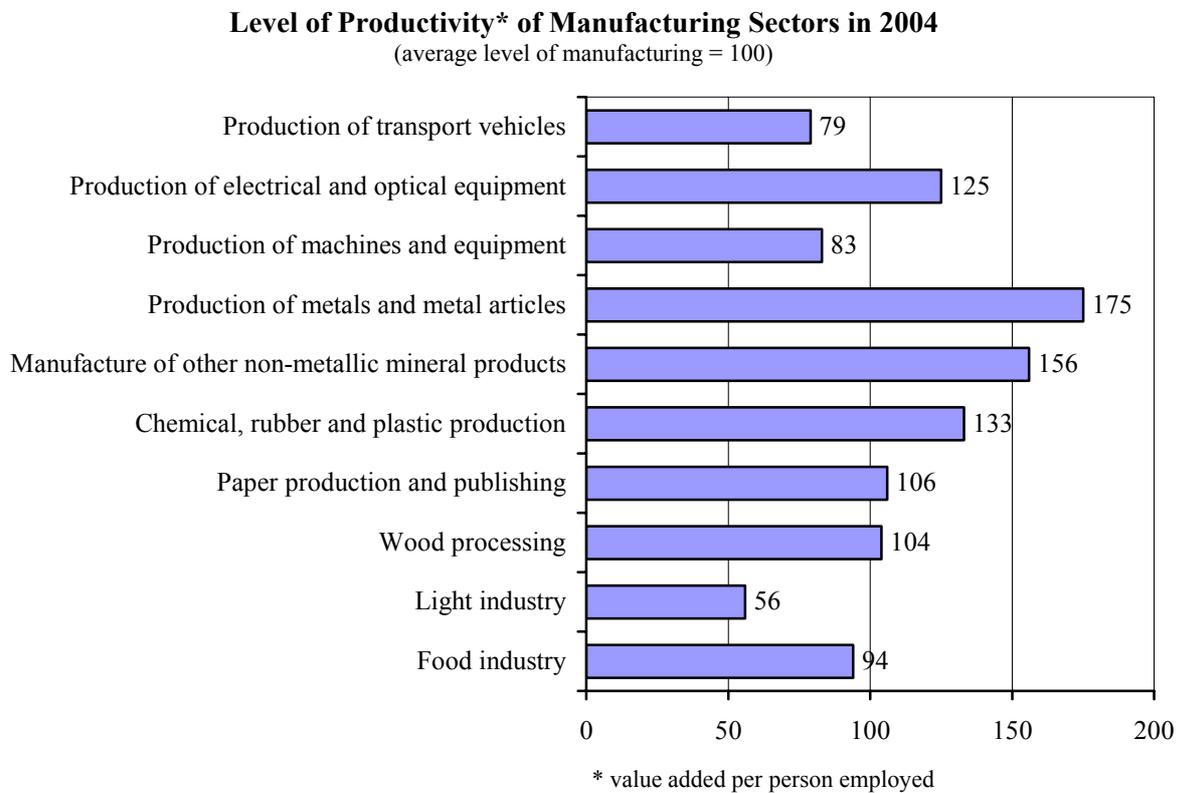


* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Producer prices have considerably increased in all sectors during the last two years, besides, the prices have increased equally for domestically sold and exported products.

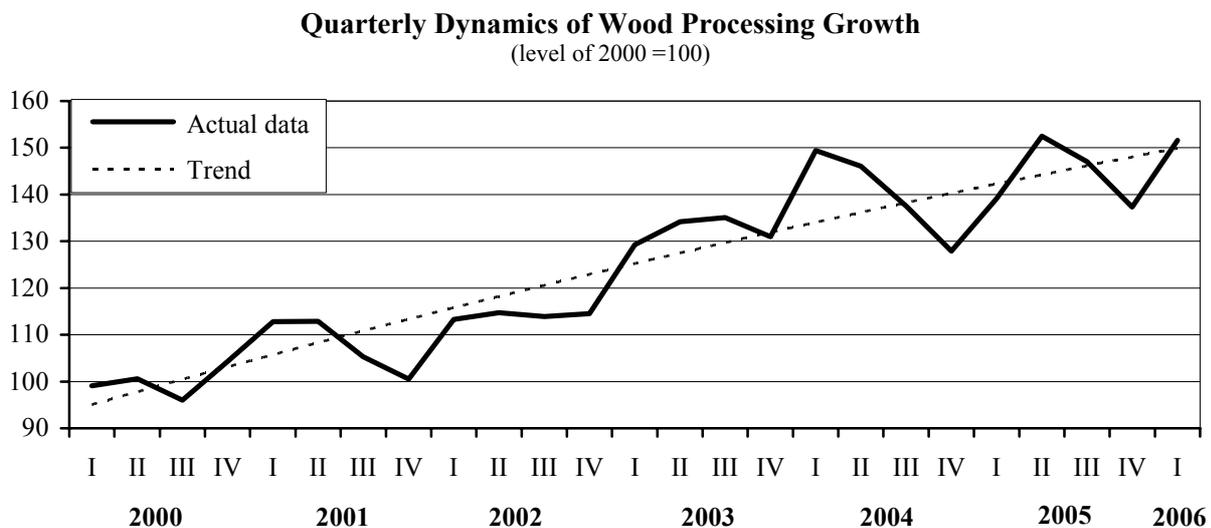
In Latvian industry, level of productivity is the highest in production of metals and metal articles but is relatively low in majority of machinery and equipment sectors. Only textile industry has lower productivity.

Figure 3.22



Wood processing is one of the biggest sectors of Latvian industry. Its value added makes one-fifth of the total value added of manufacturing. This sector has shown the fastest growth since restoration of Latvia's independence, nearly tripling its output in this period. The growth of this sector has become more moderate in the last two years. High share of exported products (almost 70% of the production output) is characteristic for the wood processing sector.

Figure 3.23

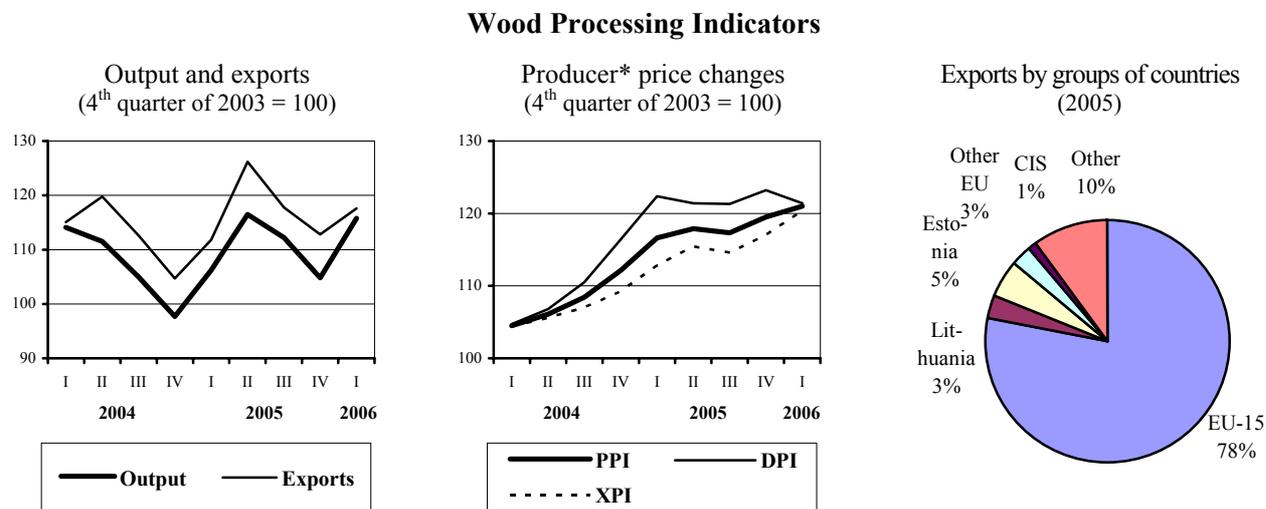


2005 was especially unfavourable year for wood processing, when demand for wood processing products in Europe considerably decreased, mainly due to the big storm at the beginning of the year. Its

production outputs in 2005 little exceeded the level of 2004. Decreased exports of wood processing products to the EU-15 countries were slightly compensated by the rapid growth of exports to Estonia and Lithuania as well as other new EU member states.

Production outputs have substantially increased in 3 months of 2006 and exceed the level of the 1st quarter of the previous year by 9%.

Figure 3.24

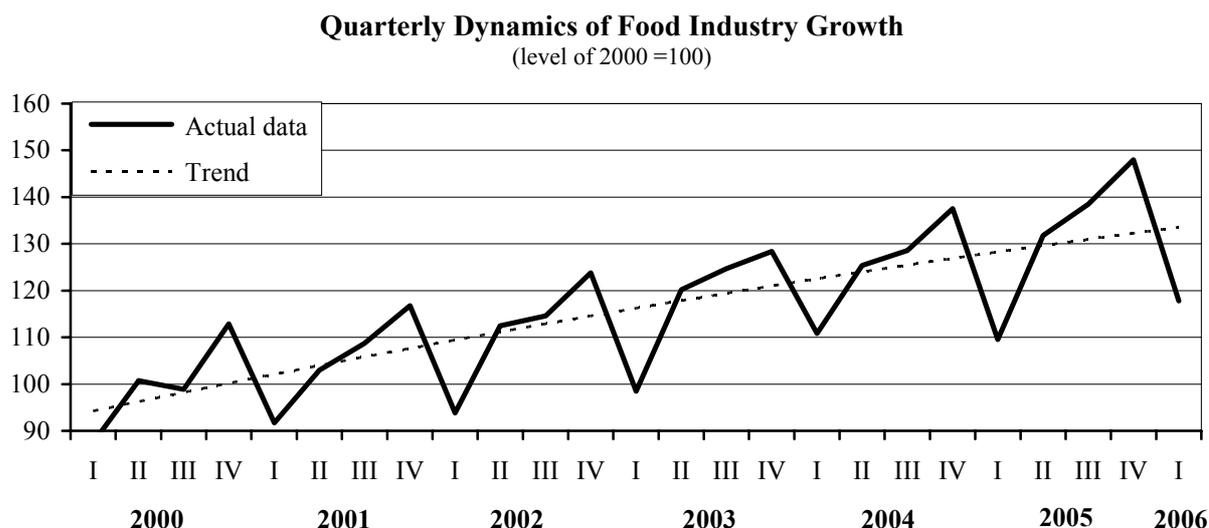


* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Producer prices in wood processing in 2004-2005 grew faster for products sold in the domestic market due to the rise of the domestic demand. Prices for exported products grew faster at the beginning of 2006, favourably affecting the export of products.

Food industry is the second biggest sector in Latvian manufacturing and accounts for one-fifth of the value added in manufacturing.

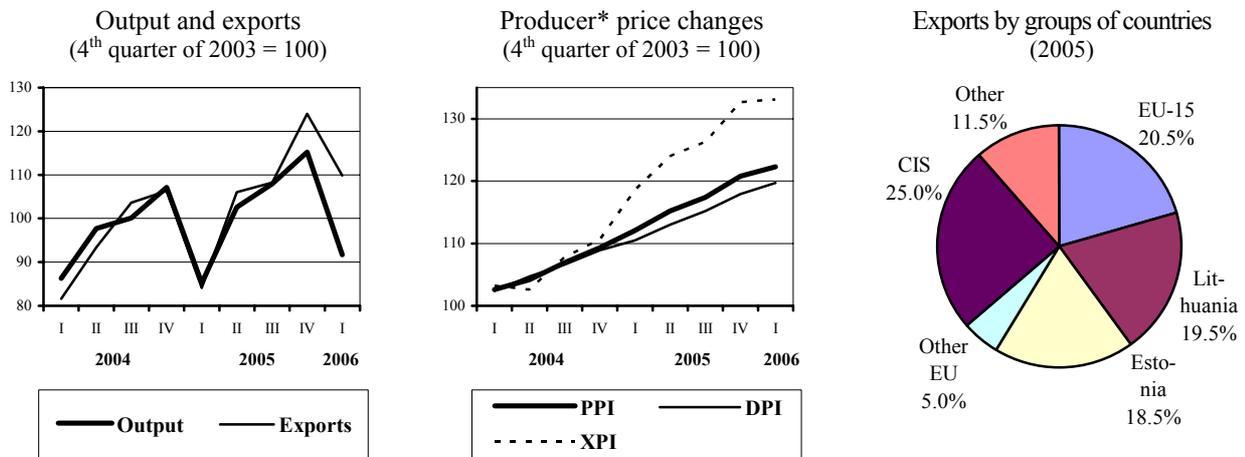
Figure 3.25



Approximately 75% of the total food industry output is consumed in the domestic market. The rest is exported mostly to Estonia, Lithuania and Russia. With accession to the EU, the demand for Latvian foodstuffs increased in all trade directions – both to Russia and other CIS countries and to the EU, and exports to EU member states rose more than 1.5 times mostly due to the increased demand in Estonia and Lithuania. Exports of food products to Lithuania and Estonia constitute more than a half of the total exports of Latvian food products to EU member states.

Figure 3.26

Food Industry Indicators



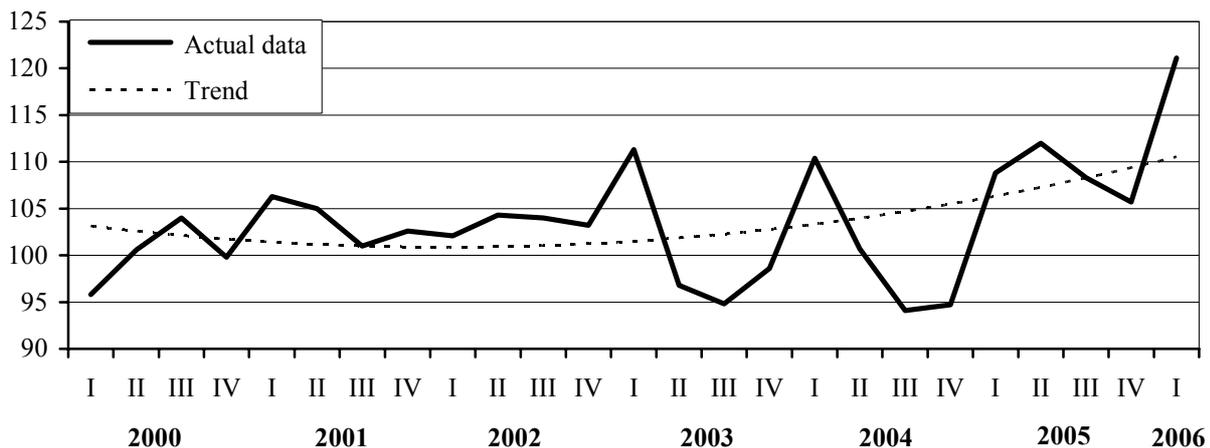
* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Export prices for food products rapidly increased as from 2005. Prices in the domestic market rose at more moderate pace, while at the beginning of 2006 (January-April) prices for products sold in the domestic market increase faster.

Light industry (production of textile and leather products) makes up less than 8% of the total value added of manufacturing. Only about one-fifth of the light industry output remains in Latvia. Most of the output (three-fourths of exports) is being exported to EU member states.

Figure 3.27

Quarterly Dynamics of Light Industry Growth
(level of 2000 = 100)



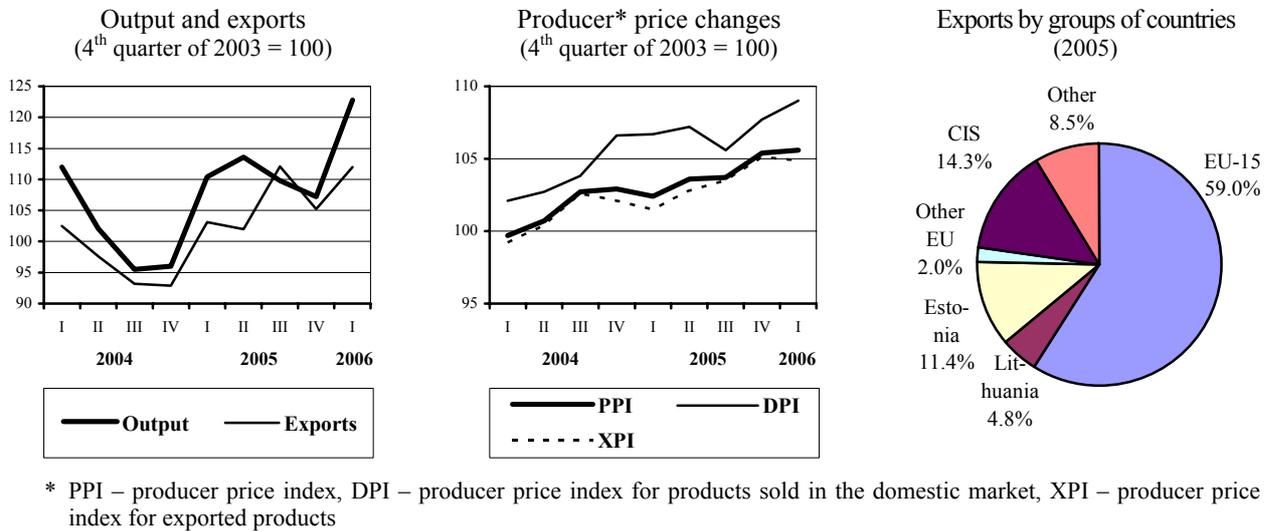
By 2005 the outputs and exports of the textile industry have not increased, and in production of clothing they even decreased. Growth of outputs only resumed in 2005.

The main sales markets for Latvian textile industry are in EU member states. Due to weak demand in EU member states and high competition in the sector, it is hard for Latvian producers to expand production outputs despite the rapid rise of prices in the last years. Narrowing of exports to the EU is partly compensated by the growth of exports to CIS countries.

As already mentioned, growth was observed in 2005. Annual output exceeded the previous level by 8.7%, mainly due to increased exports to CIS countries, Lithuania and Estonia. Exports to the old EU member states did not increase in this period.

Figure 3.28

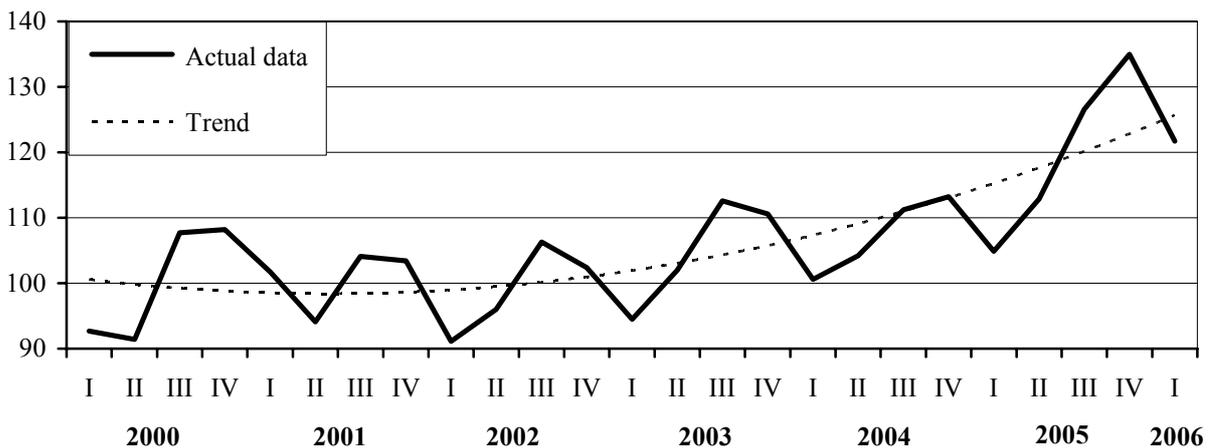
Textile Industry and Production of Clothing



Paper production and publishing has grown slowly in 2001-2004 (by 1.8% on average annually). The sector has a relatively small share of exported products. Competitiveness of the sector in the domestic market is also decreasing.

Figure 3.29

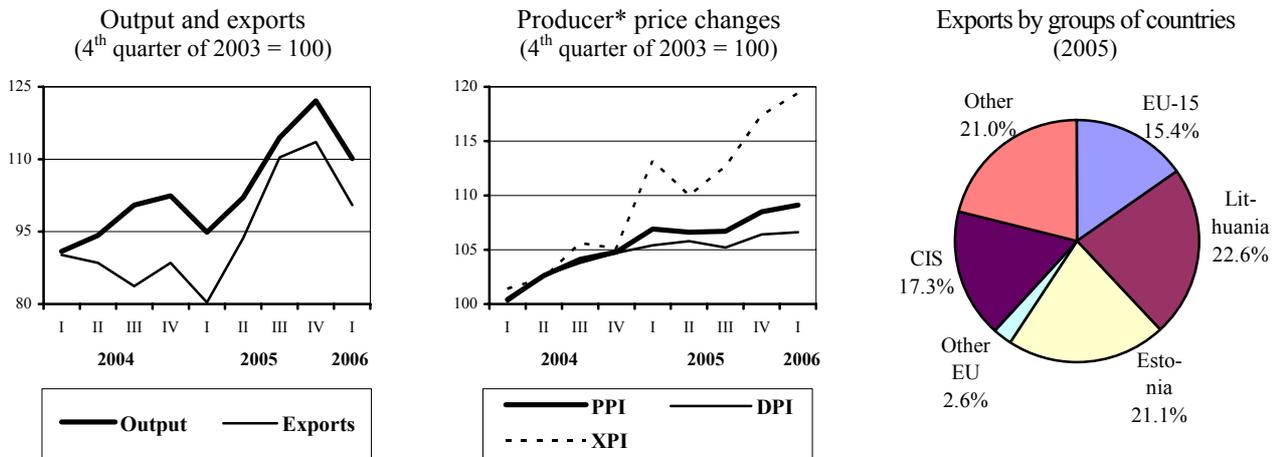
Quarterly Dynamics of Paper Production and Publishing Growth (level of 2000 =100)



Faster growth in this sector was observed in 2005 due to increased exports and rapid rise of export prices. Main sales markets for exported products in this sector are Lithuania and Estonia, whereas opportunities to expand into markets of other EU member states are weak.

Figure 3.30

Paper Production and Publishing Indicators



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

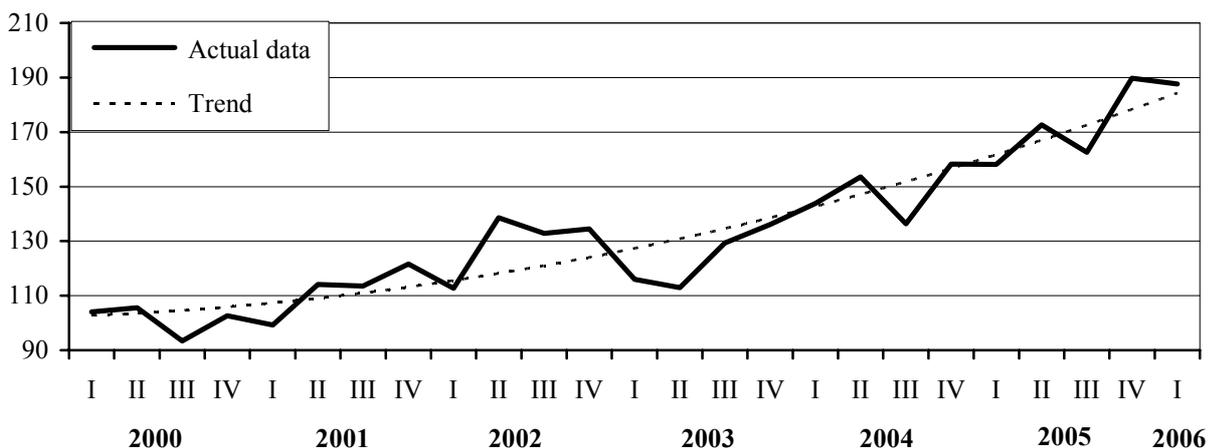
Till 2005 the growth of export prices was much slower than the average price growth, as a relatively big share of exports is connected with CIS countries and other countries outside the EU, and trade conditions with these countries worsen due to the low exchange rate of the US dollar that is one of the main currencies of account in these directions of trade. The situation improved in 2005 with increased USD dollar exchange rate.

Chemical industry in Latvia has stable traditions, highly skilled specialists, long history of producing a wide range of products both for final and intermediary consumption, and a good base for research. Chemical industry accounts for approximately 7% of the total value added of manufacturing.

Figure 3.31

Quarterly Dynamics of Chemical Industry Growth

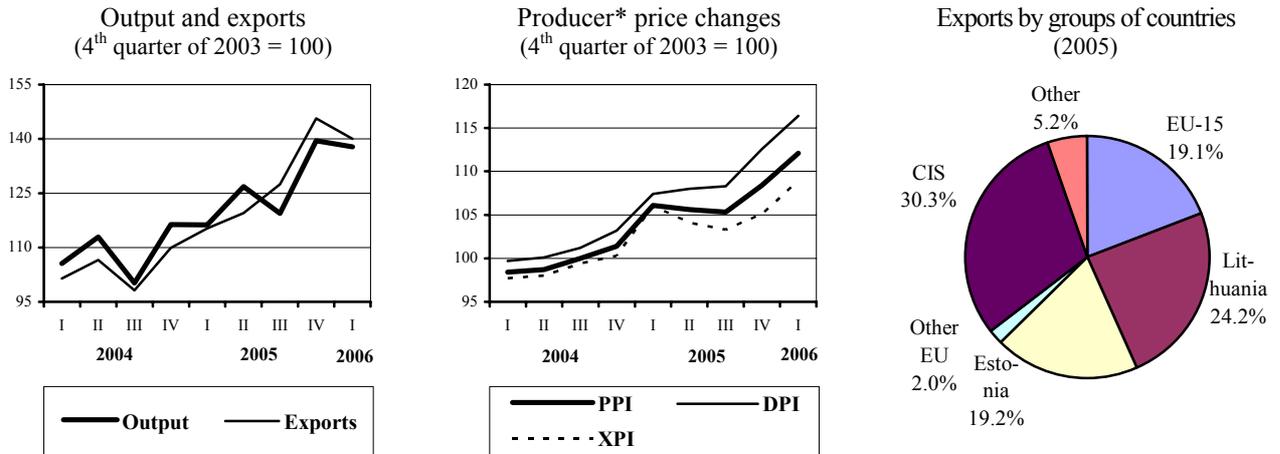
(level of 2000 =100)



Traditional sales markets for Latvian chemical industry products are mainly in CIS countries, Lithuania and Estonia. Markets in the old EU member states do not increase substantially. The sector has weak competitiveness in markets of the developed countries. Exports to Lithuania and Estonia make up about two-thirds of exports to EU member states.

Figure 3.32

Chemical, Rubber and Plastic Industry



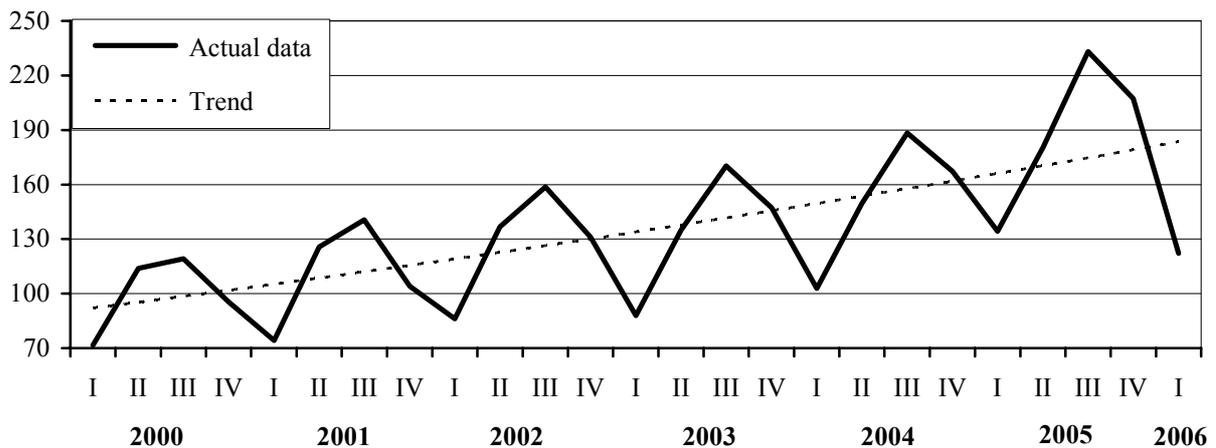
* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Growth of the sector has not been steady in the last 5 years. There have been periods of decline, for example, after the considerable growth of production volumes in 2002 they fell in 2003 and rapidly grew again by almost 20% in 2004 greatly due to increased demand in CIS countries. Growth rate was also high in 2005 (by more than 15%), mainly due to expanded exports to CIS countries. At the beginning of 2006 the growth of production volumes continued due to opportunities of increased exports.

Manufacture of other non-metallic mineral products (mostly construction materials) has very unstable growth rates. After steep growth by 15.3% in 2002 the growth rate was more moderate in 2003 (by 5.4%) but was rather fast again in 2004 and 2005 (by 12.5% and 24.1% respectively).

Figure 3.33

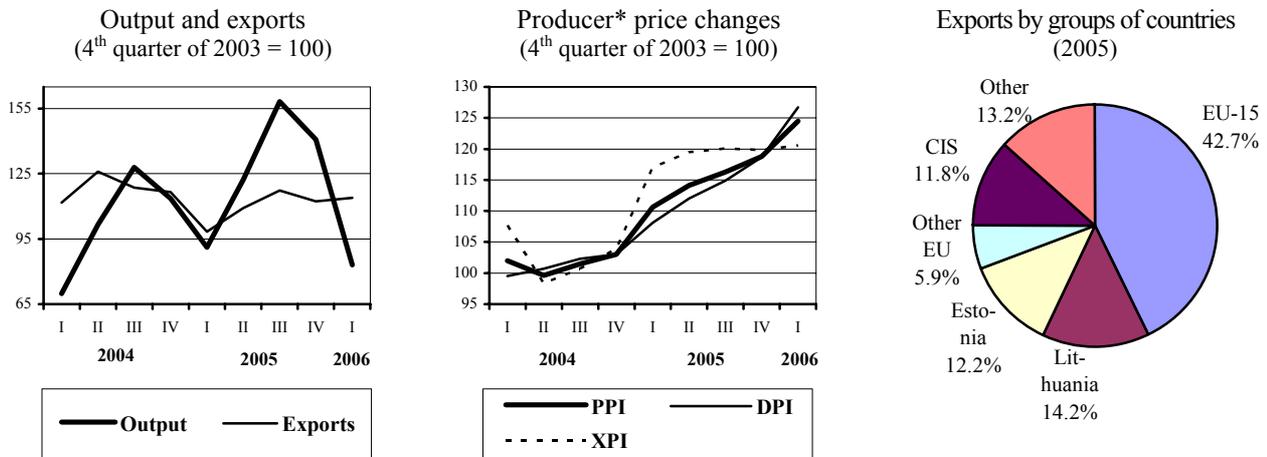
Quarterly Growth Dynamics of Manufacture of Other Non-Metallic Mineral Products
(level of 2000 = 100)



Increase of domestic demand is the main incentive for growth of the sector. Growth of exports in 2004 and 2005 was also significant and had been especially fostered by rising export prices. Exports to the EU-15 countries increased especially fast in 2005.

Figure 3.34

Manufacture of Other Non-Metallic Mineral Products



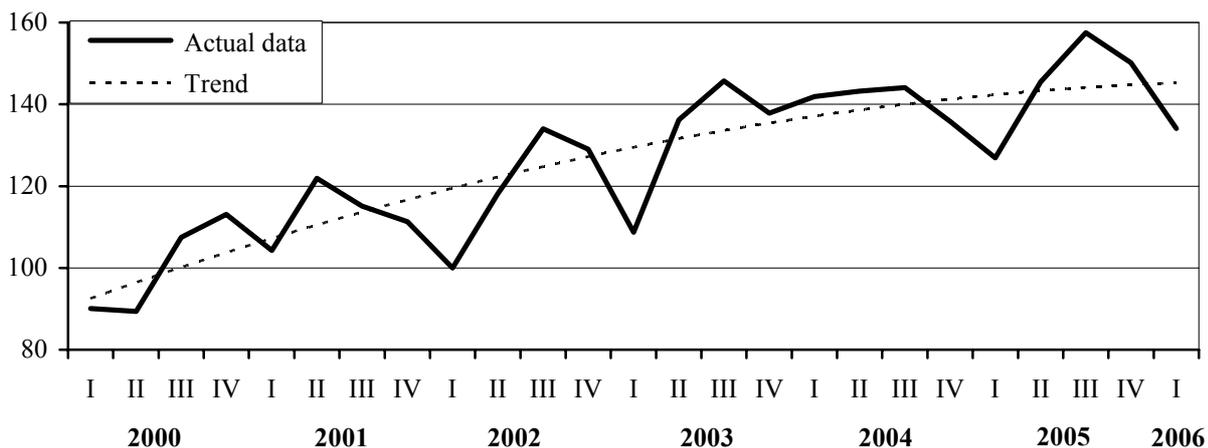
* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Production volumes fell in the 1st quarter of 2006 mainly due to unfavourable climatic conditions that decreased the domestic demand.

Sectors of *production of metals and metal articles* constitute more than one-tenth of the total value added of manufacturing. Exports account for almost 80% of the total output of these sectors. The domestic market share tends to expand recently. Development of construction has resulted in increased demand for articles of base metals.

Figure 3.35

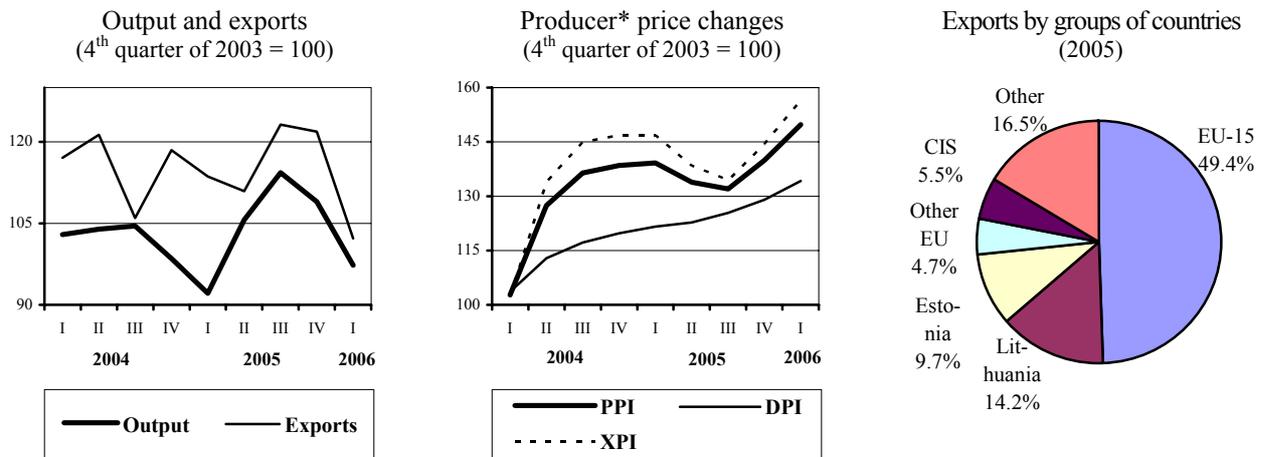
Quarterly Growth Dynamics of Production of Metals and Metal Articles
(level of 2000 =100)



Average growth in the sector reached almost 7.7% in 2002-2003. 2004 was unfavourable year for the sector with decreased production volumes due to decline of exports, and growth only resumed in the 2nd quarter of 2005. Production volumes in 2005 only slightly (by 2.7%) exceeded the level of the previous year.

Figure 3.36

Production of Metals and Metal Articles



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

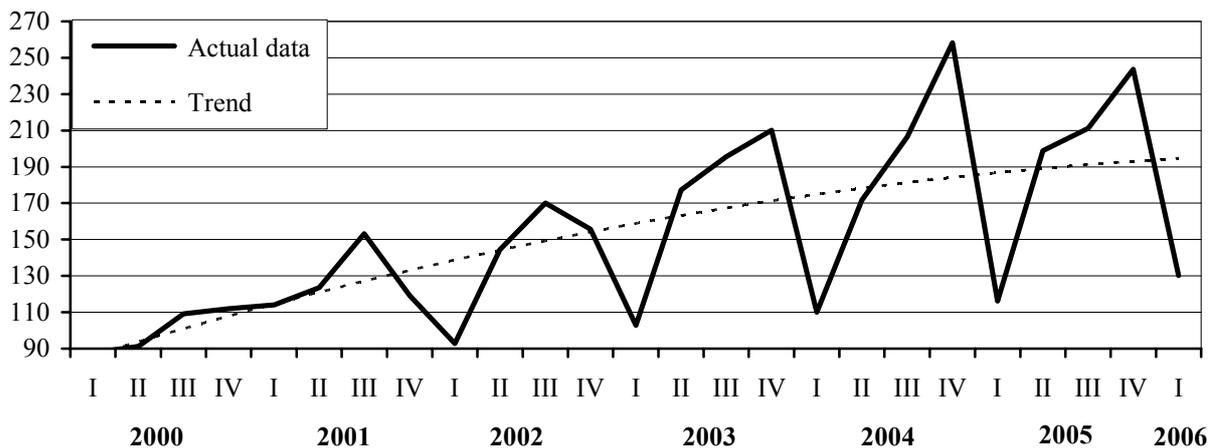
Producer prices in the sector have substantially increased in the last years both for domestically sold and exported products, and the increase was considerably faster for exported products.

Metals and metal articles produced in Latvia have high competitiveness around the world but most of them are linked with EU countries (almost 80% of exports), and almost half of the exports of these products are to the old EU member states.

Production of machinery and equipment is a rapidly growing sector, and its production volumes have almost doubled in the last five years. It is a pronouncedly export-oriented sector, as three-fourths of the products are being exported.

Figure 3.37

Quarterly Growth Dynamics of Production of Machinery and Equipment
(level of 2000 =100)

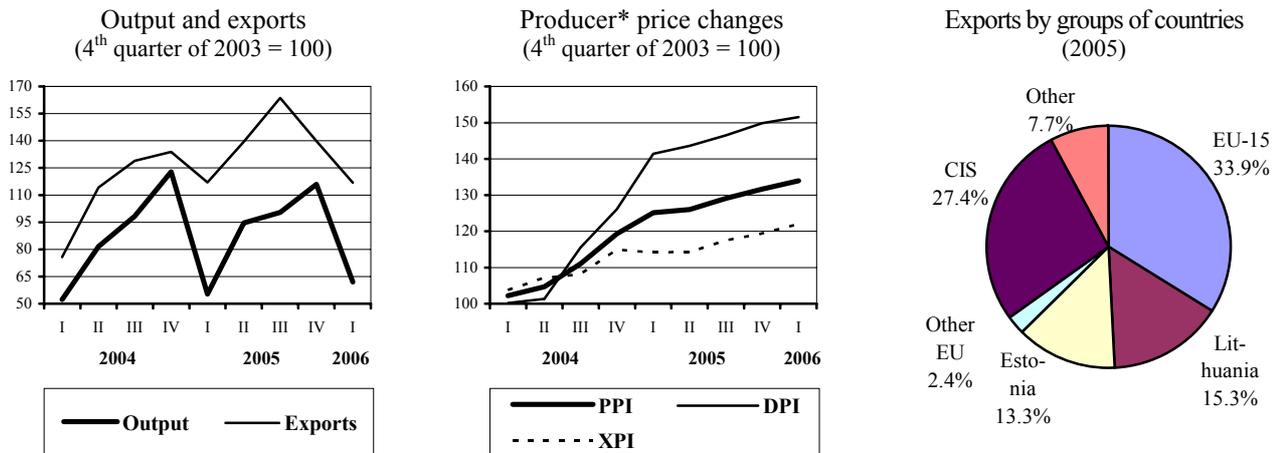


Growth of the sector was especially fast in 2001-2003 when its annual growth rates exceeded 10%. After accession to the EU the growth of the sector is not so rapid and reached only 3% in 2005. Indicators of the 1st quarter of 2006 show expanded opportunities for development of the sector. Production volumes in the 1st quarter were by 12% bigger than in the respective period of the preceding year.

The main sales markets of the sector are EU member states, and almost half of the exports to the EU are to Lithuania and Estonia. Relatively big export share of the sector is related to markets of CIS countries.

Figure 3.38

Production of Machinery and Equipment



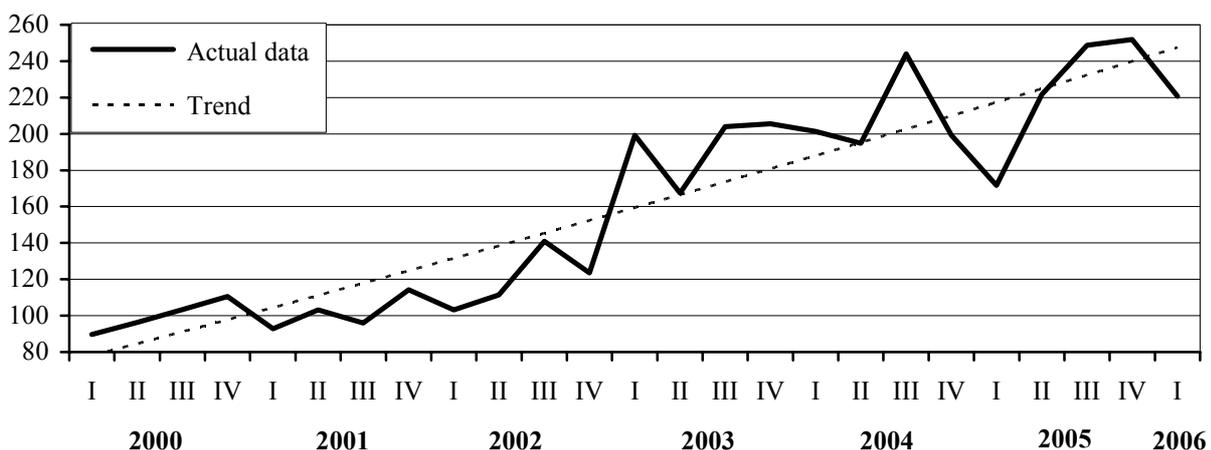
* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

With increased demand in the local market, prices for products sold in the domestic market have gone up rapidly in the last years.

Production of electrical and optical equipment has developed fast in the recent years, especially in 2002 and 2003. Production volumes of the sector in 2003 exceeded the level of the preceding year by 60%. After accession to the EU the growth rates decreased but remained at a stable level (6-8%).

Figure 3.39

Quarterly Growth Dynamics of Production of Electrical and Optical Equipment
(level of 2000 =100)

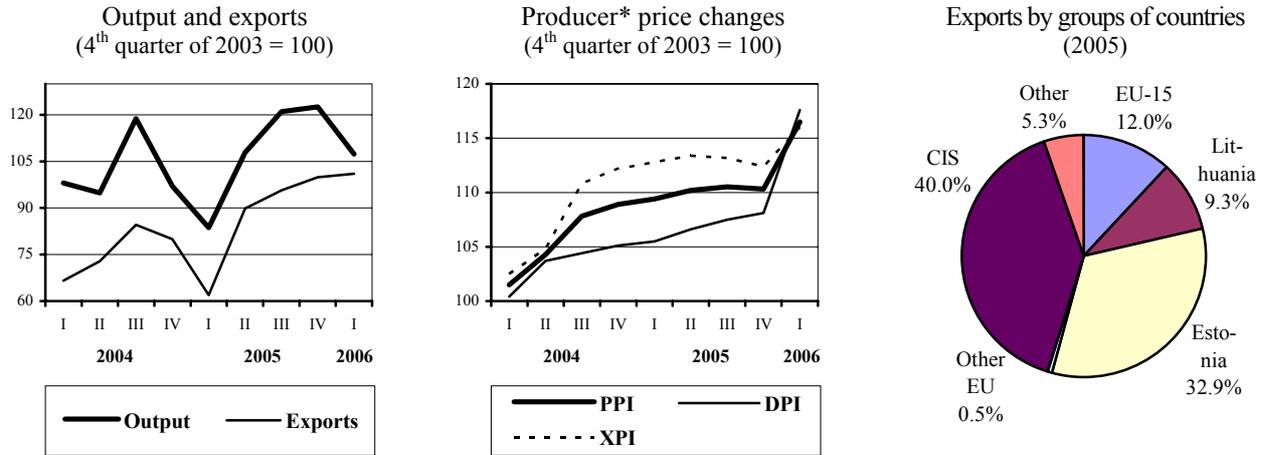


Production volumes of the sector have almost doubled in the last five years. Growth of the sector was especially fast in 2003 (by 62%). After accession to the EU its growth is not so fast and amounted to mere 3% in 2005. Indicators of the 1st quarter of 2006 show expanded opportunities for development of the sector. Production volumes of the 1st quarter are by 12% bigger than in the respective period of the previous year.

The sector has not managed to enter into markets of the developed countries but has stable trade partners in CIS countries and Estonia.

Figure 3.40

Production of Electrical and Optical Equipment



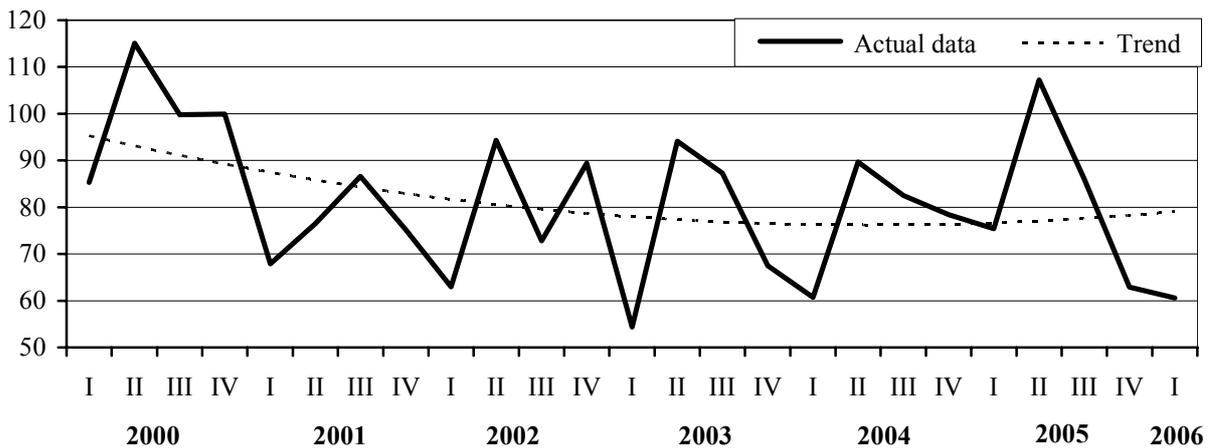
* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

The sector exports about two-thirds of its products; the domestic market share increases in the recent years, and also producer prices for products sold in the domestic market grow faster.

Production of transport vehicles is the only manufacturing sector that does not manage to increase production volumes, and they are lower by almost one-half in comparison with 2000 although they were slightly raised since 2004 after decreased output in the preceding years.

Figure 3.41

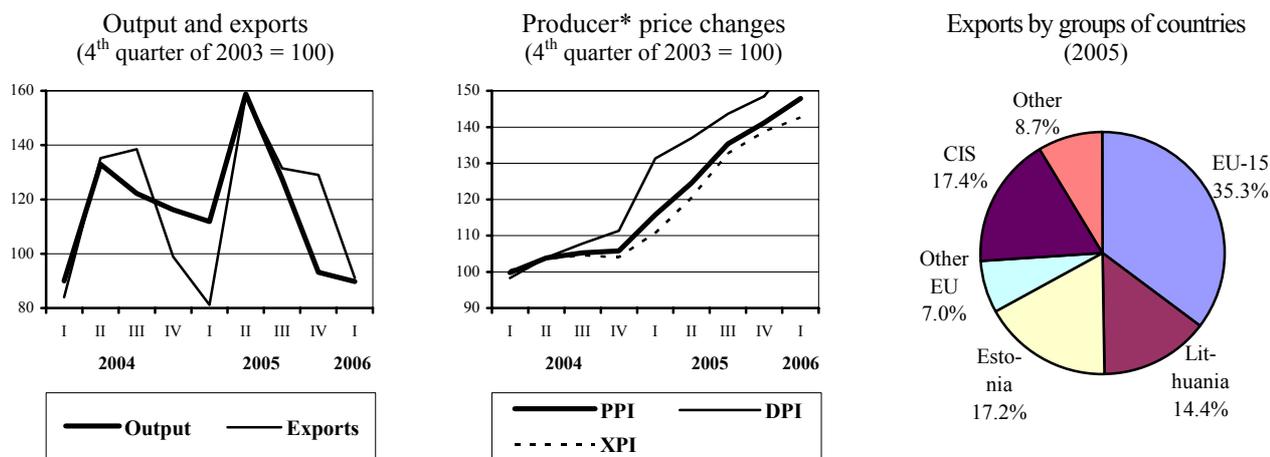
Quarterly Growth Dynamics of Production of Transport Vehicles (level of 2000 =100)



Most products of this sector are being exported. Export markets are rather evenly distributed in various sale directions – both to EU member states, among them Lithuania and Estonia, and to CIS and other countries of the world.

Figure 3.42

Production of Transport Vehicles



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

The share of products sold domestically in the total sales of products increases year by year, and accordingly prices of products sold in the domestic market rise faster.

3.3.3. Energy Sector

Both the imported (natural and liquefied gas, oil products, coal) and local energy resources (wood and peat) are used in Latvia to provide fuel, electricity and heat to sectors of the national economy, commercial consumers and population. Part of electricity is generated by Latvian HPPs and CHPs, whereas other part is imported. Mainly the imported (natural gas and heavy oil) and local fuels (wood) are used in heat generation.

In 2005 the total energy consumption of Latvia was 204 PJ and 64.9% of the consumption was ensured by imports of energy resources mostly from Russia (natural gas comprising 30.9%, heavy oil – 1.6%, other oil products – 26.6%, coal – 1.5%). Among local energy resources, wood was used the most (firewood, remainders of woodworking, wood chip, wood briquettes and granules) comprising 29.1% of the total energy consumption. Share of electricity generated by Latvian HPPs and wind power stations in the total energy consumption was 6%.

Table 3.15

Consumption of Energy Resources in Latvia¹

(thousand tons of equivalent fuel – ktce²)

Consumption of energy resources	2000	2001	2002	2003	2004	2005
Energy resource consumption – total	5259	5740	6466	6583	6764	6969
of which:						
Natural gas	1560	1980	1847	2138	2114	2155
Light fuel products and other oil products	1366	1313	1610	1727	1798	1859
Heavy oil, shale	406	269	233	166	132	113
Firewood, peat, coke and other types of fuel	1267	1475	2084	1854	1987	2057
Coal	94	123	99	90	87	107
Electricity (HPPs, wind generators and imported from abroad)	566	580	593	608	646	678

¹ Source: CSB and the Ministry of Economics.

² 1 ktce = 0.02931 PJ.

Volume of *electricity* generation directly depends on the flow of the Daugava river. Also electricity imports from Russia, Estonia and Lithuania have a quite substantial role in the electricity supply.

In 2005 Latvenergo generated 64.5% of the required electricity, 30.5% was supplied by other countries and 5% was purchased from small producers of electricity. In comparison with the preceding year, the electricity consumption has increased by approximately 3.7 per cent.

Table 3.16

Electricity Supply in Latvia¹
(billion kWh)

Components of electricity supply	2000	2001	2002	2003	2004	2005
Total electricity supply	5.922	6.163	6.323	6.608	6.786	7.053
Electricity generation – total	4.136	4.280	3.975	3.975	4.689	4.905
of which:						
HPP ²	2.799	2.801	2.433	2.216	3.044	3.267
CHP ³	1.163	1.246	1.238	1.363	1.225	1.278
Other CHP	0.150	0.198	0.263	0.298	0.306	0.255
Small HPS	0.020	0.032	0.030	0.050	0.065	0.058
Wind generators	0.004	0.0034	0.011	0.048	0.049	0.047
Import of electricity	1.786	1.883	2.348	2.633	2.097	2.148

¹ Source: state JSC “Latvenergo”, Ministry of Economics, CSB

² Daugava cascade and Aiviekste HPP (HPP of state JSC “Latvenergo”)

³ CHP of state JSC “Latvenergo”

Some key conclusions from the Informative Report “*On Situation in the Electricity Supply of Latvia*” of the Ministry of Economics are presented below:

- Ministry of Economics in co-operation with representatives of energy companies, scientists, economists and representatives of associations has worked out the policy planning document “Guidelines of Energy Sector Development for 2007-2016”. The guidelines include governmental policy, development targets and priorities in the energy sector both in medium-term and long-term;
- In the period after 2009 the excess capacity generated by energy systems of the neighbouring countries will become smaller and Latvia’s opportunities to ensure import of electricity will decrease;
- The current development of the situation in the Baltic energy supply indicates that an optimal future solution for basic capacities of electricity supply is represented by construction of a new nuclear power plant unit in Lithuania, using the existing infrastructure of the Ignalina nuclear power plant;
- Riga CHP-1 is a positive gain both for the state and Riga city. The State Loads Centre has new basic capacities of 144 MW and the centralised heat supply system of the right bank of the Daugava river in Riga has a new safe source of heat energy;
- Recent studies on the security of Latvia’s electricity supply indicate that co-generation plant projects that are already completed, under implementation or to be started (the new Riga CHP-1; construction of Imanta CHP; reconstruction of Riga CHP-2) or participation in construction of a nuclear power plant in longer term are not sufficient for safe electricity supply of the country. Necessity of one more new basic power in Latvia becomes rather clear. In view of the necessity to diversify energy supply structure of Latvia, this plant would use solid fuel (obviously, coal), admixing biofuel in it;
- Transit electric lines between Lithuania and Kaliningrad region are unburdened after starting the new 1st energy unit of Kaliningrad CHP-2. As a result, heightened voltage levels (especially in Liepāja and Klaipeda units) create problems for transmission system operators (TSOs) of Latvia and Lithuania. Transmission network links in Belarus and Russia are being unburdened, creating bigger opportunities for Latvia to import electricity from Russia. However, incomes of Latvian and Lithuanian TSOs for maintenance of electricity network and compensation of electricity losses from Russian electricity transit to Kaliningrad region will decrease;
- Transmission network will be able to ensure the necessary electricity flows in normal (standard) regimes if its renovation will take place in the current amounts.

Consumption structure of the *centralised heat supply* has not changed in the recent years, with central heating comprising 65-70% and hot water supply making 30-35%. Of the total amount of sold heat energy, 2.5% were sold to industry, 73% to households and 24.5% to other consumers.

The biggest consumers of *natural gas* are CHPs and heat generation enterprises of “Latvenergo” (61%), industry (21%) and other consumers (18%). Riga region accounts for 80% of the total natural gas consumption in Latvia. Natural gas is not used at all in Latgale region, with the exception of Daugavpils and Rēzekne cities and Preiļi district. In Kurzeme region, gas consumption is the biggest in Liepāja – 11% (by JSC “Liepājas siltums” and JSC “Liepājas metalurģs”), while in Zemgale region it amounts to 4% (in Jelgava city and Bauska district).

Oil products are used both as heating fuel and liquid fuel. Prices in the oil product market are liberalised and competitive. Free market principles function in the area of oil product deliveries in Latvia.

Oil products have an important place in the Latvian market of energy resources. Their market share is slightly lower than 30%, including the part of heavy fuel in oil fuel balance with about 6%. The biggest consumers of heavy oil are heat supply (60.7%) and industry (35%). Complying with requirements of EU Directive 1999/32/EC, the Cabinet of Ministers adopted Regulation No. 125 “Regulation on the Limitation of Sulphur Content in Certain Liquid Fuels” on March 2, 2004. It is expected that heat supply companies, which used heavy oil for heat generation, will replace this type of fuel with other energy resources.

Solid fuels used in Latvia are coal imported from CIS and local fuels (firewood and peat). The forecast of firewood consumption depends on the extent to which regions will manage to change from the extensive use of firewood to its rational use. In the total fuel consumption, the share of firewood is quite substantial already and has reached 29-30%. The biggest consumers of firewood are households (48%), heat supply companies (22%), industry (mainly wood processing companies) and other consumers (30%). Firewood and coal are evenly used across all regions of Latvia. Use of peat in the energy sector keeps decreasing.

3.4. Development of Regions

The capital of Latvia with the vicinity accumulates almost half of the country’s population. The number of inhabitants in distant regions is slowly decreasing and the number of inhabitants in Pierīga region is increasing.

Table 3.17

Area, Population and Population Density of Latvia’s Statistical Regions at the beginning of the year 2006

	Area (% of the total)	Population (% of the total)	Number of inhabitants per km ²
Rīga	0.5	31.7	2 368.4
Pierīga	15.7	16.1	36.4
Vidzeme	23.6	10.6	15.9
Kurzeme	21.1	13.4	22.7
Zemgale	16.6	12.5	26.7
Latgale	22.5	15.7	24.7

Although the economic situation in different Latvian regions gradually equalises in the recent years, marked differences in both social and economic terms still exist within the regions, and the big cities stand out especially. Like in the previous years, also in 2003 more than a half of the total **gross domestic product** (GDP) of Latvia was produced in Riga (see Table 3.17) that was the economically richest region: GDP per capita in Riga exceeded the country average by 77%. Kurzeme took the second

position, but GDP per capita in Ventspils was higher than in Rīga and exceeded six times the minimal value of Rēzekne district.

Table 3.18

GDP* of Statistical Regions in 2003

Name of territory	GDP at current prices		GDP per capita	
	total, in thousand LVL	Per cent distribution in the country	At current prices, LVL	Per cent of national average
Latvia	6 392 778	100	2 749	100
Including:				
Rīga	3 589 535	56.1	4 869	177
Pierīga	645 362	10.1	1 786	65
Vidzeme	410 760	6.4	1 646	60
Kurzeme	758 429	11.9	2 412	88
Zemgale	457 537	7.2	1 574	57
Latgale	527 489	8.3	1 418	52
Produced outside Latvia	3 667	0.1	x	x

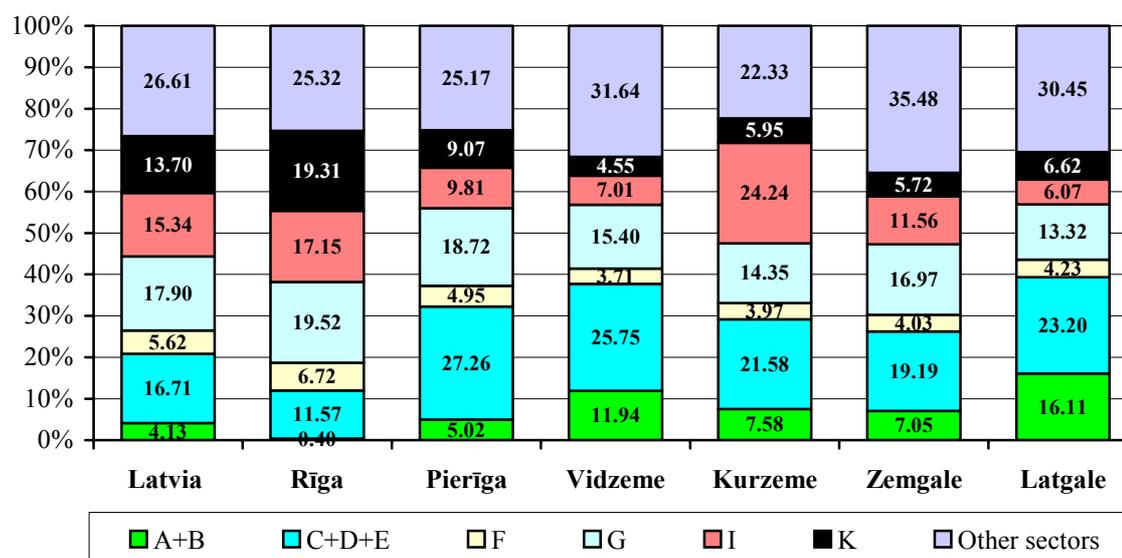
* Data on the gross value added (GVA) and gross domestic product (GDP) for 2003 are calculated in compliance with the requirements of the European Commission Regulation No. 1889/2002 regarding financial intermediation services indirectly measured (FISIM) and therefore are not comparable with data published in previous reports.

It is characteristic that regions with low GDP per capita (Vidzeme, Zemgale and Latgale regions) have a relatively high share of industrial and public services (services provided by municipal administration and educational and health care institutions) in the gross value added. In these regions, various commercial services and transport and communications services are poorly developed and, correspondingly, contribution of trade services in these regions is also lower than the average in the national economy.

In Kurzeme region, the traditionally biggest share was for the transport and communications sector, followed by manufacturing industry. The biggest share of gross value added was made by trade and commercial services in Rīga and by manufacturing industry in other regions.

Figure 3.43

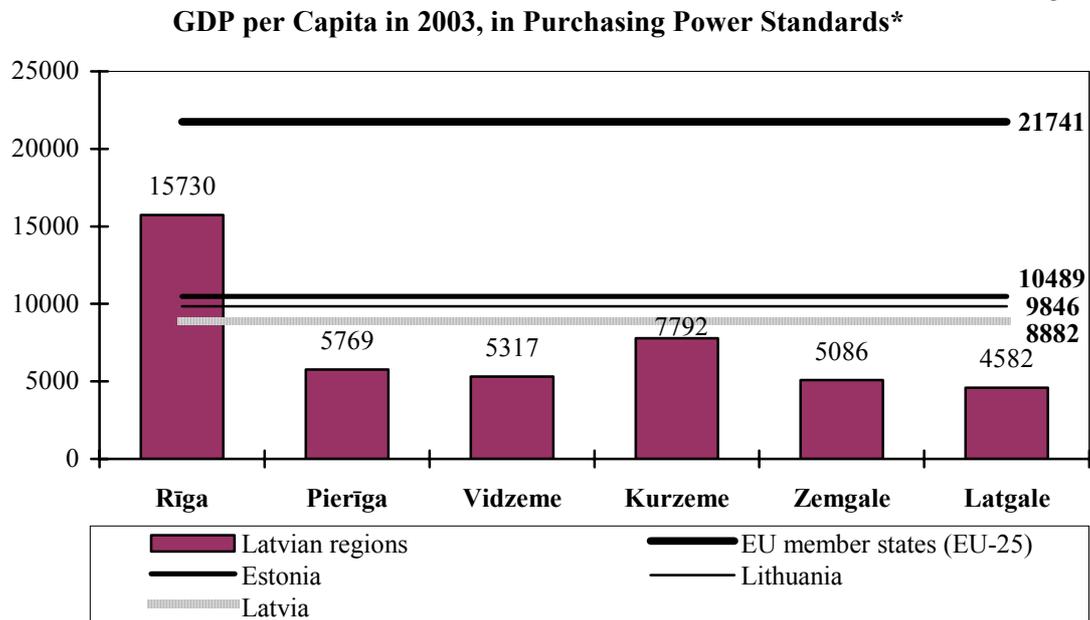
Contribution of Main Kinds of Activity to GVA* in 2003



A+B – agriculture, forestry and fisheries; C+D+E – manufacturing industry; F – construction; G – trade; I – transport and communications; K – commercial services.

Among Latvian regions, Rīga region (the capital) has the highest **GDP per capita** (72% of the EU average). It is higher than in Kurzeme region (36% of the EU average). In other regions, GDP per capita is in the range from 21% (Latgale) to 27% (Pierīga).

Figure 3.44

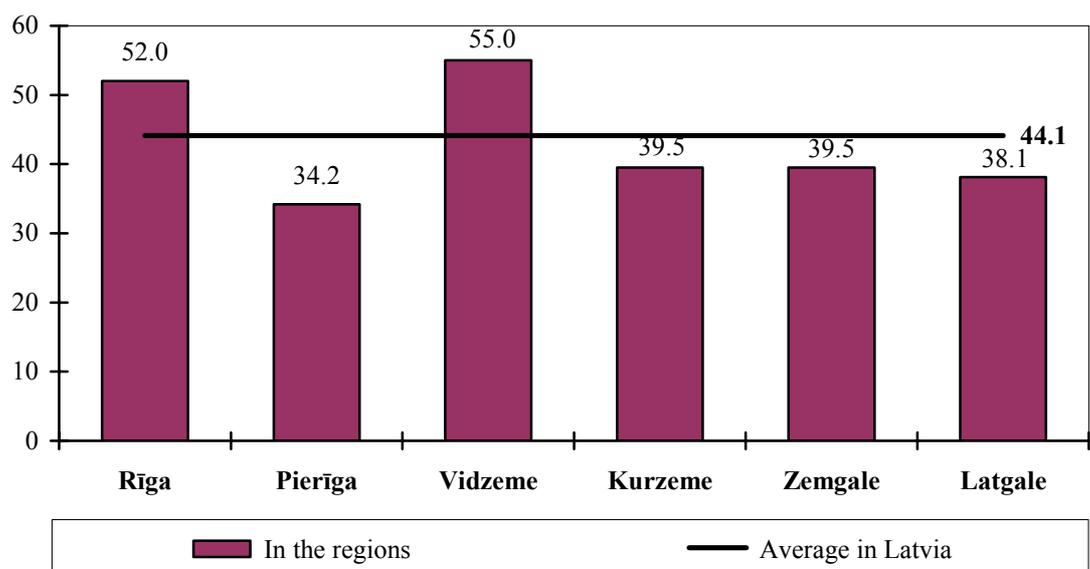


* The Purchasing power standard (PPS) shows the GDP level expressed in an artificial currency for a group of participation countries eliminating the effect at different price levels.

By the number of **economically active statistical units**¹ per 1000 inhabitants, the regional differences are less pronounced, although it is natural that Rīga and Vidzeme region have more of them than other regions. Most of the big enterprises are in Rīga and more developed districts.

Figure 3.45

Economically Active Statistical Units of the Market Sector* per 1000 Inhabitants in 2004

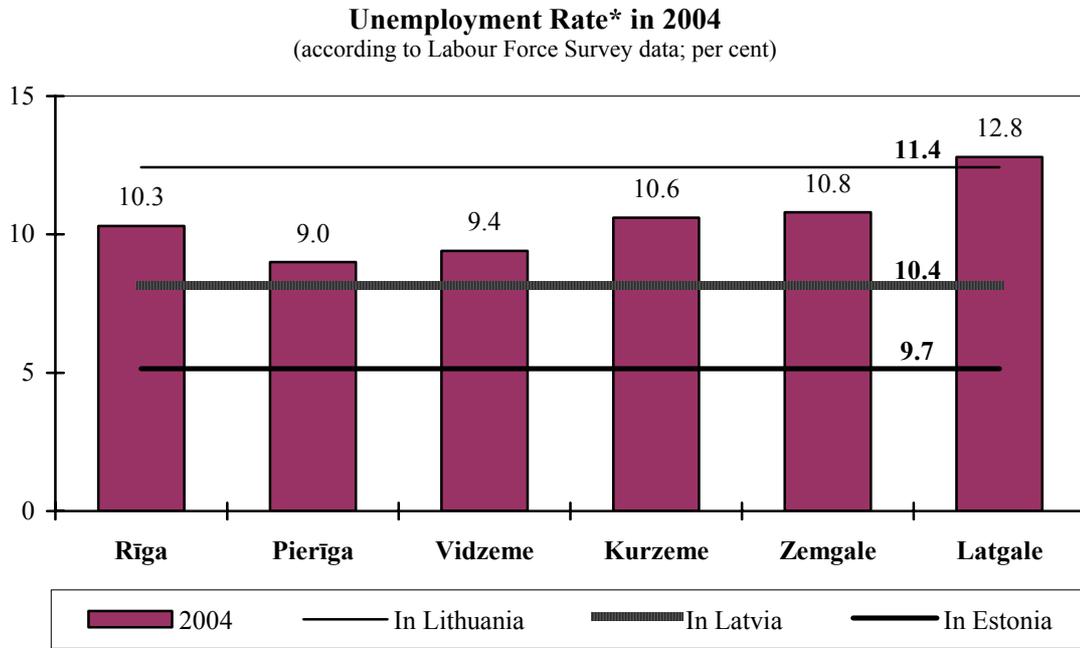


* Statistical units of the market sector: self-employed persons, individual entrepreneurs, commercial companies, agricultural and fisher farms.

¹ As economically active statistical units within the market sector are considered sole proprietors, commercial companies, peasant and fishermen’s farms but within non-market sector these are funds, foundations and associations, state and local governments budgetary institutions that manufactured goods or provided services in the particular year.

In 2004 **unemployment rate** in Latvia was 10.4% (rate of job seekers to the economically active population, according to Labour Force Survey data), while in Latgale it amounted to 12.8% (see Figure 3.46). In other Latvian regions the rate is rather similar (in the range from 9% to 10.8%). In comparison with 2003, the biggest changes were observed in Latgale, where this indicator has declined by 2.7%. In other regions (Kurzeme and Zemgale) unemployment rate rose by 0.4-1.1%. Among Latvian regions, the most positive situation was observed in Pierīga and Vidzeme.

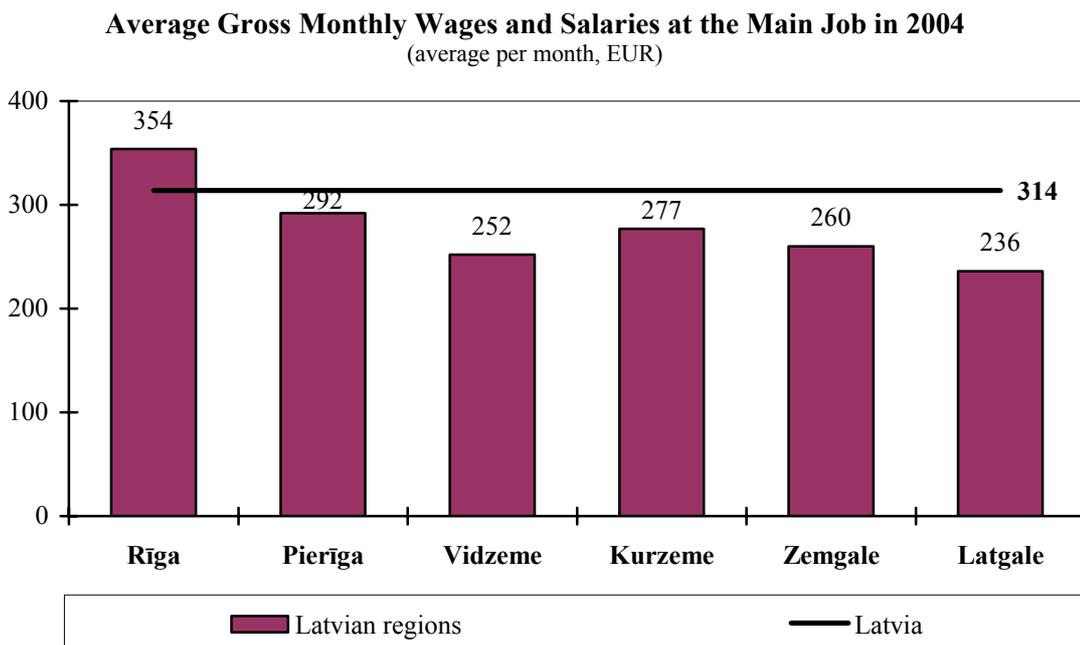
Figure 3.46



* rate of job seekers to the economically active population; persons aged of 15-74 years.

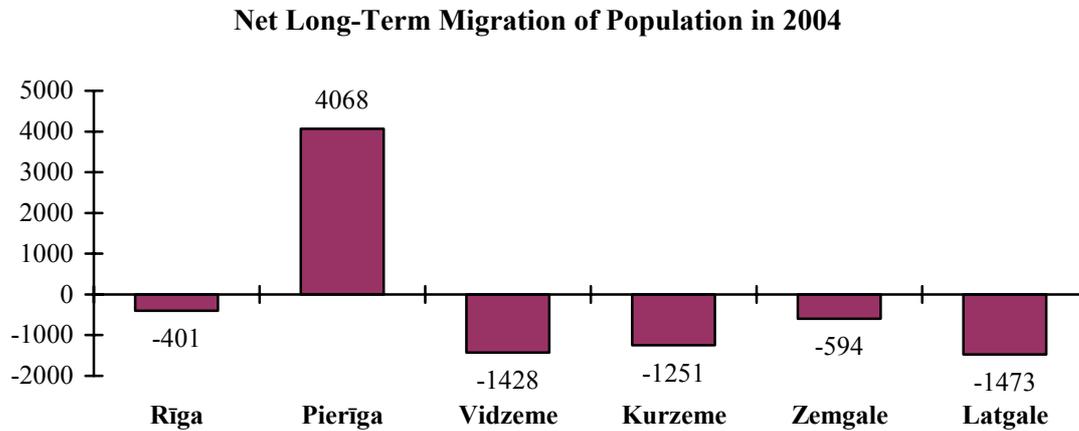
Rīga is the most competitive among Latvian regions in terms of **wages**. This indicator is the lowest in Latgale and Vidzeme.

Figure 3.47



Low payment for work is one of the reasons why people leave these regions and settle elsewhere: the biggest negative **migration net** values are in Latgale, Vidzeme and Kurzeme. As seen in Figure 3.48, the most attractive place to settle is Pierīga – the only region with a positive and, at the same time, high migration balance. This situation may be explained by the fact that the cost of living in Pierīga is lower than in the capital, but the work opportunities and payment for work are higher than in other regions.

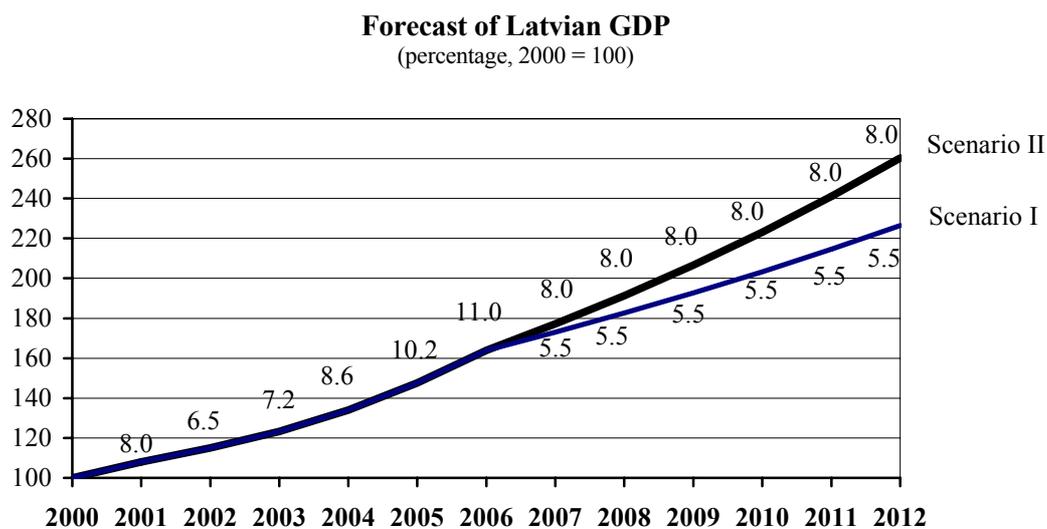
Figure 3.48



3.5. Forecasts

The Ministry of Economics has developed two scenarios of economic development for the medium-term period (until 2012): the slow growth scenario (Scenario I) and the dynamic scenario (Scenario II). The development scenario forecasts are based on the possible fluctuations of external and domestic demand, depending on several factors.

Figure 3.49



Development prospects in 2006

It is foreseen that the current trends of development will be in progress also in 2006, namely, the stable domestic demand and expansion of export possibilities. This is also confirmed by the indicators of the 1st quarter.

According to forecasts, the private consumption and GDP will increase at the same rate. This will be ensured by the growing incomes of the population both through increase of wages and expansion of opportunities to use consumption credits and mortgage loans.

Investment will increase faster than the private consumption, which will be affected by the growth of previous years and the positive future expectations of entrepreneurs as well as the good crediting conditions. Investment growth will also be stimulated by the opportunities to use EU funds, which will increase both the public and private sector investments.

The growth of domestic demand directly affects development of service sectors but its influence on the growth of industry is smaller.

Growth of *industry* is closely linked with possibilities to increase exports of goods, which should be assessed in three sales directions – to the EU, Russia and other CIS countries, and the closest neighbouring countries Lithuania and Estonia.

It should be noted that expansion of Latvian export possibilities in EU markets is to be associated not only with the growth of demand for imports of these countries (as forecasted by most economists for 2006) but also to a great extent with the ability of Latvian entrepreneurs to expand their market by using the economic advantages of offering cheaper products with appropriate quality.

Lithuanian and Estonian markets should be mentioned as an essential possibility to enlarge Latvian exports. Latvia has a negative trade balance with these countries despite the fact that exports of Latvian goods to these countries go up rather fast every year. It is possible to accelerate expansion of Latvian exports to these two neighbouring countries, and particular attention should be given to this task, not forgetting about the competition pressure created by the Lithuanian and Estonian businesses on the Latvian business in the domestic market of Latvia, which has a rather significant impact on the development of certain sectors of Latvian industry.

Expansion of export possibilities to Russia in the next few years may be fostered by agreements between the EU and Russia on mutual trade conditions as well as good growth prospects of Russia in the nearest years in connection with the high prices of oil products. There are rather good prospects to increase exports to other CIS countries, such as Belarus, Ukraine and countries of Central Asia.

Gradual rise of wages, promoted not only by the high inflation but also by the growing emigration of labour force to richer EU member states that have opened their labour markets to people of the new member states, has started having a negative impact on the industrial development. Rise of wages reduces competitiveness in some industrial sectors, especially those where the present maintenance of competitiveness is mostly linked with use of cheap labour force, such as textile industry, machine building, etc.

Table 3.19

Forecast of Latvian GDP by Sectors
(growth in per cent against the preceding year)

	2006	2007*	2008-2012 * (annual average)
Gross domestic product	11.0	5.5 / 8.0	5.5 / 8.0
Primary sectors	4.1	4.0 / 5.0	3.2 / 5.0
Manufacturing	6.1	6.0 / 10.0	5.9 / 10.0
Electricity, gas and water supply	6.1	2.0 / 3.0	2.0 / 3.0
Construction	17.9	10.0 / 17.0	8.4 / 15.0
Trade, hotels and restaurants	16.3	6.0 / 7.5	6.0 / 7.1
Transport and communications	5.4	6.0 / 8.0	6.0 / 7.8
Other commercial services	16.1	5.5 / 8.5	5.5 / 8.4
Public services	3.1	2.0 / 2.5	2.0 / 2.5

* Scenario I in the numerator, Scenario II in the denominator

Development prospects in 2007-2012

Strengthening of Latvia's competitiveness in the conditions of the EU single market, Latvia's ability to absorb the EU structural funds, and external conjuncture conditions will determine the speed of growth in this period.

Investment will continue increasing and may create additional demand for import in this period, not allowing essential improvement of the current account balance, although export-oriented sectors will start providing bigger contribution to the growth in this period. Otherwise, the disproportions (high current account deficit, heightened inflation) might subject Latvian economy to strong influence of various external and internal shocks.

Table 3.20

Forecast of Latvian GDP by Expenditure Category
(per cent, in comparison with the preceding year)

	2006		2007		2008-2012 * (annual average)	
	structure	growth rate	structure	growth rate	structure (in 2012)	growth rate
Gross domestic product	100	11.0	100	5.5 / 8.0	100	5.5 / 8.0
Private consumption	61.2	11.0	60.9 / 60.6	6.0 / 8.0	62.3 / 58.9	6.0 / 7.8
Public consumption	16.8	3.0	16.7 / 16.4	2.5 / 3.0	16.9 / 14.6	2.5 / 2.5
Gross fixed capital formation	31.7	18.0	32.1 / 33.4	8.0 / 15.0	31.3 / 37.4	6.0 / 11.6
Changes in inventories	5.2	–	4.9 / 4.2	–	0.0 / 0.0	–
Exports	44.7	7.6	44.9 / 45.6	7.2 / 11.5	46.5 / 51.2	6.5 / 10.7
Imports	-59.5	8.4	-59.5 / -60.2	6.6 / 10.3	-56.9 / -60.9	6.0 / 9.5
Export-import balance	-14.8	–	-14.6 / -14.6	–	-10.4 / -9.6	–

* Scenario I in the numerator, Scenario II in the denominator

The main problems during this period should be associated with the potential rise of wages and thereby with the decrease of competitiveness of Latvian so-called *cheap sectors* in the world markets. Such sectors are textile and food industries and, partly, manufacture of fabricated metals and some sectors of machine building. The share of these sectors in Latvian economy is very high, therefore their replacement with manufacturing of other sectors' products cannot be achieved within a short time. Rise of productivity in all sectors of the national economy (both high and low technology sectors) is the only way to retain the high growth rate of Latvia.

On the other hand, growth rates of economic activities in Latvia will also be greatly determined by the global development dynamics. If growth rates in the developed countries will be low, the growth of Latvia will be more moderate and will lag behind the dynamic growth scenario by 2-3 percentage points.

4. Macroeconomic Stability

4.1. State Finances

4.1.1. Fiscal Policy and Public Debt

The government of Latvia implements a fiscal policy aimed at balanced economic growth and stability of public finances.

Main priorities of the government for 2005-2008 in the fiscal policy area are to fulfil the Maastricht fiscal criteria and ensure efficiency of budget spending by:

- gradually reducing the deficit of the general government budget, ensuring formation of balanced budget in long term;
- introducing medium-term (3-5 years) budget planning. To introduce strategic planning in ministries in order to ensure purposeful development and efficient spending of public budget resources;
- checking the usefulness and efficiency of budget programmes, to prevent inappropriate spending of budget resources.

In order to reach the mentioned goals, development of strategic plans is being carried out in the ministries, envisaging to ground preparation of the budget for 2007 on the strategic planning principles. In conformity with the priorities set by the government, the action strategy of institutions defines medium-term development goals and directions, all according programmes and sub-programmes of the particular ministry, and their funding.

Since 2000 the fiscal deficit of the general government consolidated budget in Latvia has been lower than the level allowed by the Maastricht Treaty (3% of GDP) and gradual improvement of fiscal situation has been observed (see Table 4.1).

Table 4.1

General Government Consolidated Budget

	2002	2003	2004	2005	2006 f
Revenues (million LVL)	1874.0	2107.4	2522.2	3199.8	3826.5
(% of GDP)	32.5	33.0	34.0	35.8	40.5
Expenditures (million LVL)	2022.0	2212.5	2599.6	3297.8	3980.8
(% of GDP)	35.1	34.6	35.1	36.9	42.2
Net loans (million LVL)	-17.5	-2.7	1.0	7.3	-9.1
Fiscal balance (million LVL)	-130.5	-102.4	-78.4	-105.2	-145.2
(% of GDP)	-2.3	-1.6	-1.1	-1.2	-1.5
Fiscal balance according to the ESA95					
(% of GDP)	-2.3	-1.2	-0.9	0.2	0

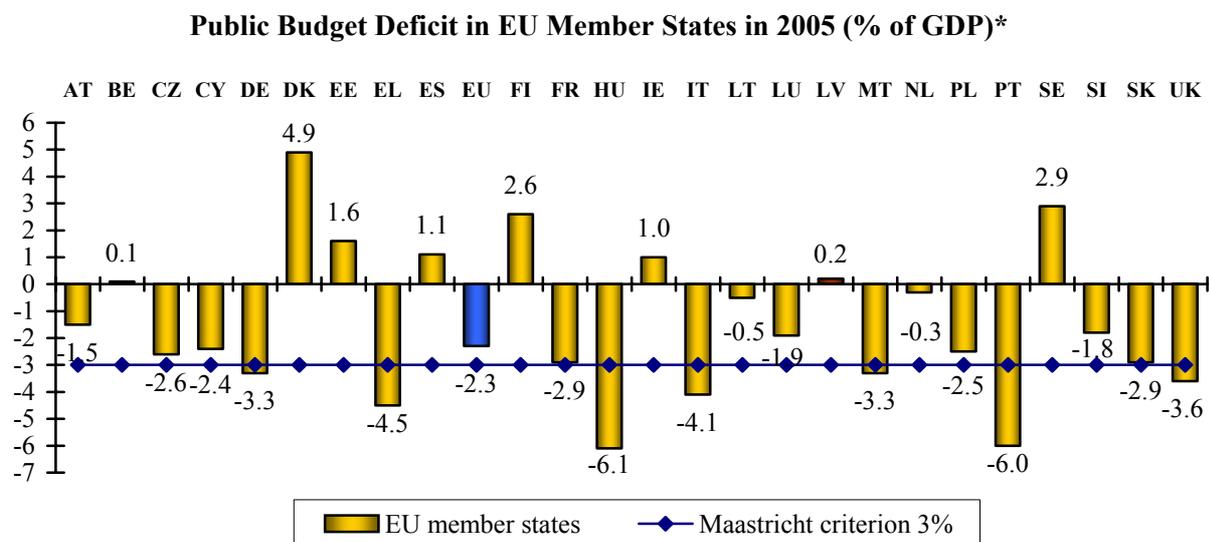
f – forecast of the Ministry of Finance

As can be seen in Figure 4.1, in 2005 the average level of the budget deficit in the EU was 2.3% of GDP¹ (2.6% of GDP in 2004, 3% of GDP in 2003). On the whole, public finances improved in 18 EU member states and deteriorated in 7 member states in 2005. In 2005 the biggest general government deficits as percentage of GDP were observed in Hungary (-6.1%), Portugal (-6%), Greece (-4.5%), Italy (-4.1%). Eight EU member states showed general government surplus in 2005, among them Latvia

¹ According to the methodology of the ESA 95 European System of National Accounts. By determining how EU Member States takes into account government budget deficit and debt accordance to the criteria established by the Maastricht Treaty, the results of the notification according to the methodology of the ESA 95 European System of National Accounts are used. According to this methodology, the calculated showings are set after so called principle of accrual basis, but the general government budget deficit calculated by the Ministry of Finance of Latvia is set after cash principle, and that is why they differ a little bit.

where the budget surplus amounted to 15 million LVL or 0.2% of GDP according to the methodology of the ESA 95 European System of National Accounts.

Figure 4.1



*According to the methodology of the ESA 95 European System of National Accounts.

AT – Austria, BE – Belgium, CZ – Czech Republic, CY – Cyprus, DE – Germany, DK – Denmark, EE – Estonia, EL – Greece, ES – Spain, EU – EU-25 member states, FI – Finland, FR – France, HU – Hungary, IE – Ireland, IT – Italy, LT – Lithuania, LV – Latvia, MT – Malta, NL – Netherlands, PL – Poland, PT – Portugal, SE – Sweden, SI – Slovenia, SK – Slovakia, UK – United Kingdom

The Saeima approved the public budget for 2006 with a fiscal deficit in the amount of 145.2 million LVL or 1.5% of GDP. General government budget revenues in 5 months of 2006 were by 27.6% higher than in the respective period of the previous year, while expenditures were by 17.4% higher. There was a fiscal surplus of 248 million LVL in the budget.

The budget for 2006 is directed towards the rise of prosperity level of the society, integration in the EU and NATO, efficient absorption of the granted resources from EU funds in a full amount, at the same time balancing the state assistance to social needs of the society. Resources envisaged for ensuring the national co-financing of EU funds and the administrative capacity (with regard to administrative, technical and financial management and control of EU projects) are considered the most essential of the budget priorities. Using the EU funds resources rationally and effectively, considerable support to business development and to development and improvement of public infrastructure will be ensured.

By implementing a socially responsible policy, as from January 1, 2006 the minimum monthly wage has been increased from 80 to 90 LVL, the monthly minimum not subject to personal income tax was raised from 26 to 32 LVL, and the monthly allowance for dependent person was increased from 18 to 22 LVL. Local governments will also benefit from this, as it is decided to redistribute the proportion of personal income tax revenues received by local governments to their benefit, and from the next year they will receive 75% of personal income tax instead of the current 73%.

Tax policy of Latvian government envisages decreasing the tax burden on entrepreneurship in order to promote economic development and ensure competitiveness of the economy. In order to achieve this goal, the following measures have been taken:

- the rate of social security contributions is reduced from 38% in 1996 to 33.09% in 2003;
- corporate income tax rate is lowered from 25% in 2001 to 15% in 2004;
- real estate tax rate is brought down from the maximum level of 4% in 2000 to 1.5 per cent.

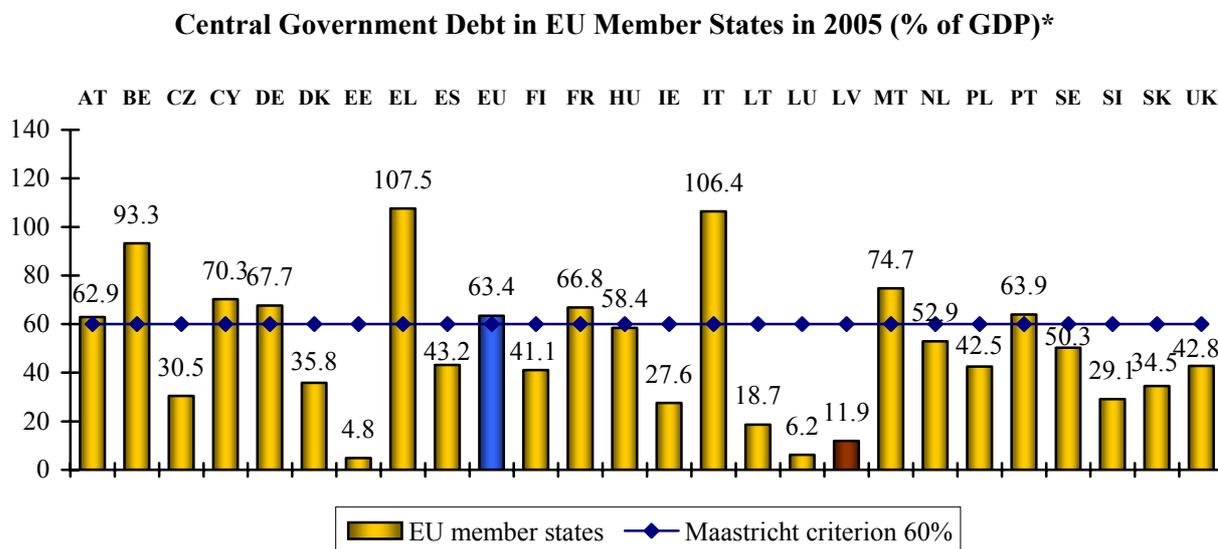
Due to the reduction of tax rates the tax revenues against GDP have dropped from 33.4% in 1998 to 28.5% in 2005. Meanwhile the tax base has been broadened, excluding taxable exemptions and improving the administration of revenues.

On February 14, 2006 the government conceptually supported a proposal to gradually decrease the personal income tax rate to 15%, setting the following transition periods:

- 22 per cent – for incomes gained from January 1, 2007 till December 31, 2007;
- 19 per cent – for incomes gained from January 1, 2008 till December 31, 2008;
- 15 per cent – for incomes gained from January 1, 2009.

The level of the **central government debt** in Latvia is the third lowest in the EU (see Figure 4.2). In 2004 the EU average level of central government debt was 63.4% of GDP¹. In 2005 the highest central government debt in percentage of GDP was observed in Greece (107.5%), Italy (106.4%), Belgium (93.3%), while the lowest general government debt in percentage of GDP was registered in Estonia (4.8%), Luxembourg (6.2%), Latvia (11.9%) and Lithuania (18.7%).

Figure 4.2



* According to the methodology of the ESA 95 European System of National Accounts.

AT – Austria, BE – Belgium, CZ – Czech Republic, CY – Cyprus, DE – Germany, DK – Denmark, EE – Estonia, EL – Greece, ES – Spain, EU – EU-25 member states, FI – Finland, FR – France, HU – Hungary, IE – Ireland, IT – Italy, LT – Lithuania, LV – Latvia, MT – Malta, NL – Netherlands, PL – Poland, PT – Portugal, SE – Sweden, SI – Slovenia, SK – Slovakia, UK – United Kingdom

In the last years the central government debt in Latvia has increased from 571 million LVL at the end of 2000 to 955 million LVL at the end of 2005, while it has decreased in percentage of GDP from 12.0% to 10.7% of GDP respectively (see Table 4.2).

Table 4.2

Dynamics of Central Government Debt
(end of period, million LVL)

	2002	2003	2004	2005
Central government debt	756.1	846.3	975.0	955.1
including:				
internal debt	291.6	426.7	423.0	420.7
of which:				
short-term debt	37.9	52.7	73.0	70.1
medium-term debt	253.6	224.1	224.1	209.2
long-term debt	–	97.0	125.8	141.4
currency debt	–	52.7	–	–
external debt	464.5	419.6	552.0	534.4
of which:				
loans	209.2	137.6	133.1	115.7
Eurobonds	255.3	282.1	418.8	418.7
	(% of GDP)			
Central government debt	13.1	13.2	13.2	10.7
of which:				
internal debt	5.1	6.7	5.7	4.7
external debt	8.1	6.6	7.4	6.0

¹ According to the methodology of the ESA 95 European System of National Accounts.

As the actual fulfilment of the state budget in 2005 was better than initially planned and the public budget deficit did not reach the volume planned in the Law “On State Budget for 2005”, it was not necessary to implement all planned borrowing measures and the opportunity to repay several foreign loans before the schedule was used in 2005. Considering the public budget deficit level forecasted for medium term, it is anticipated that the central government debt will not exceed 12% of GDP in the following years.

In order to ensure financing of the central government budget deficit, the state attracts resources from internal and external capital markets, using a variety of financial instruments. Up to now Latvia has tapped international capital market several times, issuing Eurobonds in 1999, 2001 and 2004.

In 2004 Latvia issued Eurobonds with the hitherto largest volume of 400 million EUR and the longest maturity (10 years). The opportunities to use the instrument of Eurobonds in 2006 and 2007 are being evaluated. Volumes of borrowings and their maturity terms will depend on state budget execution indicators, situation in the financial market, central government debt portfolio indices and other influencing factors.

Table 4.3 reflects costs related to the central government debt. These costs tend to rise along with the increase of the debt. According to forecasts, the costs of servicing the central government debt will go up by 3.4 million LVL in 2006 in comparison with the costs projected in 2005.

Table 4.3

Costs of Servicing the Central Government Debt

	2001	2002	2003	2004	2005 f
Central government debt servicing million LVL	39.3	44.2	46.6	46.9	47.3
% of central government consolidated budget expenditures	2.2	2.2	2.1	1.8	1.4
% of GDP	0.8	0.8	0.7	0.6	0.5

f – forecast of the Ministry of Finance

It is foreseen that the costs related to the servicing of the central government debt will continue growing in the following years, reaching 78 million LVL in 2009.

4.1.2. General Government Consolidated Budget Revenues

In 2005 the budget revenues increased faster than GDP and amounted to 3205.5 million LVL or 35.9% of GDP.

Table 4.4

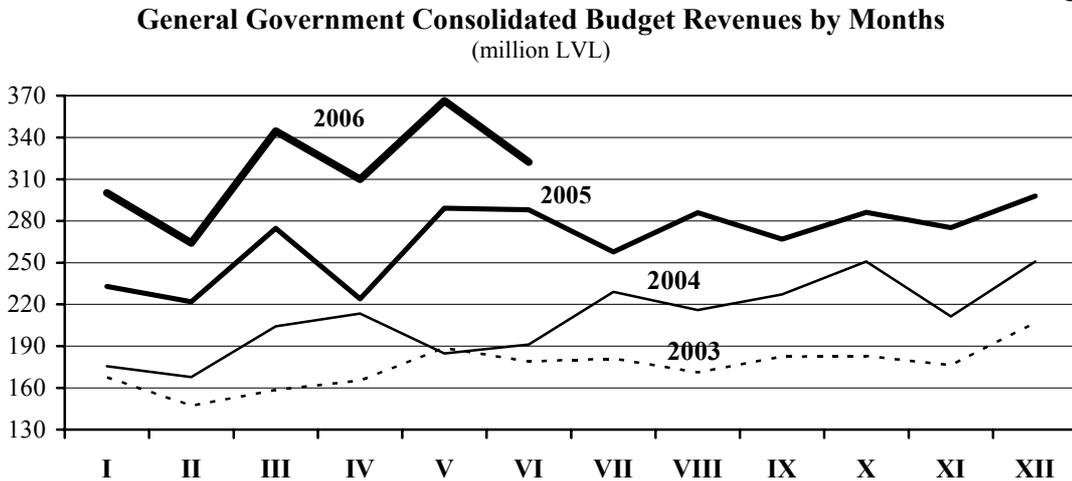
General Government Consolidated Budget Revenues (% of GDP)

	2000	2001	2002	2003	2004	2005
Revenues	34.2	32.5	32.5	33.0	34.0	35.8
I Tax revenues	28.9	27.8	27.8	27.9	27.3	28.5
1. Indirect taxes	10.9	10.1	10.1	10.8	10.0	11.3
– value added tax	7.1	6.7	6.7	7.2	6.6	7.6
– excise tax	3.5	3.1	3.1	3.3	3.2	3.5
– customs duties	0.3	0.3	0.3	0.3	0.2	0.2
2. Income taxes and property taxes	8.0	8.2	8.3	8.0	8.4	8.4
– corporate income tax	1.6	1.9	1.9	1.5	1.7	2.0
– personal income tax	5.5	5.4	5.5	5.7	5.9	5.7
– property taxes	0.9	0.9	0.9	0.8	0.8	0.7
3. Social security contributions	9.8	9.2	9.2	8.8	8.6	8.4
4. Other taxes	0.2	0.3	0.2	0.3	0.3	0.3
II Non-tax revenues	5.3	4.7	4.7	5.1	6.7	7.3

In 2005 the general government consolidated budget revenues exceeded the level reached in the preceding year by 26.9%, among them tax revenues increased by almost 25.7% and non-tax revenues grew by 31.7%, mostly due to the resources of the EU funds.

Central government budget revenues increased faster than local government budget revenues, as the corporate income tax revenues and value added tax revenues, which fully come to the central government budget, increased the most.

Figure 4.3

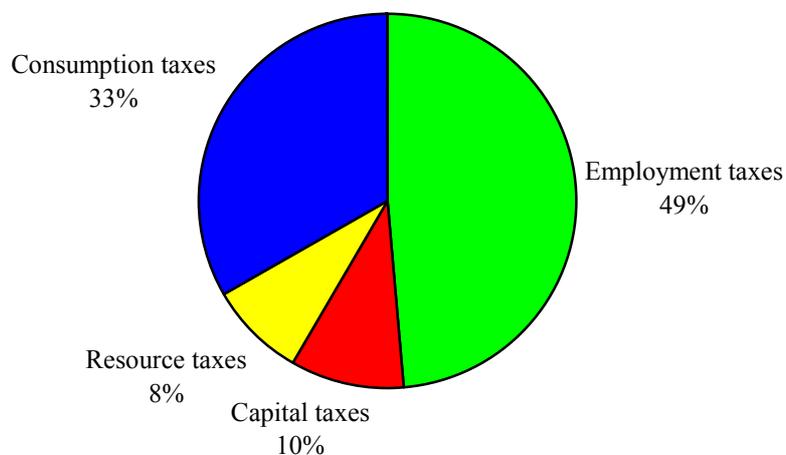


At the beginning of 2006 the general government consolidated budget revenues continued increasing substantially. In 5 months of the year the revenues exceeded the revenues of the respective period of the preceding year by 27.6%, mostly due to the increase in collection of taxes (by 29.6%), where the biggest contribution was made by increased value added tax revenues.

Considering the structure of tax revenues by separate tax groups, which comprise taxes depending on their influence on production factors and consumption, it should be noted that in 2005 the share of consumption taxes has considerably grown, but the share of employment taxes has decreased.

Figure 4.4

General Government Consolidated Budget Tax Revenues by Tax Groups in 2005
(%)



Almost half of all tax revenues or 14.1% of GDP is the collection of **employment taxes** (social security contributions and personal income tax). The share of taxes in total labour costs in Latvia was approximately 41% in 2005. This is a relatively high indicator, mostly due to the low level of non-taxable income.

Social security contributions in the majority of the new EU member states are twice higher than the collection of personal income tax, while in the group of EU-15 member states they are approximately the same. However, it should be noted that these proportions differ considerably from state to state. In 2005 the social security contributions in Latvia exceeded the collection of personal income tax by 1.5 times.

Among the new EU member states, flat personal income tax rate is applied only in the Baltic States, while the other apply progressive personal income tax rate.

As from January 1, 2005 the non-taxable minimum was increased and tax allowances for dependent persons were raised. High tax burden on low wages still remains. For example, in 2005 it amounted to 38.4% for the minimum wage (for employed without dependent persons).

Due to the increased non-taxable minimum, collection of personal income tax in 2005 grew in a smaller amount than the increase of the average wage and the increase of social security contributions in comparison with 2004.

The second biggest group of taxes is **consumption taxes** (value added tax, customs duties and excise tax on alcohol, tobacco, soft drinks, coffee and passenger cars).

80% of all taxes in this group are value added tax revenues. VAT rates are very strictly regulated in the EU member states. Two types of rates are allowed – standard rate not lower than 15% and two reduced rates not lower than 5%. As from January 1, 2003 alongside the standard VAT rate of 18%, also a reduced rate of 5% is applied in Latvia. This reduced rate may be applied to pharmaceuticals, infant food, press publications, guest accommodation and utilities. It should be noted that the average VAT rate is slightly higher in the new EU member states (20.2% in 2003) than in EU-15 countries (19.6%).

Collection of the value added tax considerably increased in 2005 due to the high inflation and improvements of tax administration and was by 39% bigger than in the previous year.

Excise tax revenues on tobacco products in 2005 were by 1.5 times higher than in 2004, which can be explained by the increased combined rate of excise tax on tobacco products as from January 1, 2005.

In 2005 the excise tax revenues on alcoholic beverages increased by 32%, while the increase for beer was minimal.

Due to Latvia's accession to the EU, customs duty revenues dropped considerably in 2004¹ (by 8.7% in comparison with the previous year), while in 2005 they increased by 12.2% in comparison with 2004.

Capital taxes (corporate income tax and property taxes) amounted to 7.3% of all taxes in 2005. Since 2002 a gradual reduction of the corporate income tax rate was started, bringing the rate down from 25% in 2001 to 15% in 2004. The rate was 22% in 2002 and amounted to 19% in 2003.

Due to the lowered corporate income tax rate, in 2003 the collection of this tax dropped by almost 15% in comparison with the preceding year, while in 2004 the corporate income tax revenues increased considerably (by 36.1%) in comparison with 2003. In 2005 the corporate income tax revenues went up by 41.3% in comparison with 2004, and this is related to increased profit of taxpayers and improvements of tax administration. Collection of corporate income tax in 5 months of 2006 exceeds the revenues of the respective period of the previous year almost by 1.5 times.

The group of **resource taxes** comprises two taxes, namely, excise tax on oil products and natural resource tax, and the excise tax makes the biggest share in the group (95% in 2005). Proportion of these taxes in the total tax revenues has slightly increased in the recent years.

Collection of excise tax on oil products considerably increased in 2005 and exceeded the level of the preceding year by 34%. Excise tax revenues on oil products constitute almost two-thirds of the total collection of excise tax.

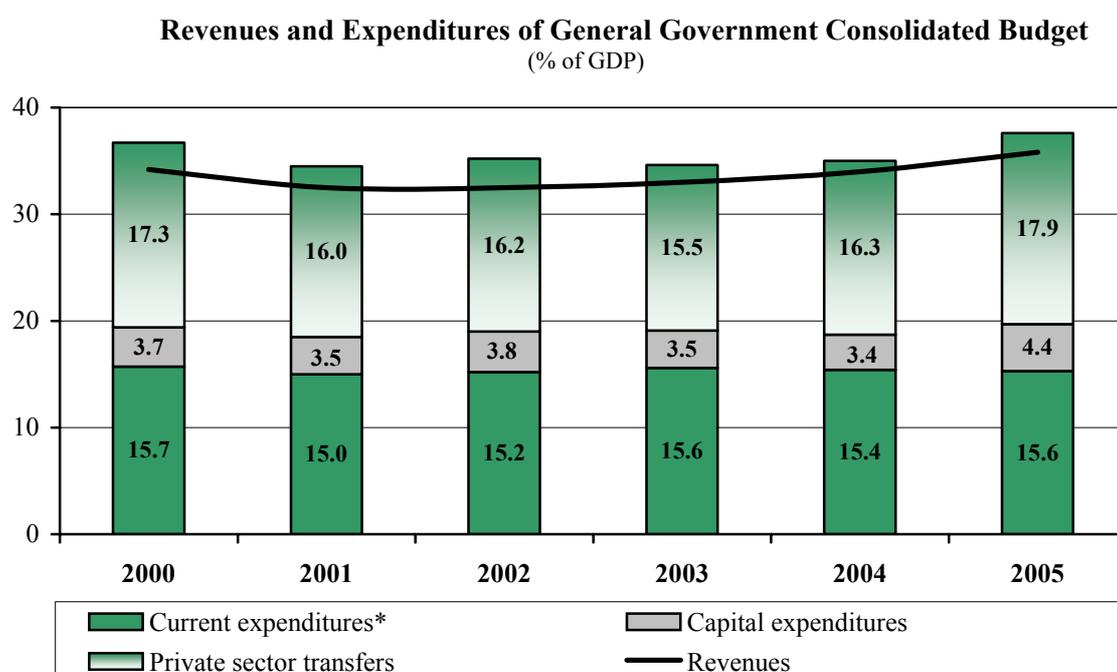
Payments of natural resource taxes are directly linked with economic activities of Latvian companies and environmental loads caused by them. Hence, tax revenues are growing, as the total economic activity increases, and are decreasing, as companies and local governments implement environmental protection measures. Collection of this tax in 2005 was by 25.3% higher than in 2004.

¹ As from May 1, 2004 customs duties are not applied to transportation of goods within the EU, but the customs tariffs set by the EU are applied to goods imported from countries outside the EU.

4.1.3. General Government Consolidated Budget Expenditures

General government consolidated budget expenditures went up slightly faster than the revenues in 2005. The amount of these expenditures was by 26.9% higher than in the preceding year, exceeding GDP growth rate (in current prices), and amounted to 3297.8 million LVL. Thus, the general government consolidated budget expenditures increased against GDP and constituted 36.8% of GDP. Capital expenditures increased more rapidly (by 56.9%), and also transfers to the private sector (especially agriculture) grew faster.

Figure 4.5



The biggest role in the growth of the total budget expenditures was played by the increase of expenditures for agriculture, which were 2.5 times higher than in 2004. Expenditures for social security and welfare, transport and healthcare also increased substantially.

Table 4.5

Expenditures of General Government Consolidated Budget
(percentage)

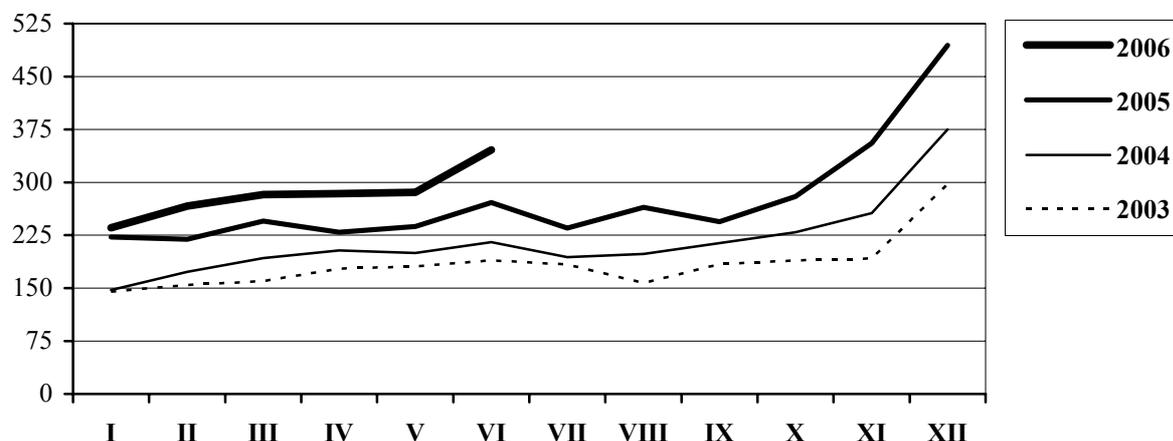
	2004		2005		2005
	struc- ture	of GDP	struc- ture	of GDP	Changes against 2004*
Expenditures – total	100.0	35.0	100.0	36.9	27.1
general government services	8.4	2.9	7.8	2.9	18.8
defence	3.6	1.2	3.3	1.2	19.6
public order and safety, law enforcement	6.3	2.2	5.8	2.2	17.5
education	16.5	5.8	15.4	5.7	18.6
healthcare	9.4	3.3	9.3	3.4	24.6
social security and welfare	28.1	9.8	25.5	9.4	15.3
housing and community amenity, environmental protection	5.2	1.8	5.8	2.1	41.0
recreation, sports, culture and religion	3.7	1.3	3.3	1.2	14.3
agriculture, forestry and fisheries	6.2	2.2	8.9	3.3	81.6
transport and communications	5.3	1.9	7.1	2.6	68.2
other economic activity	1.7	0.6	3.1	1.2	32.0
other expenditures not classified in major groups	5.7	2.0	4.8	1.7	7.7

* current data of general government consolidated budget expenditures

In 5 months of 2006 the expenditures increased slower than the revenues and were by 17.4% higher than in the respective period of the previous year. Expenditures for social security and welfare, healthcare and education increased most substantially.

Figure 4.6

Expenditures of General Government Consolidated Budget by Months
(million LVL)



4.1.4. Public Investment Programme

Public Investment Programme (PIP) comprises investment projects that are financed from the central government basic budget and the central government special budget (social security budget) as well as loans to local governments and their companies granted by the Treasury.

In 2005, resources from the **central government basic budget** were invested in projects of the Public Investment Programme in a twice bigger amount than in the previous year.

Table 4.6

Resources of Central Government Basic Budget Invested in Projects of PIP in 2003-2005, by Groups of Projects
(million LVL)

Group of projects	2003	2004	2005
Investment projects without co-funding of foreign financial assistance programmes	34.4	22.5	27.7
Projects co-funded from foreign financial assistance programmes (ISPA, Cohesion Fund, PHARE, Schengen, TEN-T)	16.7	39.1	87.8
Projects co-funded by ERDF	–	7.5	37.2
Earmarked subsidies for investment to local governments	9.7	14.2	21.1
Total investment from central government basic budget	60.8	83.3	173.9

Increase in volume of investment is mainly related to access to financing from the EU funds (mostly ERDF and the Cohesion Fund). Without foreign financial assistance, 16% of resources are invested in the projects.

Table 4.7

**Central Government Basic Budget Resources Allocated and Used for PIP Projects in 2005,
by Programmes and Beneficiaries of Financing**
(thousand LVL)

Programme of financing	Beneficiary of financing	Used in % of allocated	2005	
			allocated	used
<i>PHARE programme</i>		73	2458	1811
	Ministry of Finance	70	2018	1414
	Ministry of Welfare	100	91	91
	Ministry of Agriculture	87	348	305
<i>Schengen Facility</i>		1	1293	8
	Ministry of the Interior	1	1293	8
<i>Cohesion Fund</i>		83	102178	84923
	Ministry of Transport and Communications	83	79499	66180
	Ministry of Environment*	82	22679	18743
<i>European Regional Development Fund</i>		92	40483	37204
	Ministry of Culture	57	477	273
	Ministry of Welfare	71	4019	2868
	Ministry of Transport and Communications	100	29100	29100
	Ministry of Health	100	3899	3899
	Ministry of Environment	37	1991	739
	Secretariat of Special Assignments Minister for Electronic Government Affairs	33	997	325
<i>European Community support to transport, telecommunications and energy infrastructure networks</i>		65	1645	1073
	Ministry of Transport and Communications	65	1645	1073
<i>Investment in projects without foreign financial assistance</i>		99	27884	27734
	Ministry of Defence	98	6498	6373
	Ministry of the Interior	100	13083	13083
	Ministry of Education and Science	100	2312	2310
	Ministry of Culture	100	90	90
	Ministry of Transport and Communications	100	742	741
	Ministry of Justice	100	2320	2320
	Ministry of Health	100	30	30
	Ministry of Environment	98	1365	1343
	Ministry of Agriculture	100	1184	1184
	National Radio and Television Council	100	260	260
<i>Earmarked subsidies for investment to local governments</i>		100	21155	21147
TOTAL		88	197096	173900

* including for projects of local governments

In the field of *national defence*, informatics and communications projects started in the previous years, establishment of military platform for the Air Force and development of piers and infrastructure in Daugavgrīva were continued in 2005.

Under supervision of the *Ministry of Finance*, implementation of the project "Customs posts on the borders" was continued. Modernisation of all customs control points is carried out in the framework of the project (customs control infrastructure is developed, collection of customs duties is improved,

adequate technical equipment and information systems are established on the current foreign borders of the European Union and in domestic customs control points).

The financing for *internal affairs* in 2005 was invested in development of various communications systems, acquisition of special technology for fire fighting and rescue, development of state border infrastructure, and construction of the administrative complex of Liepāja city and district policy office.

In the field of *education and science*, support was given to 4 projects of professional education establishments and 11 projects of higher educational establishments. In the framework of the Public Investment Programme, complex reconstruction of educational establishment buildings, reconstruction of sewerage, water pipes and thermal networks, development of fire safety system, energy efficiency and sanitary measures were carried out.

Under supervision of the *Ministry of Agriculture*, projects in the field of safe, harmless and high-quality food circulation have been implemented, reconstruction of Aiviekste hydroelectric station at Lubāna lake has been carried out, projects of reconstruction of State Plant Protection Service buildings and renovation of the administrative building of the Ministry of Agriculture have been started.

Under the supervision of the *Ministry of Transport and Communications*, 8 Cohesion Fund projects in the field of roads (including Saulkrasti bypass) and 4 railway infrastructure development projects (including construction of the reception park of Rēzekne II station) were implemented in 2005. Implementation of the national programme “Development of State 1st Class Roads” is continued and road projects of common interest in trans-European networks were started.

In projects of the *Ministry of Welfare*, resources were invested in improvement of social infrastructure and development of alternative social services (9 projects implemented) and development of employment infrastructure (strengthening of institutions, development of information systems).

In the field of *justice*, projects “Unified Information Processing System of Courts” and “Transformation of Olaine Prison into Prison Tuberculosis Hospital” are continued.

Under the supervision of the *Ministry of Environment*, 10 local government projects in the fields of water management and sewerage services development and management of household waste have been implemented. Establishment of hazardous waste management system as well as dismantling and elimination of Salaspils nuclear reactor are continued, the project for construction of national cyclotron and production unit of radionuclides has been started, meteorological locator has been acquired and installed. Ecotourism infrastructure development projects (7 projects in total) have been implemented in the framework of ERDF.

In the field of *culture*, the financing was invested in construction of sport hall of Rīga Dome Choir School, establishment of the joint catalogue of the National Inventory of Museums, projects of State Unified Library Information System and Joint State Archives Information System.

In *healthcare*, support was given to projects for improvement of emergency medical aid, project for repair of departments of Latgale regional rehabilitation centre “Rāzna”, establishment of unified information system of Latvian Blood Service and modernisation of scientific infrastructure of Rīga Stradiņš University.

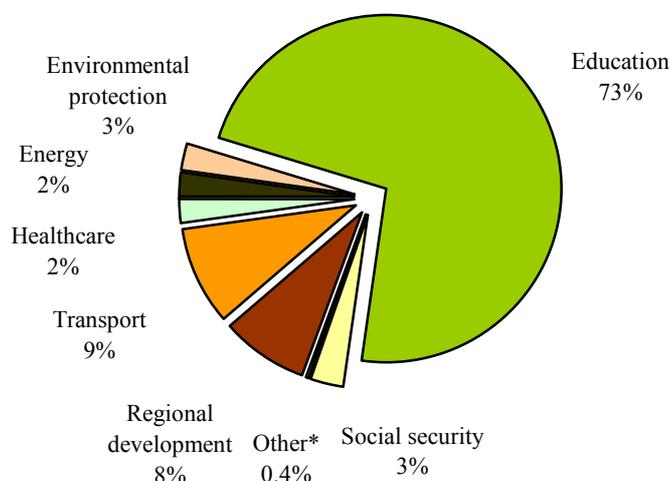
In the framework of projects implemented under the supervision of the *National Radio and Television Council*, equipment of studios of Latvian Radio has been modernised (technical base of preparation of FM digital format radio programmes for distribution of radio programmes over the airwaves in FM broadcasting networks and channels of digital over-ground television sub-programmes has been established) and expansion of the park of mobile technical means of television programmes production has been carried out.

In *information technologies*, the project “E-government portfolio” was implemented in 2005. The project envisages to create 3 national-scale informative systems and 17 state and local government compatible record-keeping systems, to arrange 2 national informative portals, introduce e-services, and ensure increased number of Internet users.

Of the granted *earmarked subsidies for investment to local governments*, 21.1 million LVL have been used for implementation of projects, and three-fourths of this amount is invested in education projects.

Figure 4.7

Earmarked Subsidies for Investment to Local Governments in 2005, by Fields
(%)



* tourism, culture and economic development sector

It has to be noted that local government projects of environmental sector are being financed, also attracting resources of foreign financial assistance programmes (mostly the Cohesion Fund). 18.7 million LVL were invested in the waste management and water management and sewerage services development projects in 2005.

Of earmarked subsidies for investment to local governments, local government projects of Vidzeme region have been supported to the greatest extent in 2005 (see Table 4.8).

Table 4.8

**Earmarked Subsidies for Investment to Local Governments
by Fields and Planning Regions in 2005**
(thousand LVL)

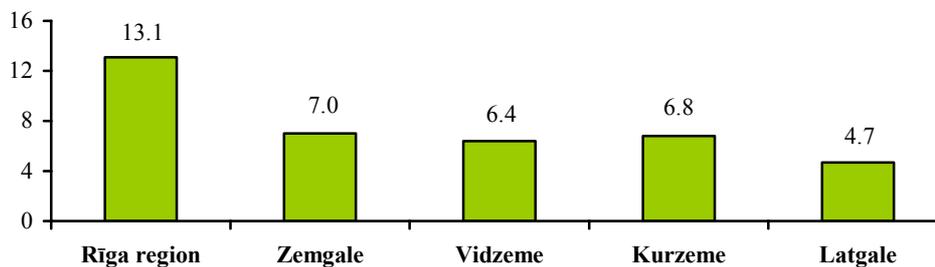
Region \ Fields	Rīga	Zemgale	Vidzeme	Kurzeme	Latgale	Total
Education	2687	2264	5467	2792	2108	15318
Regional development	177	380	254	410	481	1702
Transport	634	564	120	452	172	1942
Social security	57	280	55	54	170	616
Healthcare	133	226		72	58	489
Energy		45	167	220	37	469
Environmental protection	19	514				533
Culture				23		23
Tourism	32					32
Economic development				23		23
Total	3739	4273	6063	4046	3026	21147

Financing for the state investment project “Reform of the Welfare System” was planned from the **central government special budget** (social security budget) in 2005. Of the planned financing in the amount of 2.6 million LVL, 1.6 million LVL or 62% have been absorbed. The reason for so low absorption of resources is the changes in technical solutions and in composition of the project personnel, re-planning of activities and specification of the work tasks.

The total amount of **loans granted to local governments and local government companies** in 2005 constitutes 38 million LVL. 34% of the total amount of granted loans was received by local governments of Rīga region, especially cities of Jūrmala (4.6 million LVL) and Rīga (1.2 million LVL).

Figure 4.8

Central Government Budget Loans to Local Governments and Local Government Companies by Planning Regions in 2005
(million LVL)



Data source: report of the Ministry of Finance about implementation of the Public Investment Programme in 2005, appendix “Information about central government budget loans to local governments and local government companies” was used for analysis.

Loans granted to local governments of Latgale region make the smallest share in the total amount of loans (12%). Total amount of loans granted to local governments of Zemgale, Vidzeme and Kurzeme regions are in the range from 6 to 7 million LVL (see Figure 4.8).

4.2. Prices

4.2.1. Consumer Prices

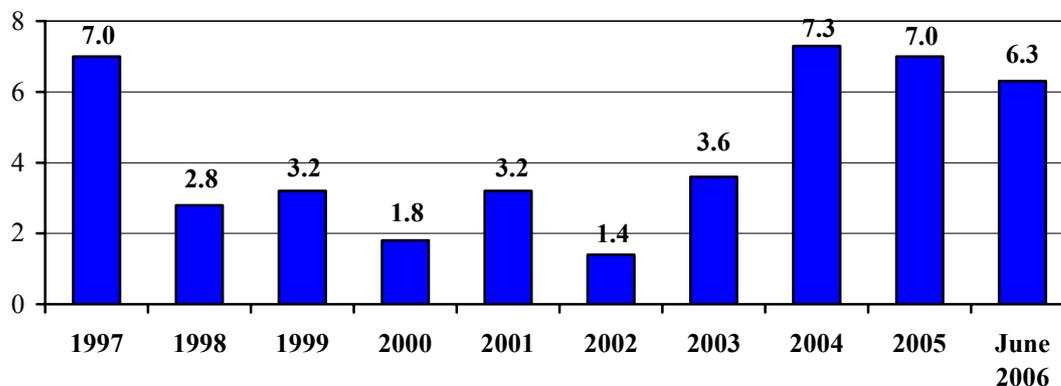
Consumer price inflation in Latvia from 1998 to 2003 was close to the inflation rate in the developed countries and among the lowest in Central and Eastern European countries.

In 2004 the inflation rate increased very rapidly in Latvia, reaching 7.3% (12-months inflation, December over December), and was among the highest in EU member states.

In 2005 the inflation rate was 7% (12-months inflation, December over December); in the 1st half of 2005 the inflation showed a trend towards decrease, but in September 2005 the rapid growth of fuel prices considerably increased the total level of prices by 1.5% (against August 2005). As a result, 12-months inflation reached the high level of the previous year.

Figure 4.9

Consumer Price Changes
(12-months inflation, per cent)



In the 1st half of 2006 the growth of prices (by 3.8%) is slightly lower than in the previous two years, but is still at a relatively high level. Rise in prices of fuel and gas substantially affected the average level of prices in 6 months of 2006.

Figure 4.10

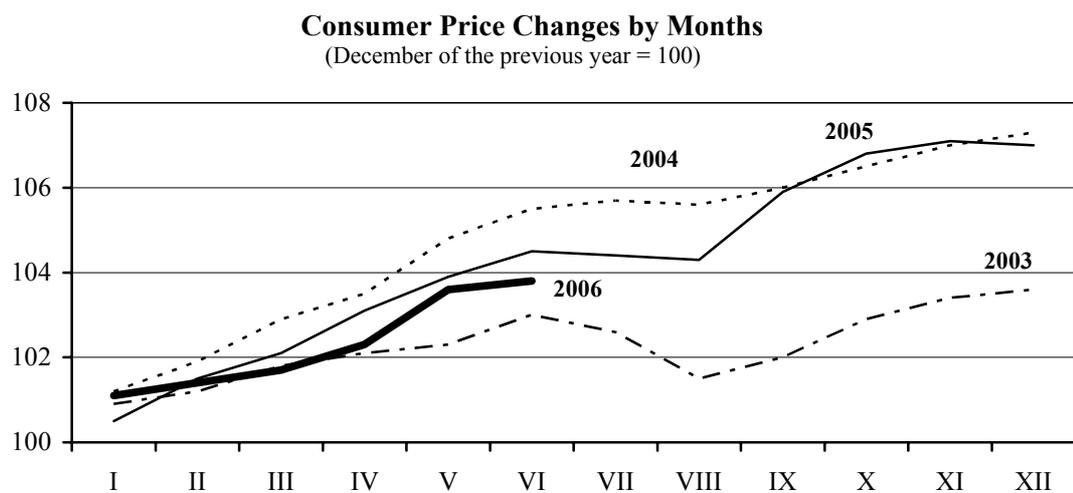


Table 4.9

Consumer Price Changes in Latvia by Months
(%)

Year	Month	Price changes (per cent)		
		compared with the previous month	compared with the respective month of the preceding year	annual average
2004	January	1.2	3.9	3.1
	February	0.7	4.3	3.3
	March	1.0	4.8	3.6
	April	0.6	5.0	3.8
	May	1.3	6.2	4.1
	June	0.6	6.1	4.3
	July	0.2	6.7	4.5
	August	-0.1	7.8	4.9
	September	0.4	7.7	5.3
	October	0.4	7.2	5.6
	November	0.5	7.2	5.9
	December	0.3	7.3	6.2
2005	January	0.5	6.6	6.4
	February	0.9	6.9	6.6
	March	0.6	6.4	6.8
	April	1.0	6.9	6.9
	May	0.7	6.3	6.9
	June	0.6	6.3	6.9
	July	0.0	6.1	6.9
	August	-0.1	6.1	6.8
	September	1.5	7.2	6.7
	October	0.8	7.6	6.8
	November	0.3	7.4	6.8
	December	-0.1	7.0	6.7
2006	January	1.1	7.5	6.8
	February	0.4	6.9	6.8
	March	0.2	6.5	6.8
	April	0.6	6.1	6.8
	May	1.2	6.6	6.8
	June	0.3	6.3	6.8

Growth of prices in the 1st half of 2006 is mostly determined by the following factors:

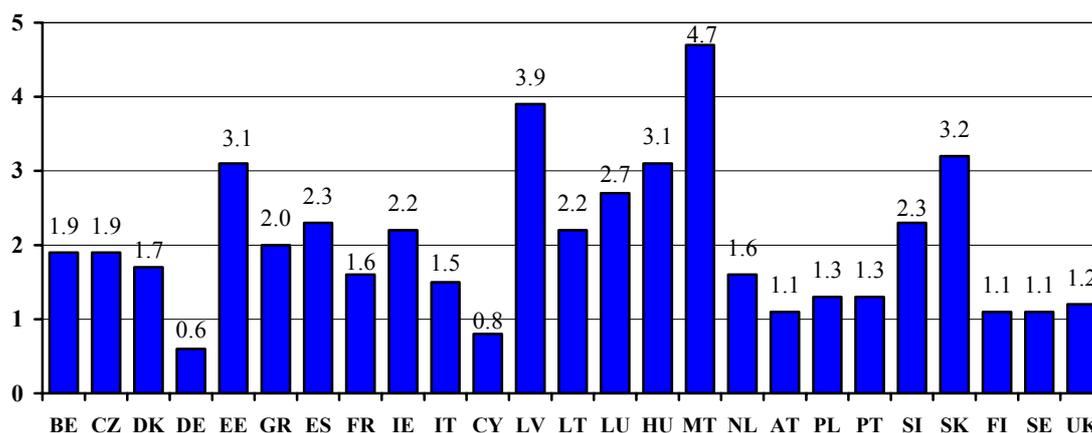
- *the rise of world oil prices*, which considerably affected the growth of domestic fuel prices by 13.1% (in June 2006 compared with December 2005) and the corresponding consumer price increase by 0.6 percentage points in this period. Also the subordinate influence of fuel prices on prices of other goods and services, which doubles the effect on the level of consumer prices, should be taken into account;
- *the rise of administratively regulated prices* for heat energy, electricity and gas. Tariffs for natural gas supply rose as from January 2006 (by 19.1%) and May 2006 (by 18.1%), increasing the total level of consumer prices by 0.2 percentage points, and payment for electricity increased by 6.7% as from March 2006 (affecting the total price level by 0.1 percentage points). Heat energy prices have increased by 6% (affecting the total price level by 0.2 percentage points). Thereby the total influence of administratively regulated prices was by at least 0.5 percentage points in this period. Payments for rent, waste collection, water supply and other expenses related to maintenance of dwelling also grew;
- *the 2nd round effect of the sufficiently high inflation rate (inflation spiral) of 2004 and 2005*. In 6 months of 2006 the inflation rate did not decrease considerably, due to the high volumes of mortgage crediting and increased wages in the private sector, as a result of the high inflation in 2005 and the increase of wages in the public sector (teachers, doctors and other employed in the public sector), which was set in the budget for 2006.

In 6 months of 2006 the consumer price inflation in Latvia was the highest among Baltic States and the 2nd highest among EU member states after Malta (see Figure 4.11). It was lower in the neighbouring countries Lithuania and Estonia, amounting to 2.2% and 3.1% respectively (see Figure 4.10).

In one year, energy prices grew faster in Latvia (by 18%), while in the EU in total and in Estonia energy prices increased almost equally by 11.5% and 11% respectively, and by 8% in Lithuania.

Figure 4.11

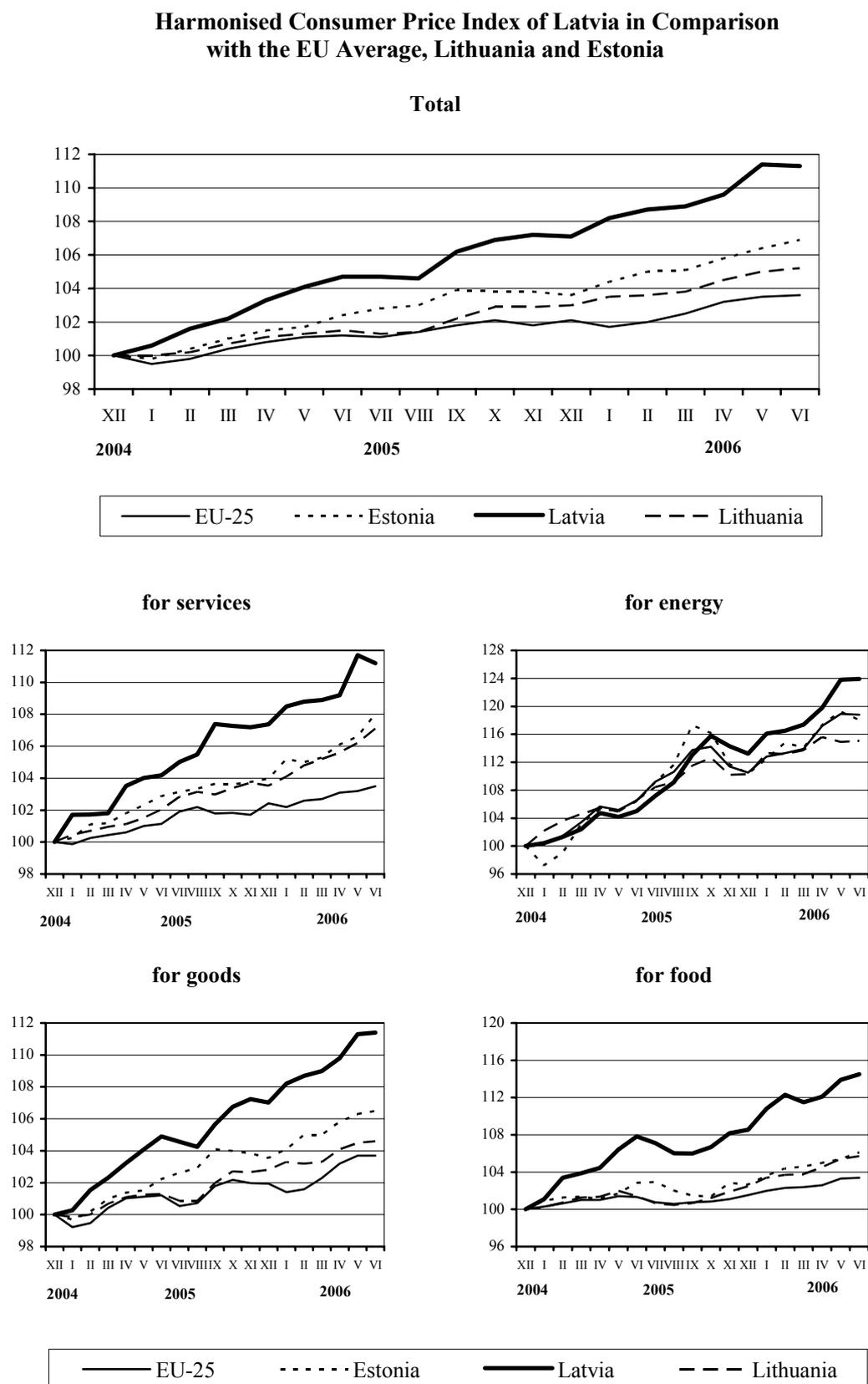
Consumer Price Changes in EU Member States in January-June 2006
(%)



Source: Eurostat

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

Figure 4.12



Source: Eurostat

It is forecasted that in the next years the inflation will gradually return to the previous level, as the influence of one-time supply side factors, which are increasing prices, will lessen gradually.

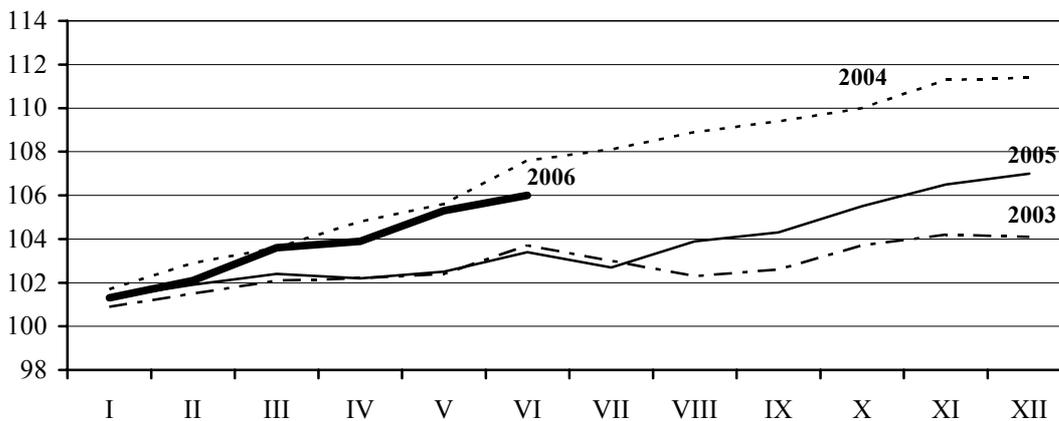
4.2.2. Producer Prices

Producer prices grew slowly in 2000-2003. Their fluctuations were mainly related to the currency rate changes, as changes in export prices greatly determine the overall dynamics of producer price changes.

In 2004 the producer prices went up much faster by 11.4% (December over December). In 2005 the producer price growth was already more moderate (by 7%). As data for the first 6 months of 2006 show, the increase of producer prices is faster than at the beginning of the previous year (by 6.0% in comparison with December of the previous year), which is mainly due to increased prices in production of foodstuffs and beverages and increased tariffs for electricity, gas, steam and hot water supply.

Figure 4.13

Producer Price Changes by Months
(December of the previous year = 100)

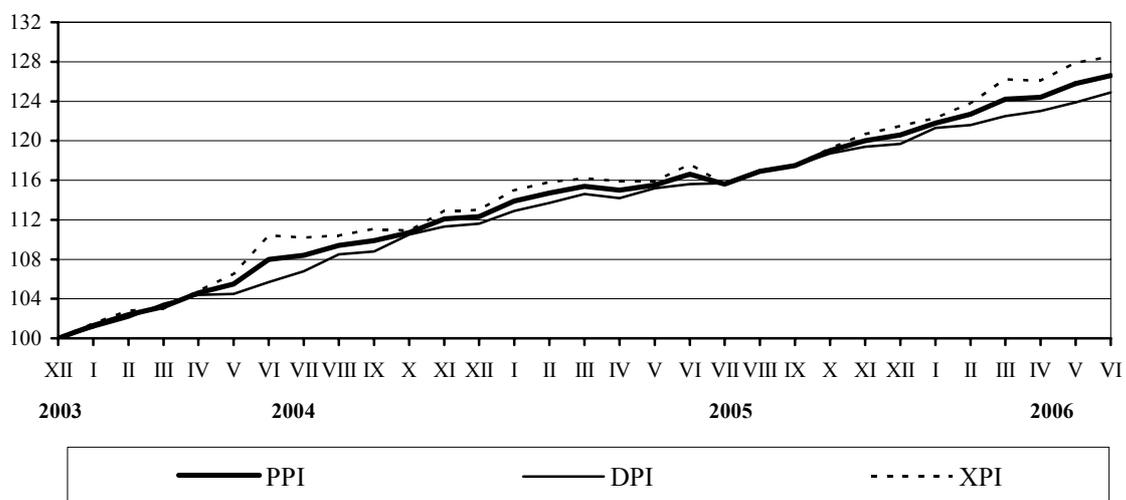


Latvia being a country with a small and open economy, producer prices largely depend on changes of foreign trade prices that are determined by world prices of the respective products and currency rate fluctuations. As world prices and/or currency rates change, incomes from export and expenses on import also change, causing direct or indirect changes of domestic prices.

During the year (June 2006 over June 2005) prices for manufacturing products sold in the domestic market rose slower (by 8.0%) than prices of exported manufacturing products (by 9.3%).

Figure 4.14

Producer Price Dynamics in Manufacturing
(December 2003 = 100)



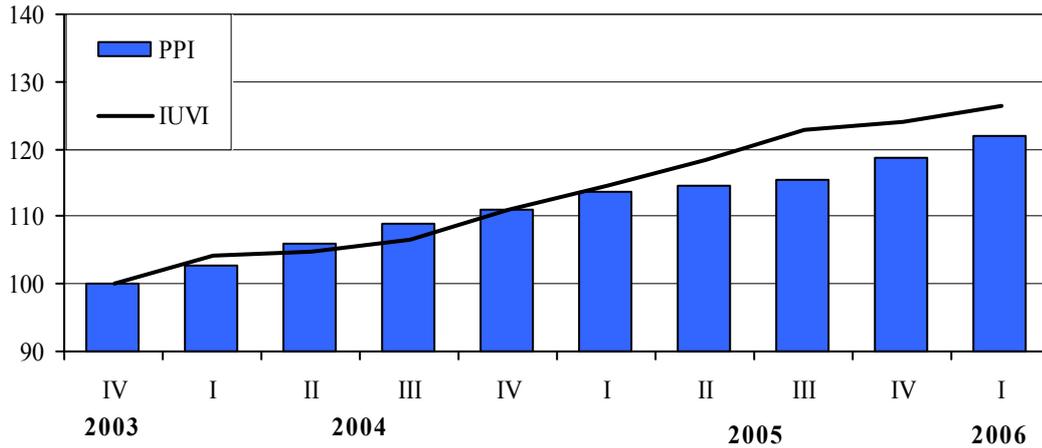
PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

The growth of prices for products sold domestically was triggered not only by the rising domestic demand, but also by the growth of export prices, as supply of some products in the domestic market fell for this reason.

The price growth of exported products in 4 months of 2006 was mainly affected by the rise of world prices.

Figure 4.15

Import Price Dynamics in Comparison with Producer Price Dynamics
(4th quarter of 2003 = 100)

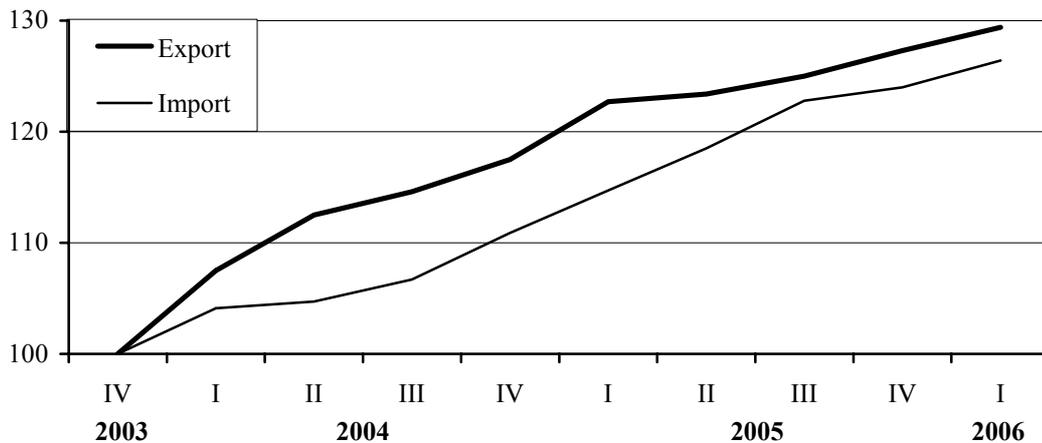


PPI – producer price index, IUVI – import unit value index

Rise of producer prices lags behind in comparison with the import price dynamics. The faster increase of import prices was greatly determined by the rise of fuel prices.

Figure 4.16

Dynamics of Import and Export Prices
(4th quarter of 2003 = 100)



Increase of the export unit value in 2005 and the 1st quarter of 2006 was almost at the same level as for the import unit value, however, slightly exceeding it. Therefore trade conditions remained unchanged in this period.

4.3. Balance of Payments

4.3.1. Current Account

Latvia typically has a relatively big **current account** deficit. The main cause of the deficit is the markedly negative trade balance. About one-fifth of it is covered by the positive balance of services. Mostly negative current account balance is covered by foreign direct investment and other long-term capital flows. The reserve assets of the Bank of Latvia are growing.

Trade balance considerably deteriorated in 2004 (see Table 4.10), as the imports of goods increased more rapidly than the exports due to the growing domestic demand and stockpiling of goods before the accession to the EU, as well as several one-time bulky purchases of investment goods, and as a result the current account deficit of the balance of payments reached almost 13%.

In 2005 the current account deficit slightly diminished with improvement of the trade balance, as the exports of goods rose faster than the imports (see Chapter 3.2.4).

Data of the 1st quarter of 2006 indicate deterioration of the current account due to the growth of the trade deficit.

Table 4.10

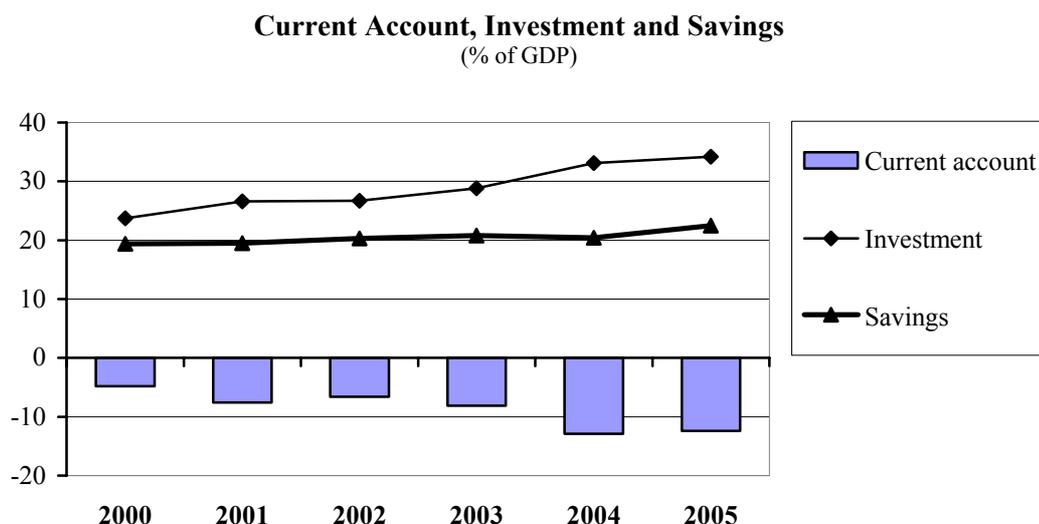
Latvian Balance of Payments
(percentage of GDP)

	2003	2004	2005	1st quarter of 2005	1st quarter of 2006
A. Current account	-8.1	-12.9	-12.4	-10.9	-14.6
Trade balance	-17.8	-20.3	-18.9	-17.4	-21.8
<i>exports</i>	28.3	30.7	33.6	35.5	32.6
<i>imports</i>	-46.1	-50.9	-52.4	-52.9	-54.4
Balance of services	5.2	4.4	3.8	4.2	4.7
Net income	-0.1	-2.0	-1.1	-1.3	-2.9
Current transfers, net	4.7	5.0	3.7	3.7	5.4
B. Capital account	0.7	1.0	1.2	1.6	1.7
C. Financial account	7.8	14.2	16.1	12.6	22.4
Direct investment	2.3	4.3	3.1	5.9	8.9
<i>abroad</i>	-0.3	-0.8	-0.9	-0.7	0.0
<i>in Latvia</i>	2.6	5.1	4.0	6.6	8.9
Portfolio investment	-1.9	1.4	-1.3	-1.5	-6.1
<i>assets</i>	-2.6	-0.4	-1.3	-1.2	-5.7
<i>liabilities</i>	0.7	1.8	0.0	-0.3	-0.4
Other investment	7.4	8.5	14.2	8.2	19.6
<i>assets</i>	-6.1	-12.8	-2.3	-2.1	-0.3
<i>liabilities</i>	13.5	21.3	16.6	10.3	19.9
D. Net errors and omissions	0.2	0.6	-1.6	0.8	-1.8
E. Reserves	-0.6	-2.9	-3.3	-4.1	-7.8

Domestic demand in Latvia is bigger than GDP, creating the current account deficit. This means that also foreign savings should be used to finance domestic investment.

As seen in Figure 4.17, in the recent years the level of savings against GDP in Latvian economy has not essentially changed and amounts to approximately 20%. In contrast, the level of investment in the economy is high, especially after accession to the EU.

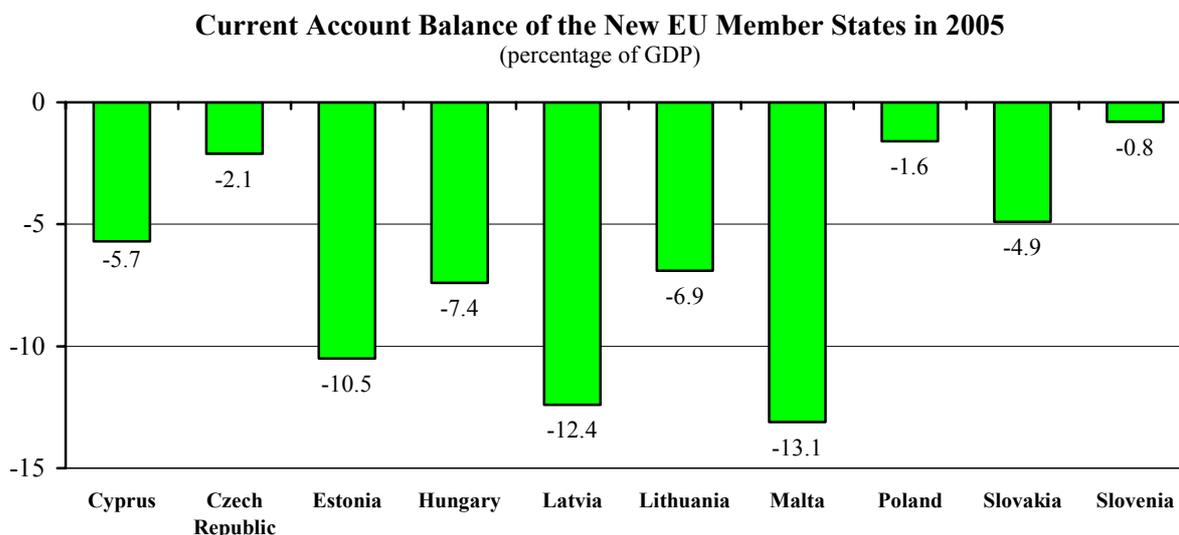
Figure 4.17



Thus, the imbalance between domestic savings and investment (the current account deficit) is a regular phenomenon in Latvian economy during the last years of the rapid growth. Until now it has not caused problems for stability of the economy, as the deficit is mostly covered by non-debt flows. Moreover, faster growth of investment in comparison with the growth of other domestic demand items increases the productive capacity of the Latvian economy and hence improves the competitiveness of economy.

All new EU member states have a negative savings–investment balance, which is mainly linked with the high level of investment. Domestic savings are too small to implement restructuring and modernisation of the national economy.

Figure 4.18



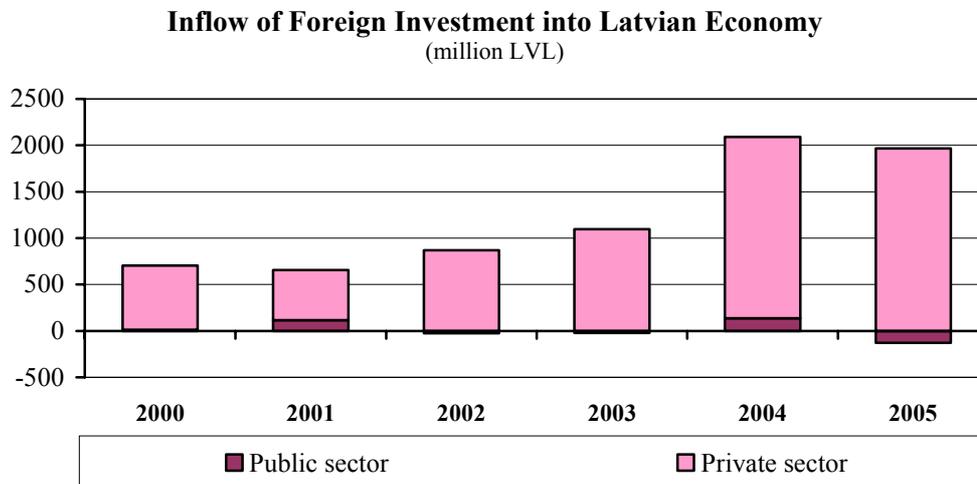
* Source: Eurostat

In 2005 the Latvian current account deficit against GDP was the second highest among the new EU member states (see Figure 4.18). It was higher only in Malta (-13.1% of GDP). No country was with a positive current account balance, the lowest current account deficit was in Slovenia.

4.3.2. Financial Flows

In order to balance the external sector in case of a large current account deficit, it is important to look at the nature of coverage of the current account deficit and financial flows.

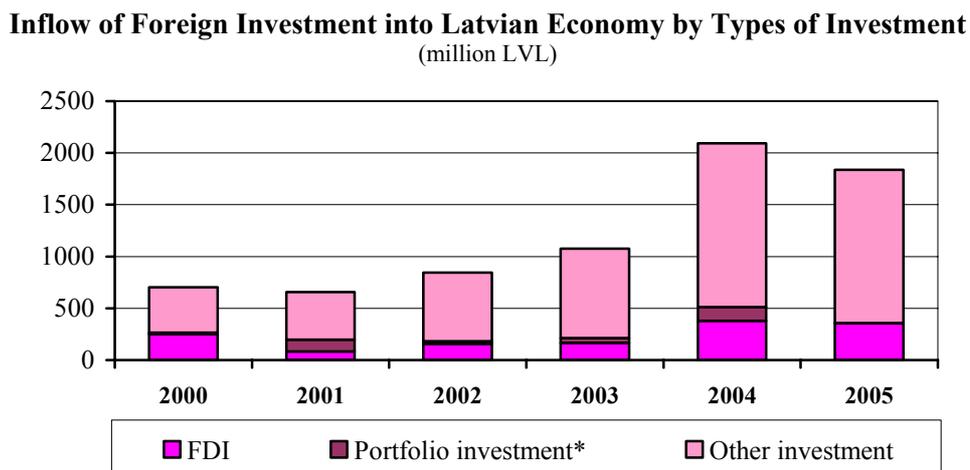
Figure 4.19



Enhanced inflow of foreign capital, ensured by the liberalisation of financial flows, started in Latvia at the beginning of transition. There are no limitations to conversion of the national currency in Latvia. Foreign companies may freely withdraw their investment and profit after paying taxes. Also every resident of Latvia is free to use financial services of any foreign company. There are no restrictions for transactions with securities and stock. Buying and selling of real estate is not restricted, either.

Foreign investment is mainly drawn in by the private sector. In 2004 and 2005 the flows markedly exceeded the level of the previous years. The majority of economists consider that the reason for success in terms of attracting foreign investors to East European and Baltic States is the progress reached in macroeconomic stabilisation, implemented structural reforms and commitment to continue the reforms in the future, strong national currencies and accession to the European Union. Therefore the majority of the new EU member states have credit ratings favourable for investment.

Figure 4.20

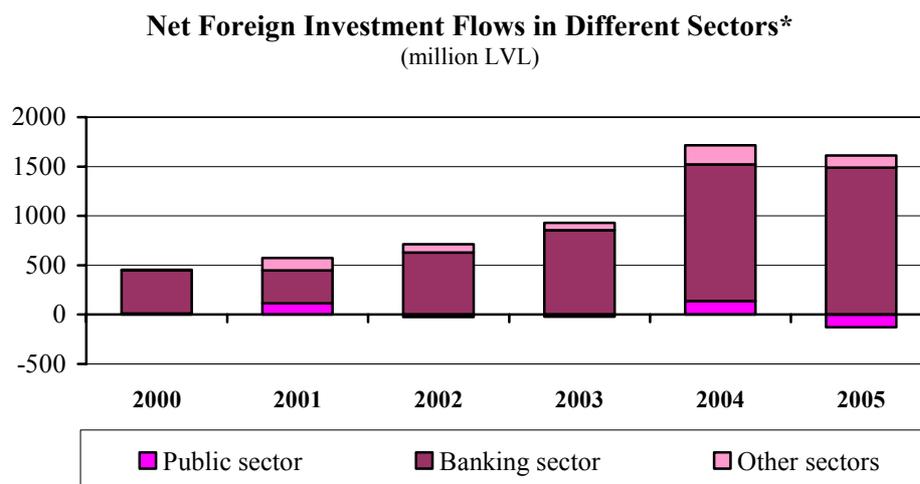


* portfolio investment with financial derivatives

Inflow of foreign direct investment in 2004 was two times bigger than in the previous year and covered 39% of the negative current account balance. In 2005 it covered 32% of the current account deficit.

The share of portfolio investment in the incoming financial flows is small and does not exceed 10% in the last three years. In 2005 the balance of portfolio investment was negative, as bigger number of Latvian banks increased investment in debt securities abroad.

Figure 4.21



* Excluding FDI

The majority of foreign investment consists of “other investment”, namely, financial transactions that are not included in direct and portfolio investment. These are trade loans, other credits and borrowings, cash and deposits, etc.

The volume of foreign financial resources attracted by commercial banks has substantially increased in the last years and constitutes the most voluminous share of financial flows. The open regime of the financial account and the fixed currency exchange rate foster free movement of funds in and out of the banking system.

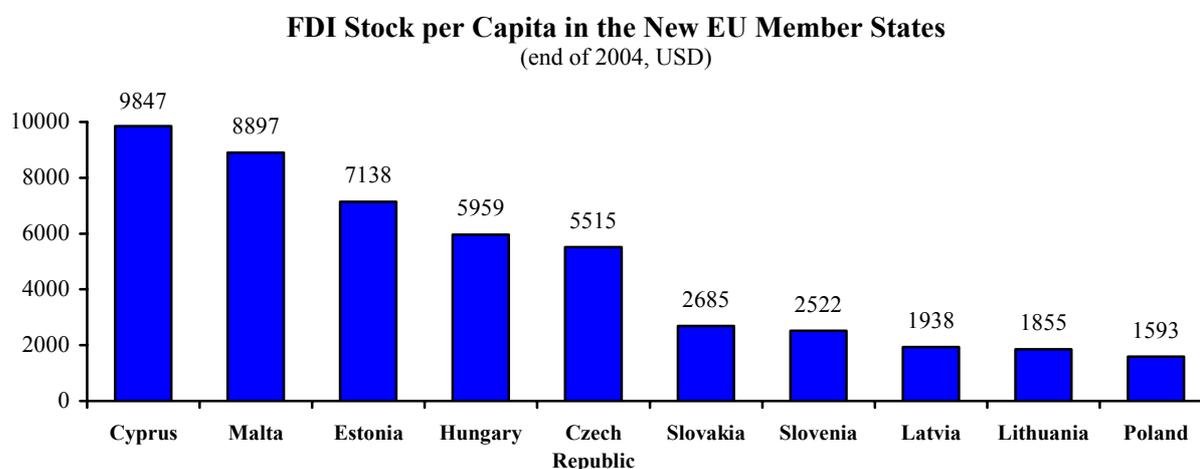
Therefore, Latvia is a capital-attracting country. In 2005 the attracted capital exceeded GDP by 25%, while the debt of Latvia to the rest of the world was 100.7% of GDP, including the central government debt (6.6%). The amount owed to Latvia by the rest of the world equalled to 66% of GDP.

4.3.3. Foreign Direct Investment

Attracted foreign capital is one of the most important financial sources for investing in fixed assets. According to Latvian savings-investment balance, the level of domestic investment in Latvia during the last five years exceeded the level of national savings by almost 10 percentage points, which means that the attracted foreign capital covered 30% on average of the funding for investment in fixed assets. It should be noted that the share of direct investment is the biggest in the structure of the attracted capital.

By the end of 2005, foreign entrepreneurs had invested 1230 LVL or 2074 USD per capita into Latvia in the form of direct investment.

Figure 4.22

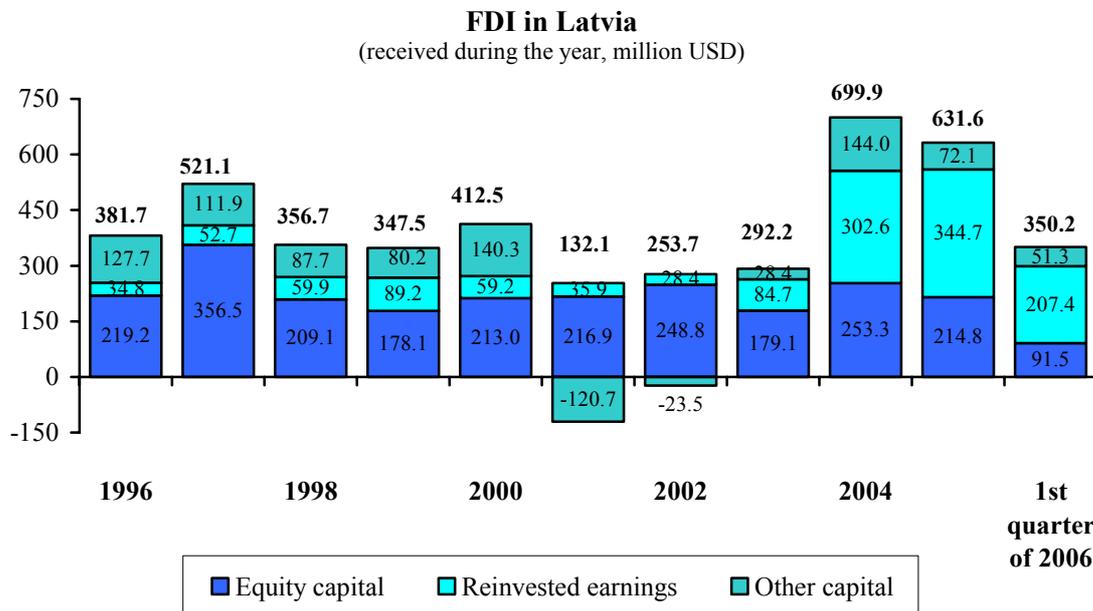


Source: UNCTD, World Investment Report 2005

At the end of 2005, the FDI stock amounted to 2836 million LVL or 31.7% of GDP and the volume of the FDI inflow in the last five years amounted to 13% on average of investment in fixed assets.

In 2005 the volume of the FDI inflow in Latvia was 353.5 million LVL or by 6.4% less than in 2004.

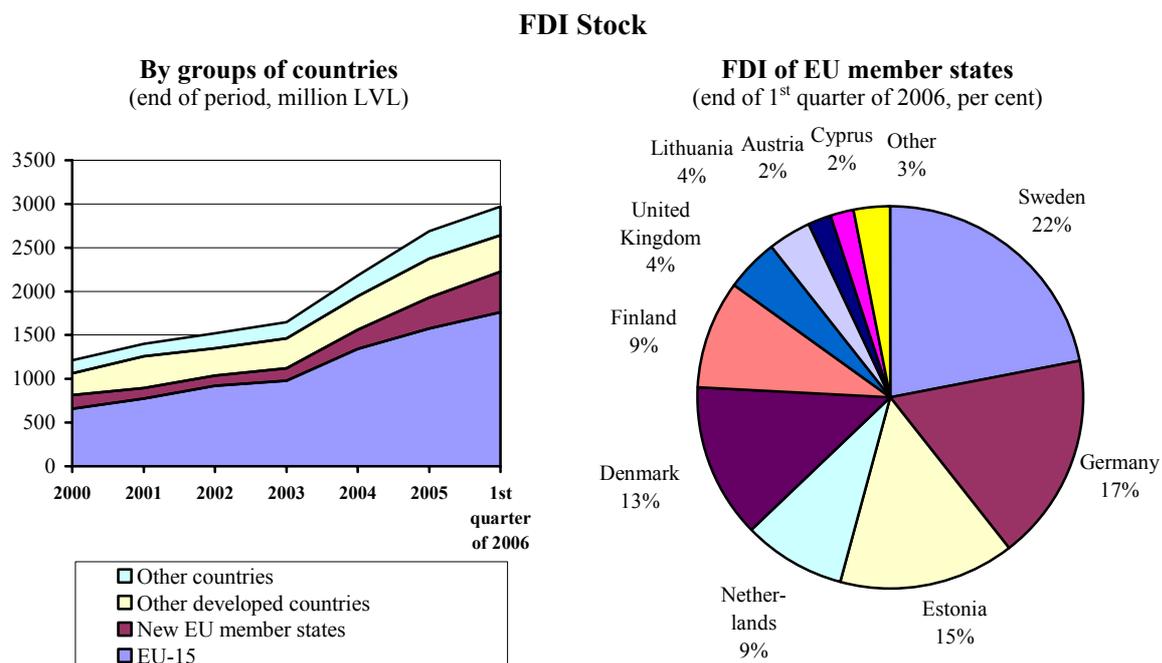
Figure 4.23



With Latvia's accession to the EU, the volume of the FDI inflow has increased considerably. During two years after the accession, foreign entrepreneurs have invested into Latvian economy in the form of direct investment almost as much as in the period from 1999 to 2003. In the 1st quarter of 2006, the volume of the FDI inflow was by 67.2% bigger than in the 1st quarter of the previous year, mainly due to reinvested earnings and other capital.

Investment of developed countries dominates in the geopolitical structure of the FDI stock. FDI stock of developed countries increased by 17.1% in 2005 and by 7.1% in the 1st quarter of 2006 and constituted 75.1% of the total FDI stock in Latvia at the end of March 2006. Investment of EU member states increased by 23.8% in 2005 (slightly slower than in 2004) and by 15.4% in the 1st quarter of 2006 and equalled to 75% of the total FDI stock at the end of March 2006.

Figure 4.24



Investors from the new EU member states have become more active since 2004. In 2004 and 2005 the FDI stock of these countries increased by 50.4% and 62.6% respectively. High growth rates remained also in the 1st quarter of 2006 (by 31.1%). At the end of the 1st quarter of 2006 the FDI stock of the new EU member states constituted 15.7% of the total FDI stock or 21% of the FDI stock of EU member states in Latvian national economy. Among the new EU member states, Estonia has marked leader positions (70% of the FDI stock of the new EU member states). It should be noted that also Lithuanian investment has rapidly increased in 2005 (more than five times).

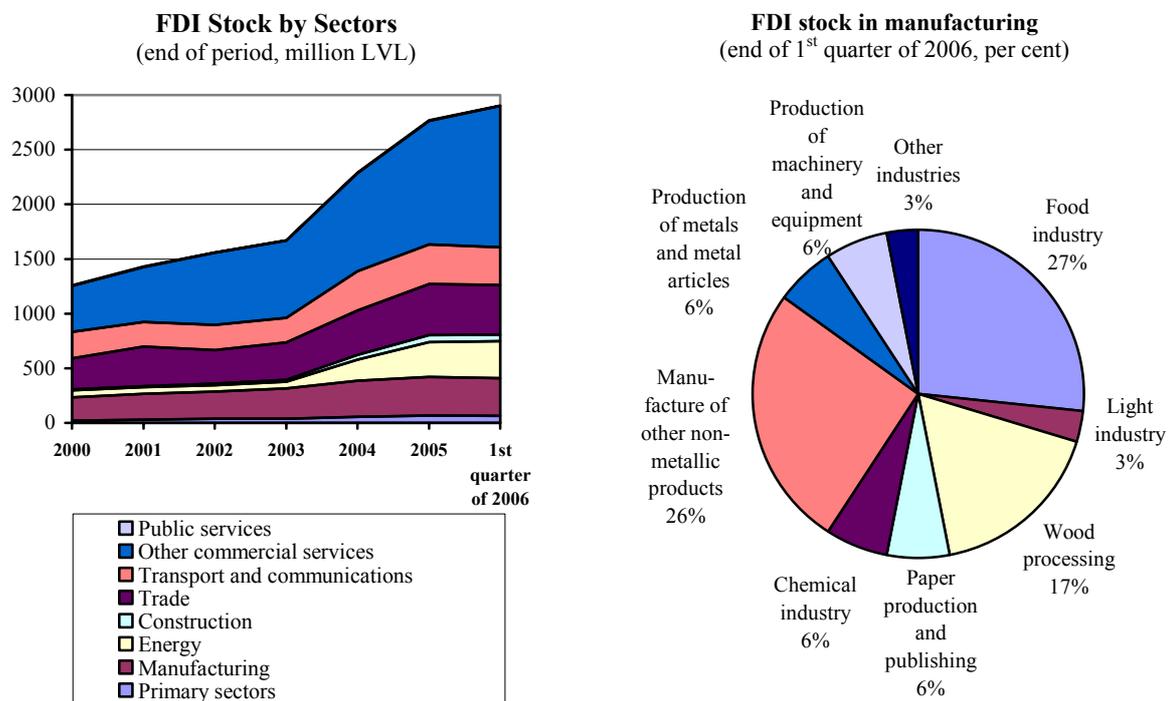
According to data of the Bank of Latvia, the biggest amounts of investment are received from Germany, Sweden, Denmark, Finland, USA, Netherlands, Norway and Estonia, contributing to almost 85% of the total FDI stock in Latvia.

In 2005 the most significant amounts of direct investment in Latvia were made by German, Russian, Dutch, Estonian, British, Lithuanian, Swedish, Austrian, Swiss, Norwegian and American entrepreneurs, accounting for 85.1% of all investment inflow.

Until the end of 2005, the highest share in the sectoral structure of the FDI stock belonged to the commercial services sector (21.5% of all FDI). Already at the end of March 2006, the leading positions were taken by financial services, which was mainly influenced by considerable FDI inflow into the financial services sphere in the 1st quarter of this year. It should be noted that, in 2004-2005, investment has increased faster than in the previous periods in such sectors as energy (by 128% on average annually), fisheries (by 193%), education (by 134%), construction (by 87%). On the whole one has to conclude that, with changes of the geopolitical situation of Latvia, since the beginning of 2004 FDI growth rates in production sectors were twice faster than in services sectors, so the share of these sectors in the total FDI stock reached 28% at the end of March 2006.

Figure 4.25

FDI Stock by Sectors



Like in other sectors, also in manufacturing the inflow of foreign capital in the form of direct investment since the beginning of 2004 was faster than in the time period from 2000 to the end of 2003. At the end of the 1st quarter of 2006, the share of this sector in the total volume of the FDI stock constituted 12%.

Data on the foreign investment stock in the equity capital of companies registered in Latvia at the end of 2005 indicate that the biggest investment in manufacturing was made by German and Swedish entrepreneurs, whose share in the foreign investment stock in 2005 reached 17.3% and 17% respectively. Almost 70% of the total foreign investment in manufacturing are attracted by three

manufacturing sectors: food industry, wood processing and manufacture of other non-metallic products. They are low and medium-low technology sectors, whose competitive advantages in the attraction of capital are mostly related to relatively low accessibility of labour and natural resources. It should be noted that the sectoral structure of the accumulated foreign capital gradually changes – the share of low technology sectors decreases but the share of medium-low technology sectors increases. Such changes were mostly determined by the capital outflow from textile industry in 2005, where the share of the foreign investment stock in the equity capital of companies declined by 90%. One should evaluate positively the fact that foreign investment in high technology sectors grew almost 2.5 times at the end of 2005 in comparison with the end of 2004. The biggest investment in high technology sectors was made by Swedish, Dutch and German entrepreneurs.

4.4. Financial and Capital Markets¹

4.4.1. Monetary Policy and the Exchange Rate

The Republic of Latvia Law “On the Bank of Latvia”² prescribes that the main goal of the Bank of Latvia is to maintain price stability in the country. The central bank is an independent decision-making institution not subordinated to decisions or instructions of the government or governmental institutions. The Bank of Latvia performs its functions under supervision of the Saeima.

Since the middle of February 1994 the Bank of Latvia had unofficially pegged the exchange rate of the lats (LVL) to the SDR³ basket of currencies (1 SDR = 0.7997 LVL) thus *de facto* implementing the policy of fixed currency exchange rate. As from January 1, 2005 the peg of the lats to the SDR basket is replaced with the peg to the euro (1 EUR = 0.702804 LVL). The change of the lat’s peg was determined by Latvia’s plans to join the European exchange rate mechanism II (ERM II) and, after fulfilment of required criteria, to join the Economic and Monetary Union (EMU)⁴.

As from May 2, 2005 Latvia has joined the ERM II with the already existing exchange rate of the lats against the euro, namely, 1 EUR = 0.702804 LVL. Latvia will have to participate in ERM II for at least two years, fulfilling the Maastricht criterion on exchange rate stability. During this period the Bank of Latvia has to reach full compliance with the European Central Bank (ECB), adjusting the monetary policy instruments.

ERM II allows standard fluctuations of the exchange rate within +/-15% around the central or peg rate. Latvia resolves to unilaterally keep the exchange rate fluctuations within +/-1%, retaining the former width of the corridor of lats fluctuations, which was habitual to the financial market, has existed since pegging the lats to the SDR in 1994 and was kept when the lats was pegged to the euro on January 1, 2005.

On July 21, 2005 the Cabinet of Ministers adopted decision to establish the Management Committee for Introduction of the Single Currency of the European Union in Latvia, with a task to develop the plan of measures required to ensure successful joining the euro zone by Latvia. The timetable for introduction of the euro, approved by the Cabinet of Ministers, envisages that Latvia will join the EMU on January 1, 2008. Taking into account that the target set by the government has become unachievable due to high inflation, the situation is being assessed and new target date for joining the EMU will be set.

It must be noted that introduction of the euro in Latvia will be an issue of EU multilateral relations, affecting the common interests of all EU member states. Therefore the timetable for introduction of the euro, approved by the Cabinet of Ministers, will get an official status only after completion of all negotiations and other formal procedures. As soon as the European Council passes the decision on Latvia’s readiness to participate in the EMU, the national currency of Latvia will be replaced with the euro and the Bank of Latvia will terminate implementation of independent monetary policy. Until then the lats will remain the national currency of Latvia.

¹ Data of the *Financial and Capital Market Commission* and the Bank of Latvia are used in this chapter.

² The Bank of Latvia is the central bank of the state.

³ Special Drawing Rights – SDR; currency code according to the classification of currencies international standard ISO 4217 – XDR.

⁴ Participation in EMU is laid down in the EU Treaty of Accession, but Latvia can select its own timeline for introduction of the euro.

The Bank of Latvia operates like the so-called currency board, freely buying and selling foreign currencies. The Bank of Latvia has managed to gain credibility without using the formal currency board system and to get experience, at the same time using wide range of market-oriented monetary instruments fully compatible with the monetary policy instruments available to ECB.

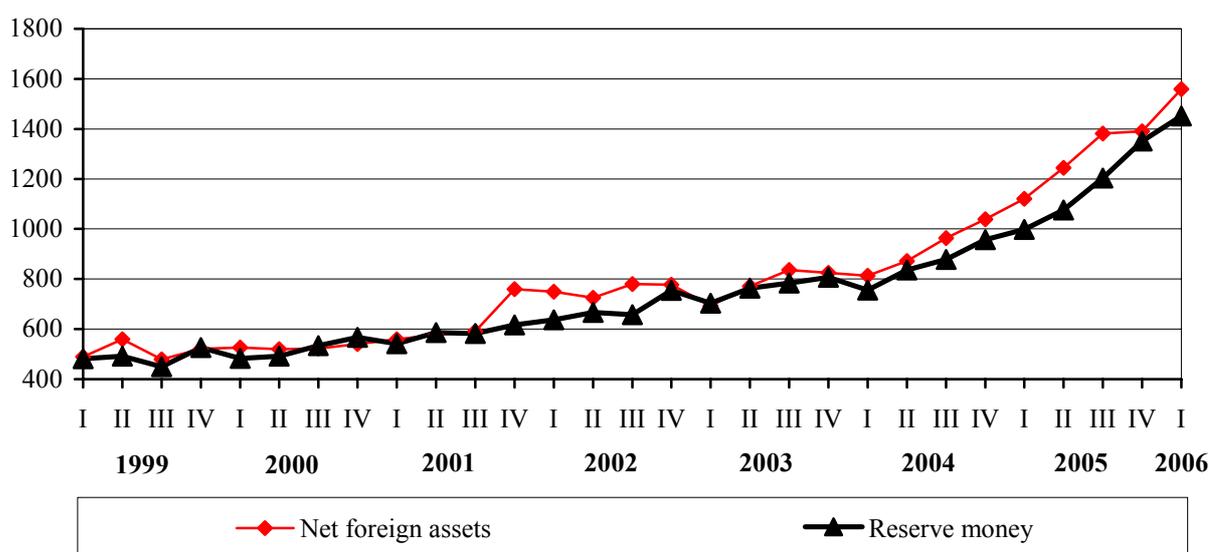
In order to keep a fixed exchange rate, it is necessary to have sufficient amount of foreign reserves. Up to now no problems had been experienced in this area in Latvia. Net foreign reserves of the Bank of Latvia constantly cover the reserve money (see Figure 4.26), and their amount equals to the value of goods and non-factorial services imported by the country in 3-4 months.

The coverage of reserve money (currency in circulation and deposits in the Bank of Latvia) with net foreign assets was 105.2% at the end of April 2006. Net foreign assets of the Bank of Latvia have gone up by 38.5% in comparison with the end of April 2005.

Foreign currency reserves are invested in 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 agencies of these countries and international organisations. Foreign reserves of the Bank of Latvia (including gold reserves) amounted to 2355 million USD at the end of 2005 (2019 million USD at the end of 2004, 1535 million USD at the end of 2003).

Figure 4.26

Net Foreign Assets of the Bank of Latvia and Reserve Money, Quarterly Profile
(million LVL, end of period)



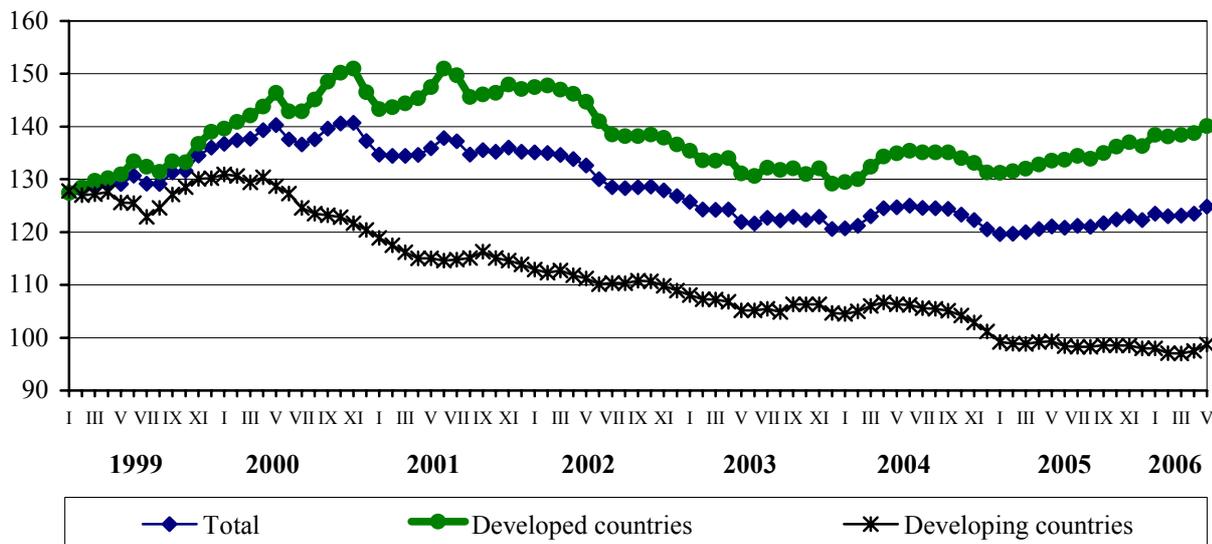
The Bank of Latvia calculates the real effective exchange rate of the lats¹ against the currencies of 13 countries that are the main trading partners of Latvia². It shows the relative competitiveness of Latvian exports in the world markets (see Figure 4.27).

¹ Real exchange rate of the lats encompasses changes of the nominal rate of the lats against the currency of a trade partner state of Latvia as well as consumer price changes in Latvia compared with consumer price changes in the trade partner state. The real rate is calculated by dividing the nominal rate index with the ratio of foreign and domestic price indices.

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

Figure 4.27

Index of the Real Effective Exchange Rate of LVL*
(by months)



* Calculated from the average monthly exchange rates, which is the price of the domestic currency unit in foreign currency. The base for the index is December 1995 (1995 = 100).

Comparing with 2000 and 2001, the real exchange rate of the lats has depreciated with regard to currencies of both the developing and the developed countries. However, in the last years it tends to appreciate with regard to currencies of the developed countries due to relatively high inflation. Decline of the real effective rate of the lats is favourable for the Latvian exporters.

4.4.2. Market Structure and Development

In the financial and capital market of Latvia, bank assets make the biggest share (96%) in total assets (see Table 4.11).

Table 4.11

Participants of the Financial and Capital Market*

	31.12.2003.			31.12.2004.			31.12.2005.		
	Num-ber	Assets, million LVL	Share in total assets, %	Num-ber	Assets, million LVL	Share in total assets, %	Num-ber	Assets, million LVL	Share in total assets, %
Banks	23	5717	96.08	23	7850	96.49	23	10943	96.41
Insurance companies	19	141	2.37	17	156	1.92	17	189	1.67
Investment management companies	8	4	0.07	10	2	0.02	10	8	0.07
Investment funds	16	27	0.45	15	36	0.44	17	76	0.67
Investment plans**	7	26	0.44	19	48	0.59	22	82	0.72
Private pension funds	5	2	0.03	5	2	0.02	6	1	0.01
Savings-and-loans companies	28	4	0.07	32	5	0.06	34	6	0.05
Other	-	29	0.49	-	37	0.46	-	45	0.4
Total		5950	100		8136	100		11350	100

* Data of the *Financial and Capital Market Commission*

** Investment plans are made for the 2nd level of the pension system (resources of the state-funded pension scheme)

22 **banks** and one branch of a foreign bank operated in Latvia at the beginning of 2006. Also credit institutions or their branches, which are registered in European Economic Area (EEA) countries and have submitted applications to the *Financial and Capital Market Commission*, may provide banking services in Latvia. 100 notifications from EEA countries about willingness of banks of these countries to start providing financial services in Latvia without opening a branch were received by the end of 2005. By the end of 2005, four Latvian banks received licences from financial sector supervision bodies of EEA countries for starting provision of financial services in EEA member states without opening branches, and two Latvian banks opened branches in these countries.

The banking system of Latvia has stabilised during the process of biggest bank mergers and takeovers in 1998-2001. Almost all banks are in private hands (at the end of 2005 the state owned 10.6% of the total paid-up equity capital of banks). Only the *Mortgage and Land Bank of Latvia* is fully owned by the state. Foreign shareholders owned 58.6% of the total paid-up equity capital of banks at the end of 2005 (57.8% at the end of 2004, 53.9% at the end of 2003). Nine banks were subsidiaries of foreign banks (their market share in the total bank assets was 52.7%).

The market share of the five biggest banks has not changed substantially in the last years and amounted to 67.3% of total assets, 75.7% of loans and 69.6% of deposits at the end of 2005.

Total amount of the bank assets reached 10.9 billion LVL at the end of 2005, growing by 39.4% during the year, while the amount of issued loans went up by 58.9% and the volume of attracted investment increased by 21.7%. To a great extent, this growth occurred due to the rapid development of crediting and improved efficiency of banking activity. Credit portfolio of banks is dominated by loans issued to companies. However, substantial growth is observed in loans issued to households.

Commercial banks operate with profit. In 2005 the total profit of the banking sector reached 193.1 million LVL¹ (for comparison: the profit amounted to 116 million LVL in 2004). According to operative data, at the 1st half of 2006 the profit of banks was 110.6 million LVL or by 18% more than in the respective period of the preceding year. Return on assets (ROA)² reached 2.1% at the end of 2005, while return on equity (ROE)³ reached 27.1% (1.7% and 21.4% respectively at the end of 2004, 1.4% and 16.7% respectively at the end of 2003). The volume of services provided by Latvian banking sector is still substantially smaller than in the developed countries, therefore this sector has great potential for the future growth. Moreover, a considerable part of Latvian population has not yet started to use banking services.

17 **insurance companies** operated in Latvia at the beginning of 2006, of which five were life insurers and 12 provided non-life insurance. In Latvian financial and capital market, the share of insurance companies in the total assets is slightly below 2 per cent.

Total of gross premiums written in the insurance market reached 156 million LVL in 2005, which was by 19.1% more than in 2004, while the volume of paid gross indemnities was 67.5 million LVL or by 19.3% more than in 2004.

Accession to the EU has encouraged increase of competition in this sector. Since May 1, 2004, non-bank institutions of EU member states no longer need to receive licence or open a branch in Latvia in order to offer their services in this country. Foreign companies now are allowed to insure assets of their subsidiaries in Latvia not only with local insurers, and this has reduced the growth of real estate insurance volumes in the Latvian market. 192 notifications by insurance supervision bodies of 22 European Economic Area countries on the intention of insurers licensed in these countries to use the principle of service provision freedom in Latvia were received by the end of 2005. Also three notifications about opening a branch in Latvia were received. Three notifications by Latvian insurers on the use of the principle of service provision freedom in EU member states were sent to insurance supervision bodies of EU member states.

Securities market plays an important role in attraction of investment. At present, the necessary legal base for development of securities market has been created in Latvia, which complies with requirements of EU directives, and institutions required for functioning of this base have been set up. Yet, the stock market in Latvia is poorly developed, so its influence on the economic development of the country is small.

¹ Non-audited data.

² ROA – ratio of profit/losses to assets.

³ ROE – ratio of profit/losses to capital and reserves.

At the end of 2005, market capitalisation of Latvian companies at Riga Stock Exchange (RSE) was 1492 million LVL or 16.8% of GDP (849 million LVL or 11.5% of GDP at the end of 2004, 608 million LVL or 9.6% of GDP at the end of 2003). 45 companies were listed on the stock exchange at the end of 2005.

Activity of RSE is increasing gradually. RSE index RIGSE reached 676 points (January 1, 2000 = 100) at the end of 2005 (414 points at the end of 2004, 288 points at the end of 2003). Growth of the capital market in the nearest future might be positively influenced by appearance of such stable investors as pension funds and investment companies in the securities market and by the efficiency of raising capital through the securities market.

At the end of June 2002, RSE shareholders accepted a proposal from the HEX Group (owner of Helsinki Stock Exchange) and signed a contract on the sale of 92.98% of RSE shares. As a result of the deal, the HEX Group has become the biggest owner of RSE group. RSE group comprises unified stock Exchange and depository, similar to Finland and Estonia, where stock exchange and depository are unified, too. The new group will be incorporated in the Baltic branch of the HEX Group.

The Finnish securities trader HEX Group, which is also the owner of the only licensed stock exchange in Latvia (RSE), has merged its operations with Swedish company OM, which is a leading developer of information technologies for financial markets of the world. The merged OMHEX group started its operations on September 4, 2003, creating the biggest securities market in Northern Europe and offering access to approximately 80% of stock markets in the Nordic countries. This merger can provide the necessary technological means for integration of Latvian capital market into united markets of the Nordic countries.

As from July 1, 2001, supervision over the financial sector is being carried out by the **Financial and Capital Market Commission** (FCMC). The FCMC took over the functions that had been previously performed by the Credit Institutions Supervision Board of the Bank of Latvia, Securities Market Commission and State Insurance Supervision Inspection. FCMC was established to promote protection of interests of investors, depositors and insured persons as well as support development and stability of the financial and capital market.

Normative acts regulating operation of Latvian banks essentially comply with requirements of the EU banking directives. National regulations in some cases are even stricter than required by the EU directives. For example, the minimum capital requirement is 10% (Directive 2000/12/EC states that the minimum level is 8%), whereas higher risk weights are established with regard to central governments and credit institutions in B zone countries. Banks and insurance companies prepare their annual reports in line with international accounting standards.

In accordance with the *Law on Deposit Guarantees*, the maximum guaranteed amount of compensation to one depositor for a deposit in one bank is being increased gradually (9000 LVL as from January 1, 2006). The law stipulates that the compensation will reach 13 000 LVL by January 1, 2008. As from January 1, 2003, the compensation is also guaranteed to legal persons in the same amount as to physical persons.

34.5 million LVL were accumulated in the Deposit Guarantee Fund at the end of 2005. It has to be noted that, since the fund started operating, its resources have not been used to pay the guaranteed compensations, because no case of the inaccessibility of deposits in banks or savings-and-loans companies has occurred in Latvia during this period of time.

In order to guarantee protection of insured persons in Latvia, Protection Fund for the Insured was established in 1999. The *Investor Protection Law* is in force since 2002, which stipulates that investors are entitled to receive compensation if investment service providers (banks and brokerage firms) cannot honour their commitments.

4.4.3. Deposits and Loans

Stability of the banking sector, growing welfare of population and increasing economic activity predetermine stable growth of basic monetary indicators of the banking system of Latvia. The growth of monetary indicators, which had been observed in the previous years, was also retained in 2005 and the 1st half of 2006. In April 2006 compared with April 2005 the broad money M2X had increased by 40.4%, currency in circulation – by 20.2%, and the volume of deposits – by 45.8%. At the same time also

loans to companies and individuals continued growing (by 61.7%) (see Table 4.12 and Figures 4.28 and 4.29).

Table 4.12

Monetary Indicators of the Banking System of Latvia
(end of period)

	2001	2002	2003	2004	2005
(million LVL)					
Net foreign assets	517.9	352.1	75.4	-231.0	-1326.6
Net domestic assets	1023.6	1512.8	2183.4	3098.8	5311.2
Domestic loans	1433.8	2004.3	2822.0	3948.1	6441.3
to government (net)	79.1	154.7	250.2	173.4	266.3
to companies and individuals	1354.7	1849.6	2571.8	3774.7	6175.0
Other assets (net)	-410.2	-491.4	-638.6	-849.3	-1130.1
Broad money M2X	1541.4	1864.9	2258.7	2867.9	3984.7
Currency in circulation (less vault cash balance)	485.2	543.1	601.1	645.4	786.4
Deposits of individuals and companies	1056.2	1321.8	1657.7	2222.5	3198.3
of which:					
demand deposits	622.1	776.8	941.7	1295.6	2020.2
time deposits	434.1	545.1	716.0	926.8	1178.1
(changes against the preceding period, per cent)					
Domestic loans	35.6	39.8	40.8	39.9	63.1
of which:					
to companies and individuals	49.8	36.5	39.0	46.8	63.6
Broad money M2X	20.8	21.0	21.1	27.0	38.9
Currency in circulation (less vault cash balance)	13.4	11.9	10.7	7.4	21.8
Deposits of individuals and companies	24.5	25.1	25.4	34.1	43.9
GDP (in current prices)	9.9	10.3	11.0	16.0	20.1

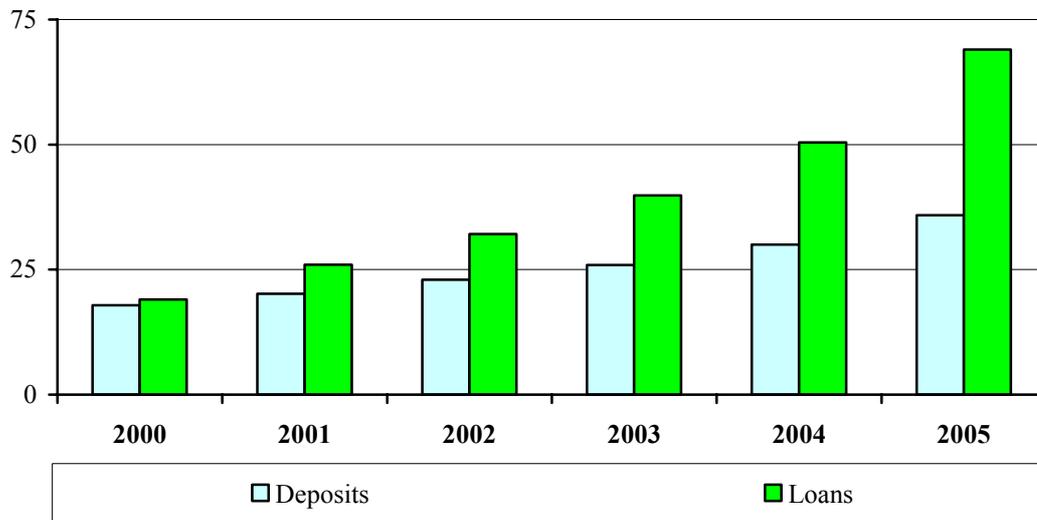
Although volumes of both the deposits and granted loans have considerably increased in recent years, their share in GDP (see Figure 4.28) is still substantially lower than in the developed countries.

The share of **deposits** of companies and individuals in GDP amounted to 36% in 2005. In 2005 the volume of deposits of companies and individuals increased by 44%. 60% of all deposits drawn by residents were deposits in LVL, whereas the rest was deposited in foreign currencies. Dominant role in deposits is played by demand deposits whose share in the total deposit structure was 71% at the end of 2005.

Deposits of non-residents constitute slightly less than a half of the total volume of deposits. Their share in the total deposits is shrinking (from 54% at the end of 2004 to 47% at the end of 2005). The relatively high share of short-term deposits and non-resident deposits is a certain risk factor. Dramatic decrease of deposits in case of economic shocks could seriously affect Latvian banking system on the whole. However, due to strict measures of bank supervision and control, such probability is small. A major part of liabilities drawn by non-residents are placed into liquid assets, and risks related to dynamic quantitative changes of these deposits are well managed. Trust in banks is also enhanced by the *Law on Deposit Guarantees*.

Figure 4.28

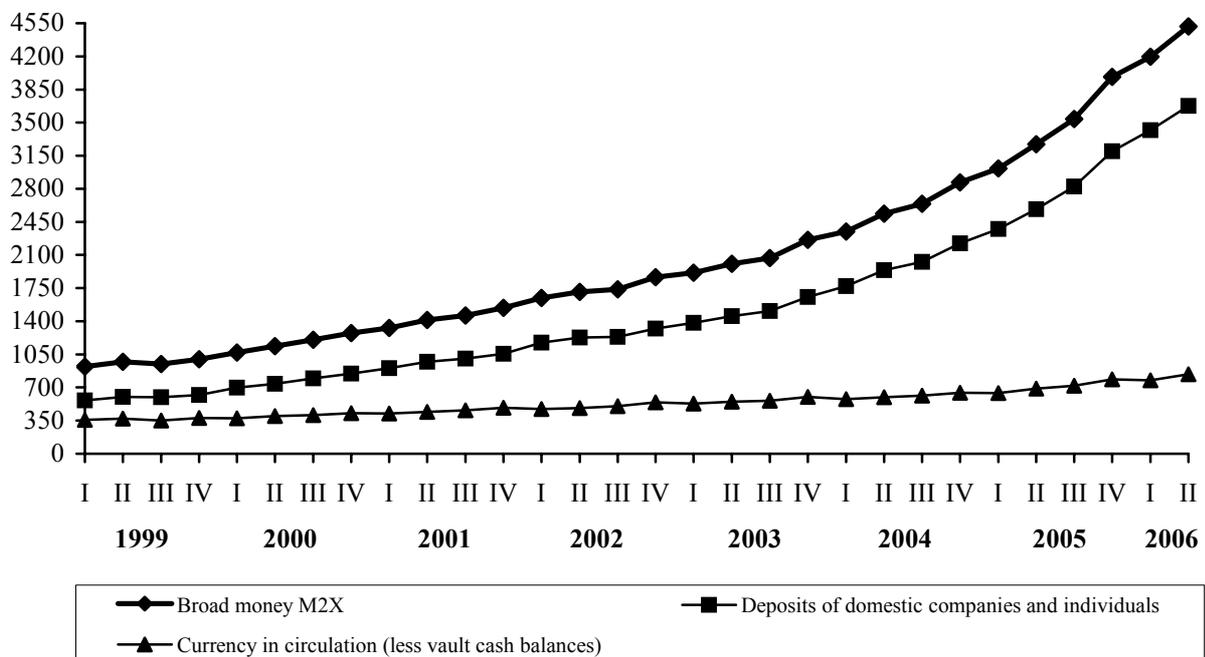
Deposits and Loans of Domestic Companies and Individuals
(% of GDP)



In 2005 the share of **loans** to companies and individuals in GDP was 69%¹. In the last years the volume of loans has annually increased by 37-50% and it increased by 64% in 2005. Both the enlivened economic activity and the reduction of credit risks have encouraged the growth of crediting.

Figure 4.29

Dynamics of Broad Money (M2X) and its Components, Quarterly Profile
(end of period, million LVL)

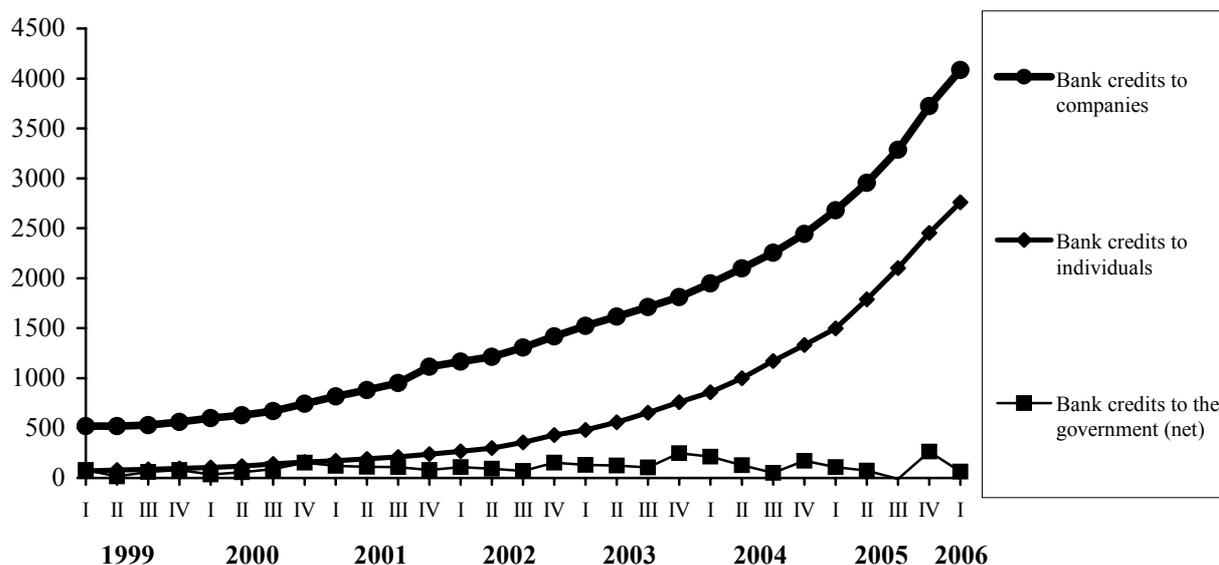


At the end of 2005, 89% of total issued loans had been granted to resident borrowers. 30% of total loans granted to resident borrowers were loans in LVL. The share of loans issued in lats and US dollars in the credit portfolio is gradually decreasing, while the share of loans issued in euros is increasing and amounted to 59% of the credit portfolio at the end of 2005.

¹ To compare: in euro zone the proportion of loans against GDP was 98% at the end of 2003.

Figure 4.30

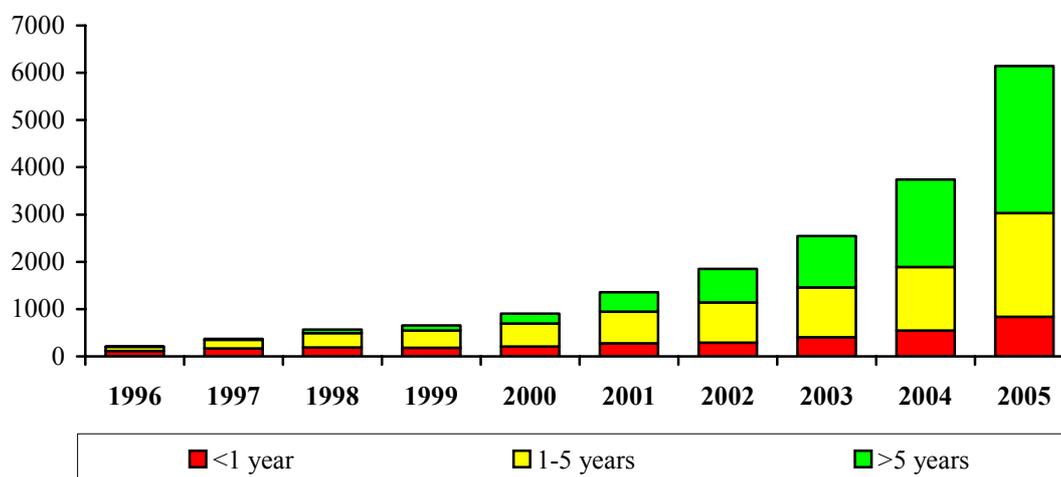
Bank Credits to Domestic Companies, Individuals and Government, Quarterly Profile
(end of period, million LVL)



Some positive changes have taken place concerning the loan term and the quality of credit portfolio. The share of short-term loans in the total structure of loans is decreasing, whereas the share of long-term loans is increasing (see Figure 4.31). The share of long-term loans in the total credit portfolio was 51% at the end of 2005.

Figure 4.31

Term Structure of Loans to Domestic Companies and Individuals
(end of period, million LVL)



While the amounts of crediting are increasing, the quality of loans is not decreasing. At the end of 2005 the quality of loans issued by banks was as follows: 98.8% of all issued loans were evaluated by banks as standard loans, 0.5% were evaluated as the loans under supervision and only 0.7% were evaluated as loans generating no income (sub-standard, doubtful or lost)¹. In compliance with the requirements of the Bank of Latvia, loans generating no income are secured by special savings, hence this category of loans does not present a serious threat to stability of banks.

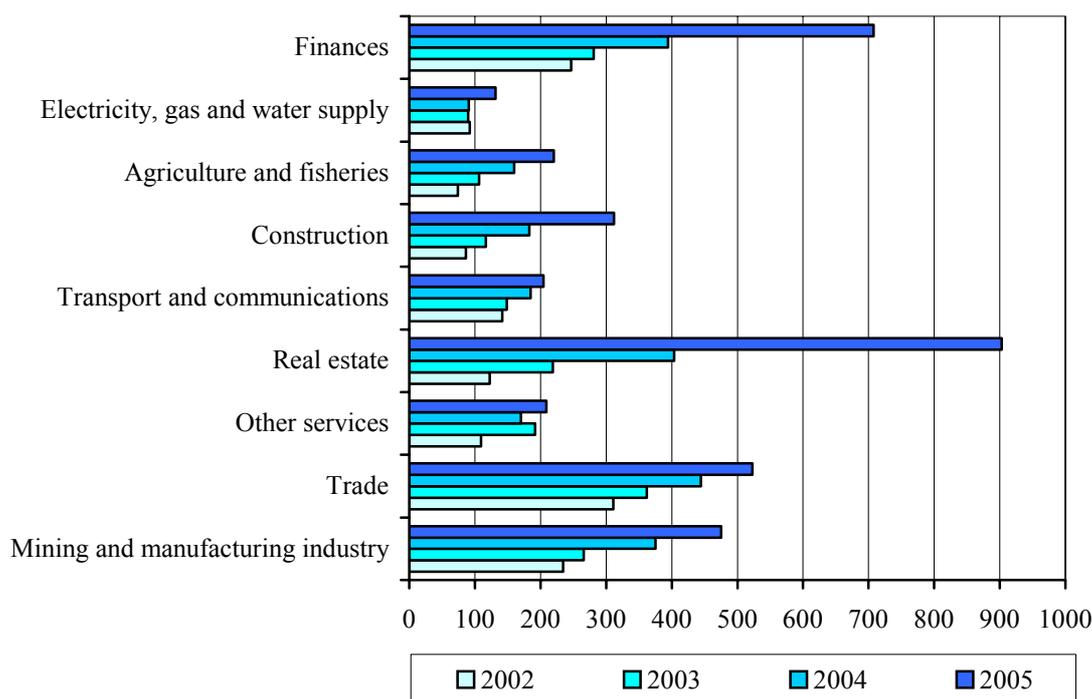
¹ To compare: 1.1% of issued loans were evaluated as generating no income at the end of 2004, 1.4% at the end of 2003, 2% at the end of 2002; this indicator equalled to 2.8% at the end of 2001, 5% at the end of 2000, 6% at the end of 1999, 7% at the end of 1998, and 10% at the end of 1997.

At the end of 2005 the biggest amounts of loans had been granted to the following national economy sectors: real estate operations (24.5% of total domestic loans), financial mediation (19.2%), trade (14.2%), mining and manufacturing industries (12.9%).

From the end of 2002 to the end of 2005, the balance of long-term loans increased fastest in the sector “Real estate operations, lease, computer services, science and other commercial services” (7.4 times), in construction (3.6 times), agriculture and fisheries (3.1 times), financial mediation (2.9 times), and mining and manufacturing industry (2 times). In 2005 crediting grew fastest in real estate operations (2.2 times), financial mediation (by 79%) and construction (by 70%) (see Figure 4.32).

Figure 4.32

Balance of Long-Term Loans Granted to Companies in National Economy
(end of year, million LVL)



Mortgage crediting develops rapidly. The volume of issued mortgage loans rose by 103.1% in 2005. The share of mortgage loans in credit portfolios of banks has grown from 17% at the end of 2001 to 37% at the end of 2004 and 46% at the end of 2005. The share of commercial loans (to increase current assets of companies) in the total credit portfolios of the banks was 27% at the end of 2005, while the share of industrial loans (for acquisition of fixed assets and financing of long-term investment projects) amounted to 19%.

Responding to the rising domestic demand, the Bank of Latvia raised the refinancing rate by 0.5 percentage points in March and November of 2004 and in July 2006 to 4.5% and increased the reserve requirement ratio from 3% to 4% in July 2004, to 6% in August 2005 and to 8% in December 2005, in order to slow down the rapidly growing lending.

In order to unify conditions of mutual competition between banks and slow down the rapidly increasing borrowing by Latvian banks in foreign banks, as from January 24, 2005 the Bank of Latvia included bank commitments to foreign banks and foreign central banks with set term or warning term on withdrawal till 2 years in the base of compulsory reserves. On March 14, 2006 the Board of the Bank of Latvia took decision to expand the base of compulsory reserves, keeping the norm of reserves at the previous level of 8%. As from May 24, 2006 the requirements on compulsory reserves are also applied to bank commitments with set term above 2 years.

However, the efficiency of these measures in Latvia has been limited by the fixed currency exchange rate regime and several specific factors, such as the low share of loans granted to resident

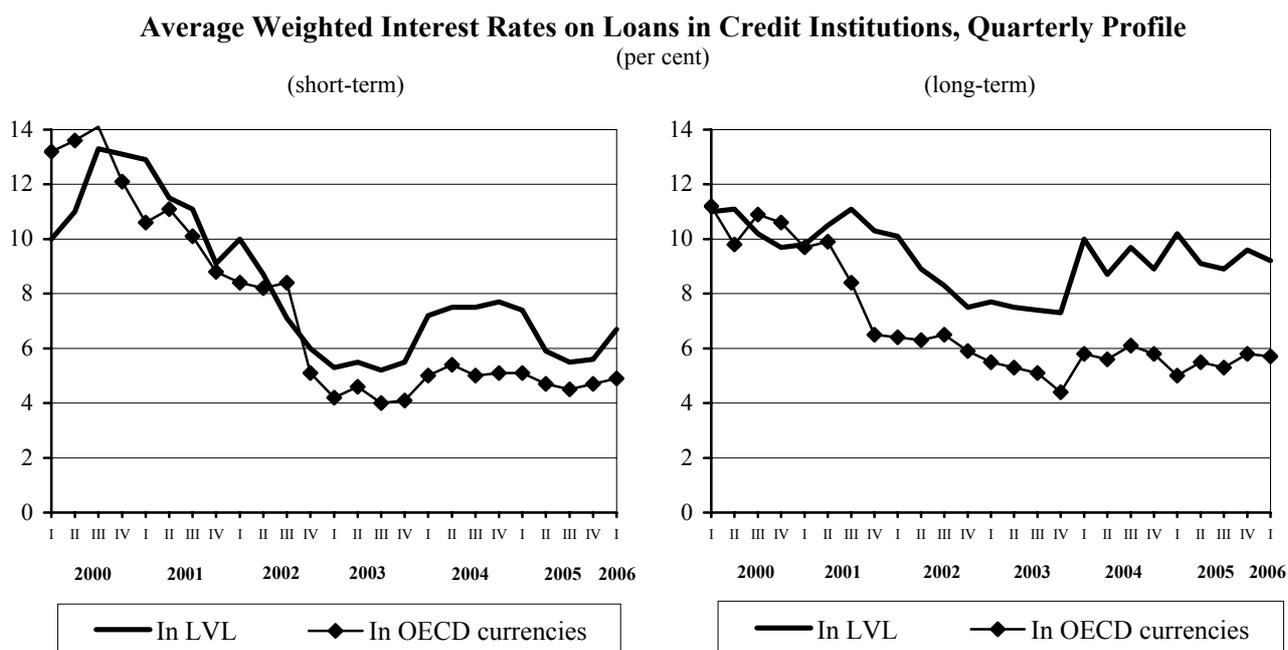
borrowers in GDP, relatively easy access by banks to foreign resources, and a relatively high share of loans issued in foreign currencies in the total structure of loans.

The dynamics of loan interest rates is reflected in the Figure 4.33.

Average weighted annual interest rate for short-term loans in LVL to companies and individuals was 7.3% in May 2006, the rate for long-term loans in LVL was 11.1%, while the respective rates for loans in OECD currencies were 4.9% and 5.9%¹.

In turn, in May 2006 the average weighted annual interest rate for short-term deposits in LVL was 3.7%, the rate for long-term deposits in LVL reached to 4.1%, while the respective rates for deposits in OECD currencies were 3.0% and 4.3%.

Figure 4.33



¹ Short-term with floating interest rate.

5. Labour Market

5.1. Employment and Unemployment

Rapid economic development in the recent years makes a positive impact on the situation in the Latvian labour market. Although the population of working age (15-64 years) continues diminishing, the number of economically active persons increases and the employment rate grows. The proportion of economically active persons in this age group was 69.2% in 2003, increased by 0.4 percentage points in 2004 and reached 69.5% in 2005 (see Table 5.1).

Table 5.1

Main Indicators of Employment and Unemployment¹

Indicators	2000	2001	2002	2003	2004	2005
Population in the age of 15-64 years (thousand)	1600.3	1594.2	1591.4	1589.3	1587.3	1583.8
Economically active persons in the age of 15-64 years (thousand)	1074.7	1082.0	1094.8	1099.6	1105.5	1100.8
Employed persons (thousand)	917.6	937.5	962.5	981.5	988.2	1003.6
Participation rate (%)	67.2	67.9	68.8	69.2	69.6	69.5
Employment rate (%)	57.3	58.8	60.5	61.8	62.3	63.4
Unemployed (job seekers) (thousand)	158.3	144.6	134.5	119.2	118.6	99.1
Unemployment rate (%)	14.4	13.1	12.0	10.6	10.4	8.7
Registered unemployed persons (end of year, thousand)	93.3	91.6	89.7	90.6	90.8	78.5
Registered unemployment rate (end of year, %) ²	7.8	7.7	8.5	8.6	8.5	7.4

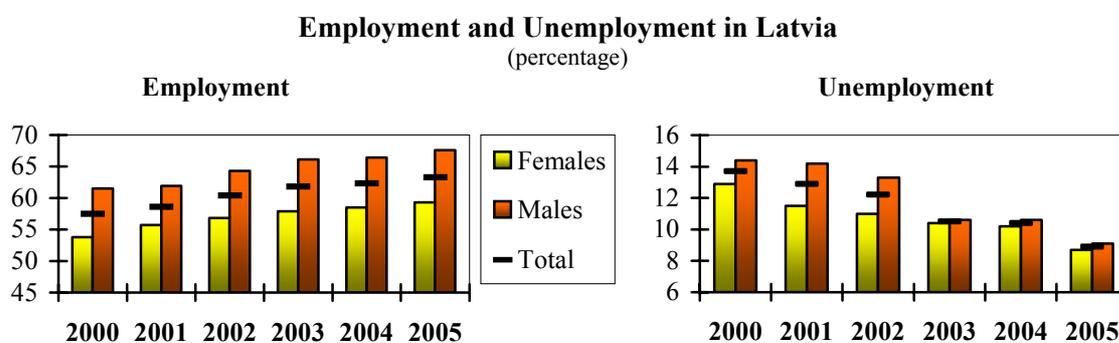
¹ In the table and further in the text, indicators of employment are shown for people in the age of 15-64 years and unemployment – for people in the age of 15-74 years.

² Share of registered unemployed persons in economically active population from 2002 is according to the new methodology

In the last five years (2001-2005) the **employment rate** has increased by 6.1 percentage points. In 2000 the employment rate in Latvia was 4.9 percentage points lower than the EU average, while in 2005 it lagged behind by mere 0.5 percentage points.

The Lisbon Strategy has set a target to achieve the average employment rate of 70% in the EU by 2010. This goal is already achieved by Denmark, Sweden, Netherlands and the United Kingdom. Cyprus, Austria, Finland and Portugal have reached an intermediate target – employment rate of 67% by 2005 (see Chapter 6.1).

Figure 5.1



Source: Eurostat, Structural Indicators, 16.06.2006.

Female employment in Latvia is higher than the EU average and this difference tends to grow, as the female employment rate in Latvia exceeded the EU rate by 2.1 percentage points in 2002 and by 3

percentage points in 2005. This can be explained by the low proportion of manufacturing in Latvian economy and bigger share of the sectors with higher proportion of women in the number of employed persons (trade, restaurants and other services).

Male employment in Latvia tends to increase every year, but still lags behind the average EU rate (by 6.7 percentage points in 2002 and 3.7 percentage points in 2005).

Male employment exceeded the female employment rate by 7.9 percentage points in 2004, while in 2005 this difference slightly increased to 8.3 percentage points.

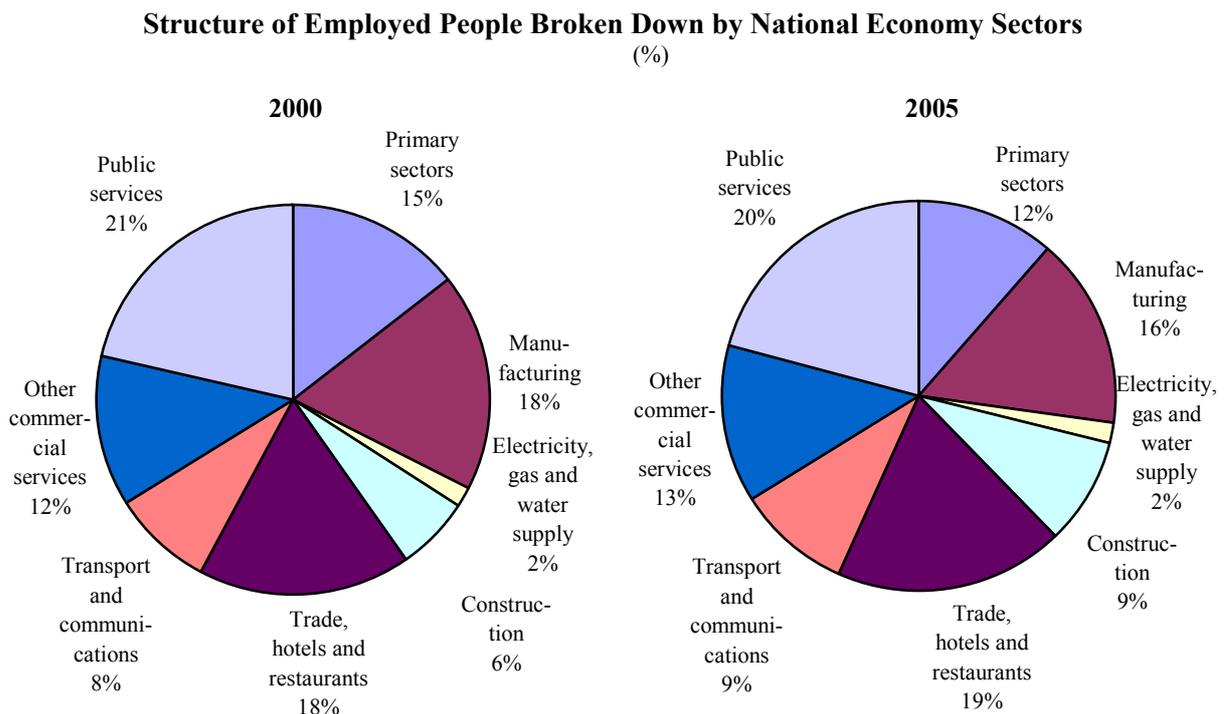
Employment rates in Latvian regions are still very different. In 2005 the employment rate was 69.3% in Riga, but equalled to mere 53% in Latgale region and it has to be noted that the employment rate in Latgale is not increasing.

Of all employed persons in 2005, 70.4% were employed in cities and 29.6% were employed in the countryside. It has to be noted that the proportion of the employed in cities grows every year, but the proportion of the employed in the countryside decreases.

Number of employed persons has markedly increased since 2000 (by 9.4%). Still the growth of employment is notably lower than the growth of GDP. These processes are objective for economy of Latvia, given the low level of its productivity. Therefore, also the further growth of economy will be mostly oriented to productivity growth and less to the growth of the number of employed people.

The structure of employed people broken down by national economy sectors has slightly changed during the last five years (see Figure 5.2). The number of employed people in service sectors has increased faster, especially in trade and communications, while the number of employed persons in agriculture and industry has decreased.

Figure 5.2



Source: Eurostat

In 2005 Latvia was the 16th among EU member states by the employment rate, while the **unemployment** rate indicators in Latvia were among the worst in the EU. Only Spain, France, Germany, Greece, Slovakia and Poland had higher unemployment rates than Latvia.

Still, an undeniable progress is reached in the last years – the unemployment rate in comparison with 2000 has decreased from 14.4% to 10.4% in 2004 and 8.7% in 2005 (according to the data of Labour Force Survey, CSB).

The highest unemployment rate still remains in the Latgale region. At the end of 2005 it exceeded 25% in three districts of Latgale region: Ludza (28%), Rēzekne (27%) and Balvi (25%) districts. The

high unemployment is determined by poorly developed business, poor self-employment and insufficient traffic infrastructure.

The lowest rates of unemployment are in Riga city and Riga, Ogre, Saldus and Tukums districts (4.6%, 5.3%, 6.0%, 6.1%, 6.5% respectively).

Share of the long-term unemployed (who have not been able to find a job during one year) in the total number of unemployed people was 45.5% in 2005 and 39% in 2004.

The majority of all unemployed are representatives of simple low-skilled professions, while the highest employment rate is among the people with higher education (84.7% of people with higher education were employed in 2005).

In 2005 the majority of unemployed was among the people in the age of 35-54 years. The share of pre-pension age unemployed in the total number of unemployed persons increases every year, which is mostly related to the increase of pension age according to the law on pensions.

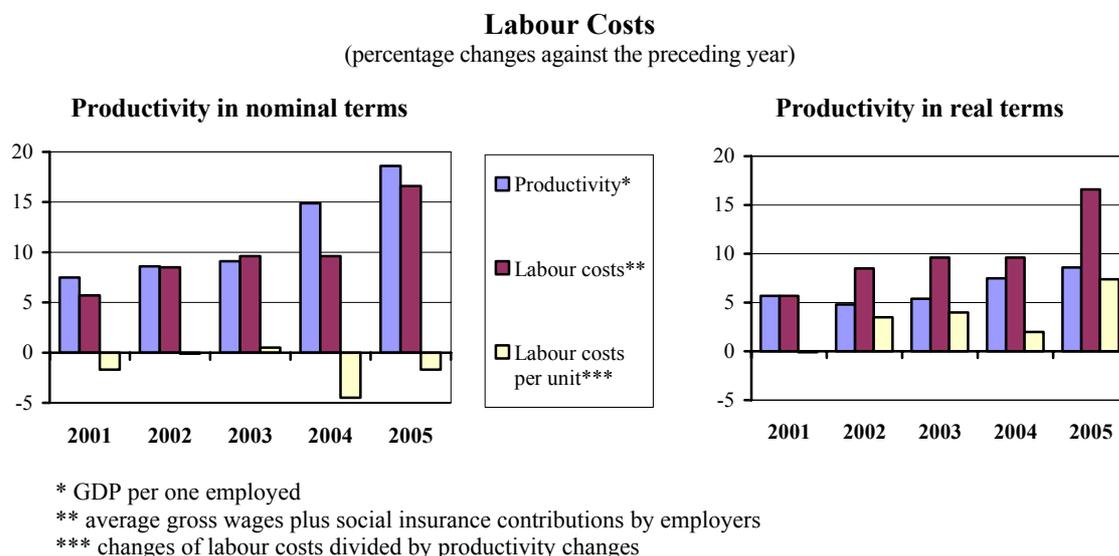
The rate of *registered unemployment* in Latvia was 8.6% at the end of 2003 and 8.5% at the end of 2004. The rate of registered unemployment was 7.4% at the end of 2005, which is by 1.1 percentage points lower than in 2004.

The number of unemployed people decreases not only due to the increased employment rate. In the last years after Latvia's accession to the EU, labour outflow takes place to some old EU member states, where labour markets are open to the citizens of the new EU member states. Therefore, shortage of labour force in several sectors is starting to develop in Latvian labour market.

5.2. Labour Costs

In 2002-2003, as wages grew slightly faster than productivity (in nominal terms) in the national economy, labour costs per production unit increased, while in 2004-2005 productivity went up at a more rapid pace. Increase of wages for growth in real terms considerably exceeded growth of productivity.

Figure 5.2



This process does not take place in equal terms in all sectors of the national economy. Labour costs increase much more rapidly in service sectors or so-called non-trading sectors not related to external competition. Unit labour costs in manufacturing declined.

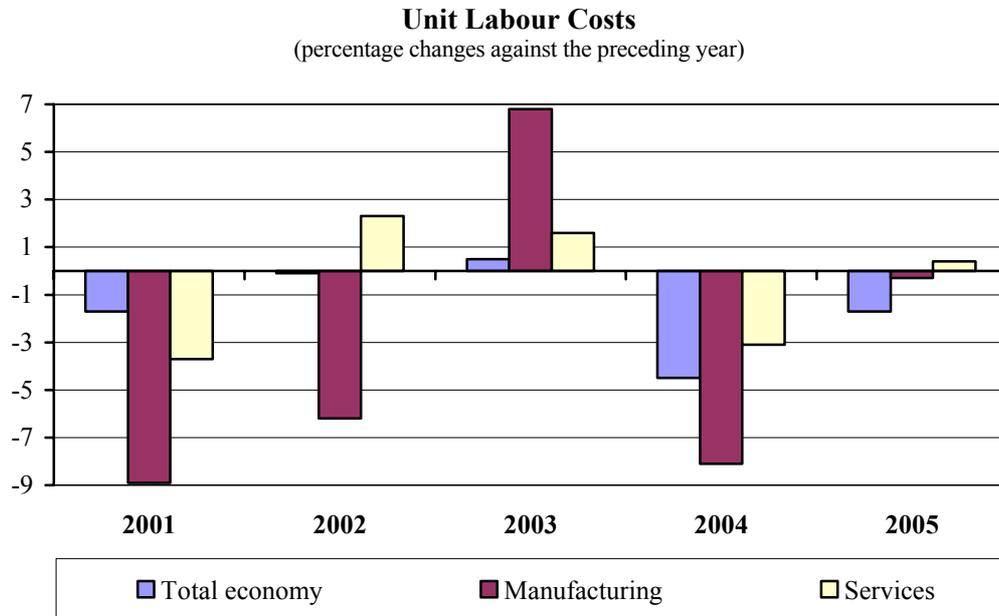
At the current stage of development, Latvian economy undergoes quite substantial structural changes characterised by three main directions.

One direction regards the general economic growth that is mostly based on productivity growth and less related to employment increase.

The second process is related to the rise of the general level of prices. Convergence of prices is mostly linked to the increase in prices for services, and this in turn is closely connected with the third process, namely, rise of wages in service sectors.

Wages of the employed in Latvia are very low in comparison with the EU average indicators. In majority of sectors these wages make 15-20% of the EU average. Therefore, increase of wages objectively may occur faster than dynamics of the other two convergence processes. As productivity in Latvia presently grows more rapidly in industry, increase of wages in this sector is compensated by productivity growth and unit labour costs are decreasing. Such compensation is not so typical in service sectors and unit labour costs in these sectors increased, even though labour costs per production unit decreased also in service sectors in 2004 and grew minimally in 2005.

Figure 5.3



Convergence of wages is an objective process and should be taken into consideration in the future. The main question is how fast it will happen. It is affected by several factors, and productivity increase in export sectors plays the determinant role in the long term.

5.3. Employment Policy

Latvian employment policy is closely related to the employment policy of the EU. The Treaty on European Union has a definite goal to promote economic and social development and high employment rate. In order to fulfil this, member states and the Community work out a co-ordinated strategy in the field of employment.

In March 2000 in Lisbon the European Council accepted strategy with an aim to achieve sustainable economic growth with more and better jobs and bigger social cohesion, setting long-term employment targets: to reach an overall employment rate of 70% in the EU by 2010 (including 60% for women and 50% for pre-pension age population of 55-64 years).

However, the economic development and employment rates in the first half of the decade markedly lagged behind the planned ones. In order to ensure achievement of Lisbon goals, in spring of 2005 the European Council decided to start new governance cycle of the Lisbon strategy. For this purpose, the European Commission developed and the European Council accepted (in July 2005) the Integrated Guidelines package by merging the hitherto separate Broad Economic Policy Guidelines and Employment Guidelines. In order to achieve fulfilment of the main targets of the European employment strategy, three priority lines of action are formulated:

- inclusion and keeping of a bigger number of people into employment, increase of labour supply and modernisation of social security systems;
- improvement of mutual adaptation of employee and business interests;
- increase of investment into human capital, thereby raising education level and professional skills of the population.

According to situation, these lines of action are specified in National Reform Programmes (National Lisbon Programmes) of member states. Also Latvia developed (in 2005) the National Lisbon Programme of Latvia for 2005-2008 (hereinafter Programme) (see Chapter 6.1).

Employment goals for 2010 set in the Programme slightly lag behind the level set by the EU, because several problems in Latvian labour market do not allow setting higher goals. The main problems pertain to:

- pronounced regional differences in employment and unemployment – high unemployment rate in the districts more distant from Riga and at the same time a shortage of labour with certain skills in Riga;
- relatively high rate of undeclared employment in particular sectors of the national economy (construction, manufacturing industry, agriculture and transport services), which reduces social security benefits and does not allow to diminish the burden of labour taxes, which especially negatively affects low-paid workers;
- high risk of unemployment for young people, persons after childcare leave, ethnic minorities with poor knowledge of Latvian, and other social exclusion risk groups;
- non-compliance of labour skills with labour market requirements.

The following priority lines of action of Latvian employment policy are formulated in the Programme for solution of the mentioned problems:

- to promote economic activities in the least developed regions;
- to address the issue of undeclared work more intensively and stimulate population to be engaged in the formal economy;
- to improve infrastructure of the State Employment Agency (SEA) and provided services by expanding the range of active employment measures;
- to expand opportunities of education and training, especially for low-skilled persons, as well as develop the life-long learning, at the same time improving education quality and developing professional orientation activities.

As a result of implementation of these measures, it is envisaged to raise the employment rate to 67% on average by 2010, including 62% for women and 50% for people in the age of 55-64 years. This means that it is envisaged to reach targets set in the Lisbon Strategy only for employment of older people and women, which already exceeds the EU average. However, the general employment rate of 65% (for people in the age of 15-64 years) envisaged in the Programme for 2008 may be exceeded. The general employment rate already increased by 1.1 percentage points in 2005 and reached 63.4%.

Labour supply will be promoted by implementing the so-called **life-cycle approach to employment**. Attention is paid to ensuring the growth of employment rate in those population groups, where employment rate is much lower than the country average, including young people and old people, as well as making it easier to become re-employed for persons after long-term unemployment and economically inactive persons.¹ For this purpose, paid temporary works and subsidised jobs for disabled people and other social exclusion risk groups will be created with joint financing from the state funds and European Social Fund (ESF). Active employment measures will be diversified according to the needs of the regions.

One of the most important tasks is to modernise work organisation and balance opportunities of at-work and out-of-work life, safety at work, gender equality, etc. At present, the level of labour quality in Latvia falls behind the situation in EU member states in many aspects. In 2005, less than one-tenth of employees in the age of 25-64 years had participated in professional training activities or attended some educational establishment. Number of people injured in accidents at work is still high (136 cases per 100 000 employed in 2004), which has slightly decreased in comparison with 2003, but still is among the highest in EU member states. Number of people suffering from occupational diseases tends to grow. However, it has to be noted that trade unions, strengthening their influence in the sphere of labour protection and safe working environment, keep increasing the number of trustees in labour protection issues.

¹ Employment rate for persons 55-64 years old is increasing in the recent years and reached 49.8% in 2005. Situation is worse among young people (15-24 years old), where employment was mere 32.6% in 2005, but has increased by 2.1 percentage points in comparison with 2004.

Task of heightening awareness of employers about observance of gender equality principles in companies and inclusion of women into employment is topical in Latvia. Women often leave work or cannot start working due to inflexible work organisation, lack of childcare institutions or other reasons. This accounts for considerable difference between female and male employment rates. In comparison with 2003, this difference has slightly decreased in the last two years from 8.2 to 8 percentage points. At the same time it has to be noted that a marked difference between female and male wages still exists. Labour force surveys carried out by CSB in 2005 indicate that 42.4% of women were employed in low-paid work (under 100 LVL, after taxes), which is by 1.7 times more than among the employed men.

Due to the growing globalisation of economy, rapid development of technologies and negative demographic processes, an increasingly bigger attention to **issues of flexicurity** (labour market flexibility and employment security) is paid in the European employment strategy. In this regard, in March 2006 the European Council asked member states to pay bigger attention to implementation of reforms in labour market and social security policies. It is necessary to achieve that labour contracts are sufficiently flexible and correspond to interests of both the employer and the employee. In case of necessity, the active labour market policies have to efficiently encourage transition from one workplace to another or from the status of unemployed person to employment. Life-long learning systems have to be improved, which would allow the employee to be employed during all his capacity for work. At the same time a modern social security system has to be established, which would give an adequate assistance to people in case of unemployment and would promote mobility and faster return to the labour market.

Latvia has a relatively high rate of *undeclared employment* in particular sectors of the national economy (construction, manufacturing, agriculture and transport services), which reduces social security benefits and does not allow to diminish the burden of labour taxes. In order to address this problem more intensively and stimulate population to be engaged in the formal economy, net wages for low-paid workers are being increased, raising the minimum wage and increasing the amount of non-taxable minimum, state control institutions are being strengthened and co-operation with social partners (trade unions and employer associations) is being activated.

The European employment strategy pays a big attention to improvement of education and industrial training. The Lisbon Strategy envisages that by 2010 at least 85% of young people in the age of 20-24 years will complete secondary education. In the previous year this indicator slightly exceeded 77% in the EU on average (by preliminary calculations of Eurostat), while in Latvia it was close to 82% and is forecasted to exceed 86% in 2010.

The Programme for 2005-2008 envisages improving the adaptability of educational system and students to the changing requirements of the labour market. Material and technical provision of professional education establishments will be modernised and a set of measures to ensure practice for students will be established, using also financing from EU funds for this purpose. Modernisation of practical teaching system and mastering of practices in national economy sectors important for regions will be promoted as well.

At the same time, availability of education at all levels will be improved and measures to reduce the number of students, who do not graduate or do not achieve professional qualification will be implemented, creating pedagogical correction programmes, applying educational services to socially excluded population groups, etc. In 2003, education ministers of EU member states agreed about the necessity to achieve reduction of the number of students, who do not graduate and do not continue learning from 16% of the total number of young people (in the age of 18-24 years) to at least 10% by the end of the decade. This indicator in Latvia equalled to 12% in 2005 and is forecasted to be lower than the EU indicator in 2010.

Availability of higher education and its conformity with labour market needs will be increased. In order to improve the life-long learning system, a life-long learning strategy is being worked out and professional orientation system is being improved. According to EU indicators, at least 12.5% of people in the age of 25-64 years should participate in life-long learning activities in 2010. At present, this indicator in Latvia is considerably lower and reaches only 7.6%.

The European Commission, by assessing National Reform Programmes of the member states, approved the Programme developed by Latvia on the whole and held a view that this Programme foresees to address the most essential labour market challenges in the country in the planned three-year period. At the same time the European Commission noted that, through implementation of the Programme, a bigger attention should be paid to raising the economic activity of the population, reduction of difference between

welfare rates of urban and rural population, ensuring compliance of education and professional skills with labour market demands, and development and implementation of a comprehensive life-long learning strategy.

Tens of millions of LVL from the budget are earmarked every year for employment promotion measures. However, after Latvia's accession to the EU, the ESF and the European Regional Development Fund developed into the main source of financial means for this purpose (see Chapter 6.2.1). ESF is the key financial instrument of the EU for development of human resources and improvement of labour market functioning. Resources in the amount of 119 million LVL have been attracted from ESF for this purpose in the period of 2004-2006.

Resources of the European Regional Development Fund in the amount of approximately 26 million LVL are attracted to development of education, healthcare and social infrastructure as well as to promotion of business activity.

6. Economic Policy and Priorities of Structural Policy

6.1. National Lisbon Programme of Latvia for 2005-2008

6.1.1. Targets and Priorities, Main Directions of the Programme

In March 2000 in Lisbon the European Council approved the EU strategic development document (hereinafter the Lisbon Strategy), which sets the main goal to achieve that the EU becomes the world's most competitive and dynamic knowledge-based economy in 10 years, which would ensure sustainable economic growth with more and better jobs and greater social cohesion.

In November 2004 the High Level Group chaired by Wim Kok, which was established after proposal of the European Council in order to prepare an independent report on the process of implementation of the Lisbon Strategy, submitted to the European Commission the report "Facing the Challenge: The Lisbon Strategy for Growth and Employment". The report reflects progress of EU member states in priority areas of the Lisbon Strategy on grounds of quantitative macroeconomic indicators. It assesses possibility to reach the goals set at the 2000 Lisbon meeting of the European Council by 2010 and comes to conclusion that the currently slow progress is linked with the lack of political will of EU member states to introduce the required structural reforms, thereby the member states are asked to be more active in implementation of the strategy. The working group acknowledges that the goals of the Lisbon Strategy are vague and emphasises that in the future it is necessary to focus on the most important issues, namely, growth and employment.

Taking into account the recommendations made in the reports of Wim Kok, in February 2005 the European Commission presented a new EU strategy to promote growth and employment. The aim of this strategy is to relaunch the Lisbon Strategy. The European Commission indicated three main tasks, which have to be fulfilled to ensure accomplishment of Lisbon Strategy's goals: 1) to ensure that Europe is an attractive place for investment and jobs; 2) to promote bigger role of knowledge and increased innovation to ensure growth; and 3) to create conditions for development of employment.

In March 2005 the European Council approved the relaunched Lisbon Strategy, envisaging the necessity to focus its policy on growth and employment. It was decided that every member state has to develop national reform programmes for 2005-2008 and submit them to the European Commission by October 15, 2005. In July 2005 the European Council approved the Integrated Guidelines for Growth and Jobs, which combine the Broad Economic Policy Guidelines and the Employment Guidelines, and they constitute a base for the development of national reform programmes.

According to the March 2005 meeting of the European Council, Latvia has prepared the *National Lisbon Programme for 2005-2008* (hereinafter Programme) and submitted the Programme to the European Commission in October 2005. The Programme is a policy-planning document that shows how Latvia will reach the Lisbon Strategy's goals in the medium-term (promotion of national growth and employment) and how Latvia will implement the Integrated Guidelines approved by the Council in July 2005. It is based on the policy-planning documents approved in Latvia and reflects the most essential problems of Latvia for achieving the Lisbon Strategy goals, indicates the main lines of action and activities to solve the problems, as well as performance indicators for achieving the goals.

National Lisbon Programme of Latvia for 2005-2008 prescribes that Latvian GDP per capita has to reach 51% of the EU average by 2008 (it amounted to 43% in 2004) and 54% by 2010 (see Figure 6.1). In order to reach this goal, annual GDP growth of 6-8% has to be ensured in 2005-2008.

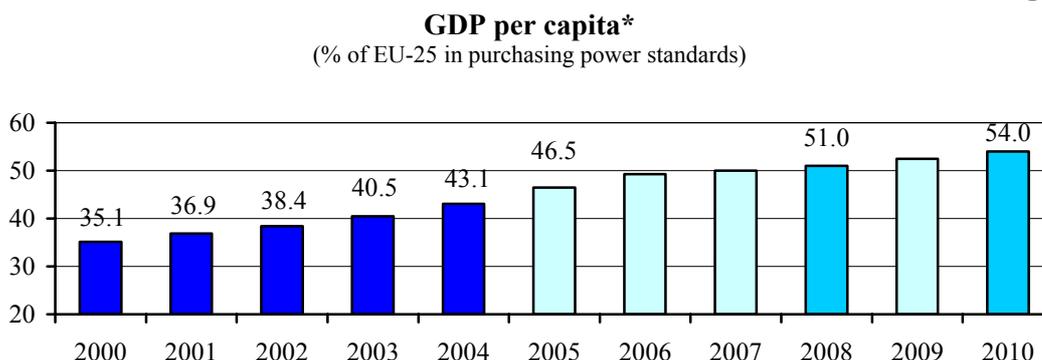
Latvia has defined 23 performance indicators for the medium-term period.

The Programme points out five main economic policy directions to reach the Lisbon goals in Latvia, namely:

- securing macroeconomic stability;
- stimulating knowledge and innovation;
- developing favourable and attractive environment for investment and work;
- fostering employment;
- improving education and skills.

For each of these main economic policy directions, main tasks (priorities) are defined and specific measures with implementation terms are determined and, if government has decided, also funding is set.

Figure 6.1



* 2000-2004 – fact, 2005-2010 – forecasts and targets

National Lisbon Programme of Latvia takes into account the EU approach of dividing the economic growth from resource use so that the economic and social progress is not achieved at the expense of excessive use of natural resources and deteriorated environmental quality.

Ensuring macroeconomic stability

Latvia has a goal to maintain stable macroeconomic environment that is a necessary precondition for ensuring growth and workplaces. At present, the comparatively high inflation and imbalance of the external sector have to be assessed carefully although the current influence of these processes on development of the national economy still does not require fast and cardinal interference.

The comparatively high inflation negatively affects the business environment, reducing competitiveness of the national economy. Besides it can be an obstacle to the euro introduction in 2008¹.

The high current account deficit of the balance of payments is a risk factor that may negatively affect domestic consumption volume in the future due to sudden changes of financial flows caused by various reasons. In the medium-term it is forecasted that the current account deficit level may slightly decrease mostly due to faster export growth ensured by structural reforms. However, demand for imports will also remain comparatively high, which will be determined by further modernisation of the national economy and increasing openness of the economy.

Possibilities of the monetary policy to restrict domestic demand under fixed exchange rate regime are rather limited, because the inter-target and operational target of the monetary policy is maintenance of the national currency rate at a fixed level. Latvia is an open economy country, where increase in domestic demand encourages increase in imports. Comparatively high share of loans granted in foreign currencies in the overall credit structure, as well as relatively easy access of the banks to foreign resources limit effectiveness of the instruments at disposal of the Bank of Latvia.

In implementation of the fiscal policy, a prudent permissible amount of the total budget deficit and rational budget spending directed to growth will be maintained.

The Programme for 2005-2008 defines the following main tasks for maintaining the macroeconomic stability:

- to comply consistently with the fulfilment of the Maastricht fiscal criteria in Latvia and ensure gradual reduction of the government budget deficit;
- to introduce medium-term (3-5 years) budget planning and strategic planning in the ministries and, in accordance with it, to base the budget formation on financing the action policy goals and results;
- to promote coherent increase of wages and labour productivity in order to disallow additional economic instability, at the same time taking into account the consequences of inflation;
- to ensure successful accession of Latvia to the euro zone.

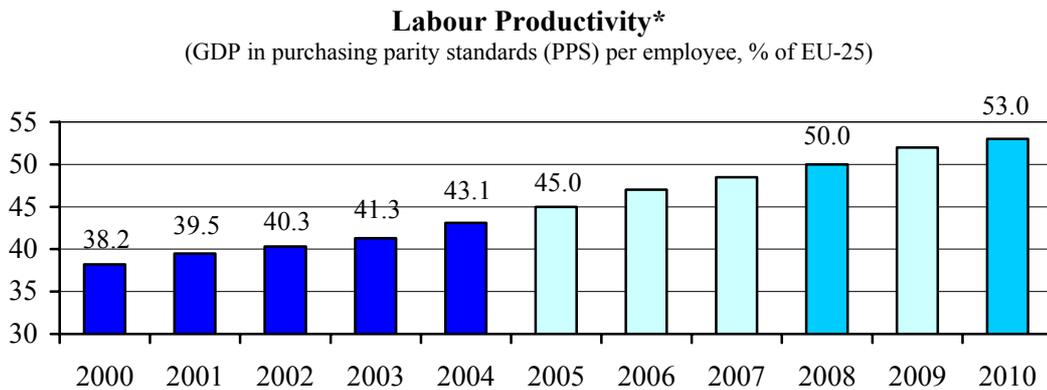
In order to fulfil these goals successfully, development of strategic plans is being implemented in the ministries, envisaging to base preparation of 2007 budget on the strategic planning principles. In accordance with the priorities set by the government, the action strategy of institutions will define medium-term development goals and directions as well as all the corresponding programmes and sub-programmes of the particular ministry related to these goals and directions as well as their funding.

¹ The government has set January 1, 2008 as the target date for introduction of the EU single currency in Latvia.

Measures for maintaining the macroeconomic stability are described in detail in the *Convergence Programme of Latvia for 2005-2008* accepted by the government in November 2005. Moreover, on July 21, 2005 the Cabinet of Ministers adopted decision to establish the Governmental Committee for Introduction of the EU Single Currency in Latvia, which has the task to work out the plan of necessary measures in order to ensure successful accession of Latvia to the euro zone.

It is forecasted that the average increase in wages will be greatly ensured by growth of labour productivity, and the Programme envisages that its level will reach at least half of the EU average in 2008 (see Figure 6.2).

Figure 6.2



* 2000-2004 – fact, 2005-2010 – forecasts and targets

Sustainability of public finances is also covered in the Programme. From a long-term perspective, sustainability of public finances will be mostly affected by the population ageing process resulting in decreased number and proportion of the able-bodied people and in increased demographic load.

Initial calculations of financial sustainability show that the population ageing will have an impact on Latvian society, national economy and public finances but, due to the implemented pension reform, this impact will not create insurmountable consequences. The low level of Latvian public debt, with the growing expenditure pressure, also provides certain flexibility to the government, preserving the stability of public finances.

However, it has to be noted that the population ageing creates new challenges for the healthcare system. Breakdown of healthcare expenditure by age groups clearly shows that the bigger costs fall on older people whose number will significantly increase in the next 50 years. Long-term care expenditures in Latvia are currently quite low, determined by both the limited central and local government resources to be spent for these purposes, and traditions and values of the society. At the same time, health of other demographic groups has to be ensured as well, because the overall sickness rate is high. The government is working out efficient healthcare system based on a long-term perspective.

Changes in the public finance policy will be required in the future in order to adjust the budget to a substantially different demographic situation.

As the demographic load will increase in a more distant future, GDP growth based on growing labour productivity will play a decisive role in the rise of living standards of all population groups. Therefore it is important to ensure training of Latvia's main resources – human resources – in accordance with labour market demands and create an inclusive labour market.

Stimulating knowledge and innovation

One of the main goals of Latvian economic policy is to develop an effective and competitive sectoral structure. The present dominant model of Latvian economy, which is characterised by using advantages of the cheap labour and available natural resources as well as manufacturing products with low value added, will not be able to ensure high economic development rates and promote achievement of higher prosperity level in the future.

Essential drawbacks hindering structural changes are the low public and private sector investments in research and development, poorly developed innovation system, incompatibility of educational structure with long-term labour market requirements, low level of internet availability, and non-introduced electronic signature, which is one of the main obstacles to development of e-government.

In order to stimulate knowledge and innovation, the main tasks of the Programme in 2005-2008 will be as follows:

- to increase public investment and foster private investment in research and development;
- to ensure renewal of the intellectual potential in science, improving the system of doctoral grants and modernising the scientific infrastructure;
- to promote transfer of knowledge and technologies in production (including business incubators and technology parks);
- to increase internet availability and introduce electronic signature as well as ensure wider public services in e-environment.

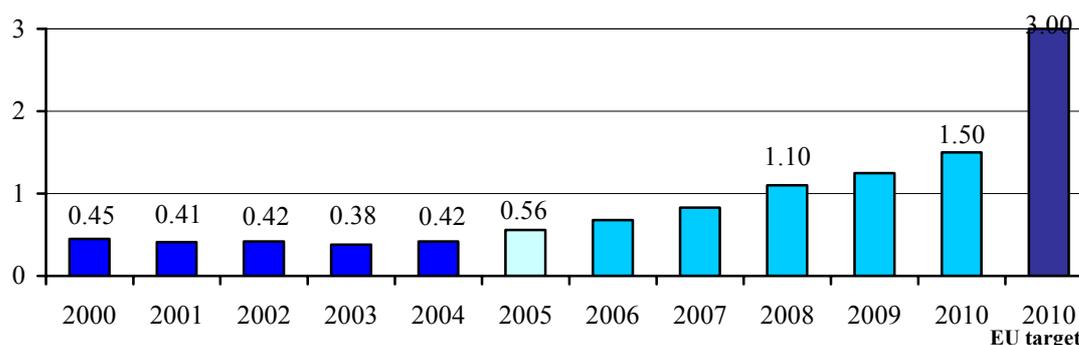
The Programme sets the target that gross domestic expenditures on research and development has to reach 1.5% of GDP in 2010. In order to reach this target, according to the Law on Scientific Activity the annual increase of financing for scientific activity in the state budget is prescribed to be at least 0.15% of GDP or by 10-15 million LVL on average annually (see Figure 6.3), at the same time improving the procedure of granting public financing for scientific activity set out by the normative acts, in order to ensure attraction of private investment as much as possible, improving conditions of financing for research commissioned by public administration bodies and market-oriented research. Essential modernisation of scientific infrastructure in research institutes and higher educational establishments and reorganisation of state science institutes are envisaged.

The Programme envisages several measures for improvement of innovation support structures in order to promote transfer of knowledge and technologies and encourage development of new products and technologies. The target is to increase the number of innovative enterprises to 32% of all enterprises in 2008 and raise the number of national patents to 95, of which 24 are international.

In order to promote creation of effective and competitive industry with rational sectoral structure correspondent to conditions of Latvia, which would ensure high economic growth also in the future, the Programme envisages provision of bigger support to development of clusters. The goal is to stimulate increased competitiveness and productivity of enterprises, promoting their mutual co-operation and collaboration with educational, scientific, research and other related institutions. It is planned to conduct study on the potential of cluster creation and, through a tender procedure, provide support for development of three most perspective clusters.

Figure 6.3

Expenditures on Research and Development*
(% of GDP)



* 2000-2004 – fact, 2005-2010 – forecasts and targets

The government has set several tasks for faster development of information society. The first thing that has to be ensured (and much has been done already) is a free competition in the market of information and electronic communication services.

The Programme also foresees to encourage widespread use of ICT in public services, SME and households by developing various channels and organisations for provision of services, building technical and organisational infrastructure for complex provision and convenient use of services, establishing a single state portal, and improving co-operation of public registers.

Developing favourable and attractive environment for investment and work

Conditions for ensuring conducive environment for investment and work are improving every year: obstacles to EU internal market freedoms are basically prevented, tax burden is diminished, competition is strengthened and liberalisation of monopoly sectors has been started.

The main problems hindering business development in Latvia, especially SME, are the encumbered receipt of funding, various administrative obstacles, lack of adequate information and shortage of skilled labour force. Guarantee and investment instruments have not been sufficiently developed at the moment. Latvian enterprises, working with EU directives on quality, lack information on product standards and new production methods. Product quality assessment instruments are not available in Latvia.

Small progress is only observed in the improvement of the state road network. However, road deterioration is high and carrying capacity of transport network is insufficient in several segments.

Economic activities in the regions outside Riga increase at pronouncedly slower pace than in Riga and its neighbourhood. One of the reasons is too slow administrative territorial reform and that is why a big number of economically and administratively weak local governments, which are unable to ensure fulfilment of all municipal functions, exist protractedly in Latvia.

In the Programme, the following main tasks have been set as priority directions for creation of favourable and attractive environment for investment and jobs in 2005-2008:

- to promote entrepreneurial culture, lessen administrative obstacles and burden, create supportive environment for SME;
- to strengthen supervision of competition and ensure effective competition in public services;
- to improve and develop the transport infrastructure, increase the number of connections with other European infrastructure networks;
- to speed up the administrative territorial reform.

The Programme foresees to prepare and implement the Action Plan for Improvement of Business Environment annually, including recommendations of entrepreneurs, social partners and the Foreign Investors Council in Latvia (FICIL) into this plan. Public funding is granted for measures to ensure efficient implementation of transposed directives, performing adequate market surveillance, which would create favourable business environment and fair competition and would reduce consumer risks of traumas and getting hurt in accidents, using unsafe goods or services.

In order to improve access of SME to funding, in the following years it is planned to focus on allocation of financing for business development in the early stage (measures for availability of seed capital, opportunities to obtain loans on preferential terms) and availability of finances in the form of venture capital as well as co-financing for development projects of business people in the territories requiring special assistance.

Transport infrastructure is one of the determinant factors of business environment. Long-term objective of the transport development policy is to create effective, safe, competitive, environmentally friendly, balanced and multimodal transport system that is integrated in the European transport system and satisfies economic and social needs of the state for passenger and cargo transportation in domestic and international traffic.

In order to ensure improvement of condition of the state road network and raise the load carrying capacity of the road surfacing and bridges in accordance with EU requirements, it is necessary to increase financing for the road maintenance, improving the system of financing and changing the financing model of state roads. The Programme envisages to channel certain bigger part of the excise tax on fuel to roads (65% in 2007 and 70% in 2008), including increased financing for maintenance and development of 2nd class state roads, in order to promote development of regions.

Special attention in the Programme is paid to quality improvement and development of international transport corridors, including both Via Baltica and East–West road corridors and the East–West railway corridor as well as development and rise of competitiveness of the port infrastructure.

In order to promote competition, it is envisaged to implement ex ante measures of competition ensuring policy, among them analysis of competition conditions and prices in markets, where suspicions of insufficient competition and its pressure on prices of goods/services exist.

The Programme also emphasises the necessity to participate in the development process of sectoral normative acts in institutions of Latvia and the EU in order to encourage competition in sectors, where high level of administrative regulation and inefficient use of public resources exist. In 2005-2008, participation in market liberalisation process of gas, electricity, rail and air transport sectors will be especially important in this regard.

In order to encourage development of local governments, the Programme especially stresses the necessity to carry out the administrative territorial reform by the local elections of 2009 in order to create optimum administrative and organisational structure of local governments and promote their capacity, which would foster development of regions.

Fostering employment

Although employment in Latvia has increased in the last years, which was affected by the economic growth, the employment rate still lags behind the EU average and the unemployment rate is among the highest in the EU.

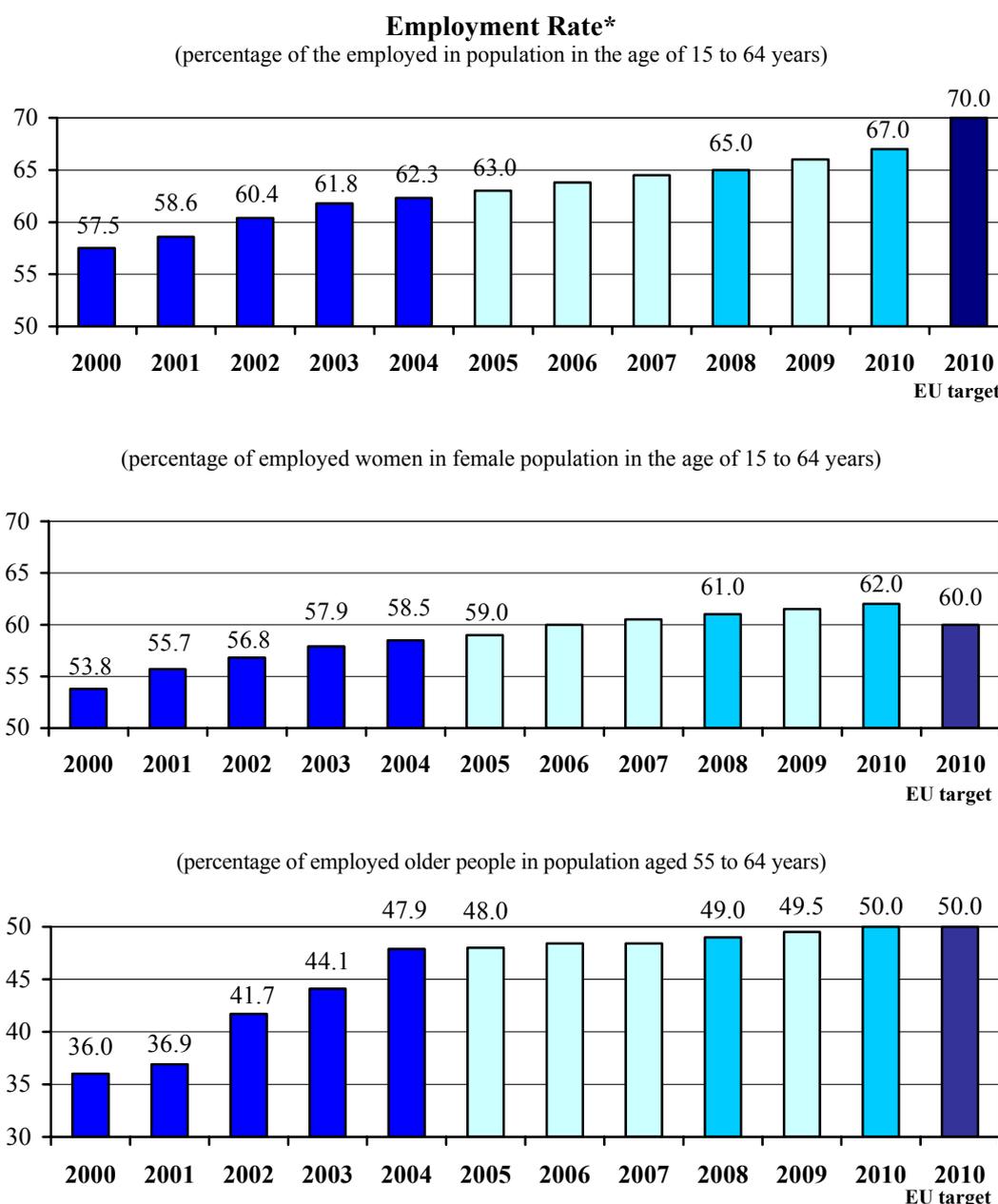
The main problems in Latvian labour market are considerable regional differences in employment and unemployment, incompatibility of employee skills with labour market requirements, relatively high rate of undeclared employment, high unemployment rate among the young people, persons after childcare leave, disabled persons, people with insufficient knowledge of Latvian language and other socially excluded risk groups.

The Programme for 2005-2008 defines the following main tasks for fostering employment:

- to promote inclusive labour market;
- to encourage economic activities in less developed regions;
- to reduce the undeclared employment.

Latvia has a goal to reach employment rate of 65% in 2008 (61% for women and 48% for older people) and 67% (62% and 50%) respectively in 2010 (see Figure 6.4).

Figure 6.4



* 2000-2004 – fact, 2005-2010 – forecasts and targets

Life-cycle approach to employment, improvement and diversification of active employment measures along with development of labour market institutions, employment partnerships and social dialogue are the basic elements that make up the set of employment policy measures of the Programme.

It is envisaged to make improvements of employment promotion measures and preventive measures of unemployment reduction in the Programme, by improving professional training and retraining of the unemployed and raising skills, carrying out measures for the rise of competitiveness (among them teaching of the state language) and diversifying active employment measures in accordance with the needs of regions.

Measures related to inclusion of young people, pre-pension age people and women (especially after childcare leave) in the labour market are particularly highlighted in the Programme.

For inclusion of the disabled and people from other social exclusion risk groups in the labour market, it is envisaged to create subsidised workplaces and develop the system of social services by improving availability of professional and social rehabilitation services, integrating persons with functional disorders into society and providing them with technical aids, and improving the infrastructure of social care and social rehabilitation institutions.

In order to lessen the marked regional differences in employment rates, the Programme stresses the necessity to pay more attention and allocate resources to measures of starting business and to promotion of geographic mobility in less developed regions.

There is no single decisive measure that would guarantee substantial decrease of undeclared employment (shadow economy). Set of measures involving all interested parties is important. For that reason, the Programme foresees solution of the problem both by raising administrative capacities of the State Labour Inspectorate, improving control over observance of labour law norms, increasing the level of society's awareness about the issues of labour law, as well as developing a model of co-ordination mechanism for effective exchange of information with the adequate public administration bodies and other institutions, and by strengthening the roles of trade unions and employer associations, encouraging employers to unite in employer organisations in order to create favourable environment for raising the reputation of socially responsible business activity, and also stresses the necessity to raise the minimum wage and increase the untaxed minimum in order to reduce tax burden on people with low income.

Improving education and skills

Market economy, setting down new requirements for professional skills, develops faster than the supply of adequate professional and higher education programmes. Therefore a discrepancy between the labour market demand and the current education supply exists in several professions. Distribution of students by thematic fields of studies does not correspond to the national economy needs and labour market changes. Co-operation between educational establishments and employers is insufficient.

The life-long learning system, which would increase the opportunity of population to adapt to conditions of the changing labour market, has not been established in Latvia.

There is a shortage of professional orientation services in the basic stage of education. Adaptation of the first-year students in professional education establishments is incomplete and the awareness of the opportunities for education and further education is insufficient. Number of students, who do not complete their study or do not achieve professional qualification is relatively big.

Professional skills and further education opportunities of teachers are insufficient. Teachers as well as academic staff become old. The number of new teachers and academic persons with a scientific degree decreases. The low wages of teachers do not encourage involvement of young teachers into education. Preparedness of medium-generation teachers in bilingual education is insufficient.

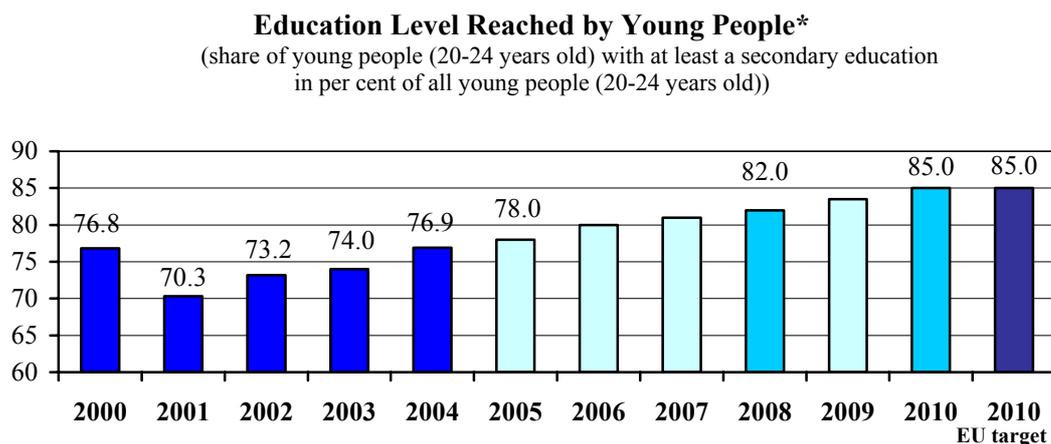
The Programme envisages the following main tasks for improvement of education and skills in 2005-2008:

- to strengthen co-operation between public administration institutions, educational establishments and employers in order to adjust the supply of educational system in accordance with labour market needs;
- to raise cost efficiency in all levels and forms of education;
- to improve availability of education at all levels and reduce the number of students, who do not complete their studies or do not achieve professional qualification;
- to increase availability of life-long learning and motivation of population in this area;
- to raise the overall level of technological skills and natural science knowledge, improve the professional orientation system and ensure availability of professional orientation services for all population in the context of life-long learning.

Investment in human capital is a decisive factor for the rise of productive capacity in order to promote transition to knowledge-intensive economy. This investment has to ensure substantial improvements in the ability of the educational system to adjust to the changing demands of the labour market, improve availability of education at all levels, raise participation and responsibility of regional governments and employers in ensuring availability of professional education, and create an effective life-long learning system.

The Programme sets a goal to raise the education level of young people, which is quantitatively defined for 2010 – the share of young people (20-24 years) with at least a secondary education should reach 85% (see Figure 6.5). This indicator corresponds to the target indicator set by the EU for 2010.

Figure 6.5



* 2000-2004 – fact, 2005-2010 – forecasts and targets

To solve these tasks, the Programme pays a big attention to measures of improvement of professional education (both the secondary and the higher), such as modernisation of the material and technical provision and the practical teaching of professional education establishments, and development and implementation of an information campaign in order to raise prestige of engineering sciences, natural sciences, medicine and other fields necessary for development of Latvia.

The Programme stresses necessity and includes measures to increase availability of higher education and its conformity with labour market needs. This requires raising the number of study places financed from the government budget in natural sciences, engineering sciences and environmental sciences, increasing the amount of student loan and the fund of grants in higher educational establishments, by establishing the set of normative measures to ensure practice for students, by acquiring modern technologies for research institutes, where education process and innovation are ensured, by supporting entrepreneurs, who provide places of practice, by creating a system of employer and employee co-operation agreements.

The Programme defines the following priority activities for improvement of educational and teaching system quality: improvement of educational programme in accordance with labour market needs, establishment of quality assurance system of professional education, ensuring high-quality comprehensive services of professional orientation, and application of education services to socially excluded population groups.

6.1.2. Ensuring Implementation of the Programme

In order to provide co-ordination and supervision of implementation of the Lisbon Strategy, the government has developed the mechanism for monitoring of the implementation in Latvia and has established:

- the *Supervisory Board of the Lisbon Strategy* – established in order to ensure fulfilment of the tasks set up in the Lisbon Strategy in Latvia. The Board is chaired by the Minister of Economics approved by the Cabinet of Ministers as the co-ordinator of the Lisbon Strategy's implementation and supervision. Ministers and representatives of the Saeima, local governments and social partners, who are linked to the Lisbon process, are included in the Board. Tasks of the Board are to co-ordinate development of the *National Lisbon Programme of Latvia*, involve public

- institutions, the Saeima, local governments and social partners in development of the Programme, supervise fulfilment of the Programme and inform the society about fulfilment of the tasks;
- the *Advisory Working Group of the Lisbon Strategy* – established in order to ensure development of the *National Lisbon Programme of Latvia* and its implementation at the inter-institutional level. The Working Group is chaired by the State Secretary of the Ministry of Economics. Senior civil servants of the ministries linked to the Lisbon process are included in the Working Group.

Social dialogue is important to achieve the goals of the *National Lisbon Programme of Latvia for 2005-2008*. That is why the Programme envisages several measures to improve the social dialogue both at the national and the regional levels. In the framework of the national programme “Support to strengthening the capacity for introduction of labour market and gender equality policy in responsible institutions, distribution of information and improvement of understanding” co-financed by ESF, institutions involved in employment partnership will be strengthened, among them the Employers’ Confederation of Latvia and the Free Trade Union Confederation of Latvia. Capacity of Latvia’s local governments and the Latvian Association of Local and Regional Governments is also being strengthened in the framework of the Programme in order to ensure development of employment partnership and social dialogue at the local government level.

Assessment by the European Commission

On January 25, 2006 the European Commission published the *Annual Progress Report*¹, which also includes assessments of national reform programmes of EU member states, among them the assessment of the *National Lisbon Programme of Latvia for 2005-2008*.

The European Commission supported and appreciated the main economic policy directions chosen by Latvia for reaching the Lisbon goals (to continue economic growth and increase employment rate) in Latvia: securing macroeconomic stability, stimulating knowledge and innovation, developing favourable and attractive environment for investment and work, fostering employment, and improving education and skills. The European Commission considers, that the strength of the Programme is in the focus on the reforms in R&D and ICT. The European Commission also appreciates the measures directed to improvement of the transport infrastructure and promotion of inclusive labour markets in Latvia.

The assessment by the European Commission points at the following issues requiring further attention from Latvia:

- a clearer and stronger commitment to achieving macro-stability, including fiscal consolidation;
- development of policies regarding stimulation of partnerships between research and education institutions and businesses;
- working out more specific measures to adapt education and training to labour market requirements and to develop and implement a life-long learning strategy.

In order to ensure further implementation of the *National Lisbon Programme of Latvia for 2005-2008*, a meeting of the *Advisory Working Group of the Lisbon Strategy* took place on February 8, 2006 and a meeting of the *Supervisory Board of the Lisbon Strategy* was held on February 10, 2006. The above-mentioned meetings were held with the goal to discuss further implementation of the Programme and the *Annual Progress Report* of the European Commission, especially its second part, which includes the European Commission’s assessment of the *National Lisbon Programme of Latvia for 2005-2008*.

The four main priority actions defined by the European Commission and Latvia’s readiness to reach sub-targets of the priorities by 2007 were also discussed at the mentioned meetings. The European Commission identified the following 4 priority actions in its *Annual Progress Report*: 1) investing more in knowledge and innovation; 2) unlocking the business potential, particularly of SMEs; 3) responding to globalisation and ageing; 4) moving towards an efficient and integrated EU energy policy.

The meeting of the *Supervisory Board of the Lisbon Strategy* decided on February 10, 2006: “To support the necessity of increasing budget expenditures for research and development, including channeling a bigger part of the state support and resources from the structural funds”.

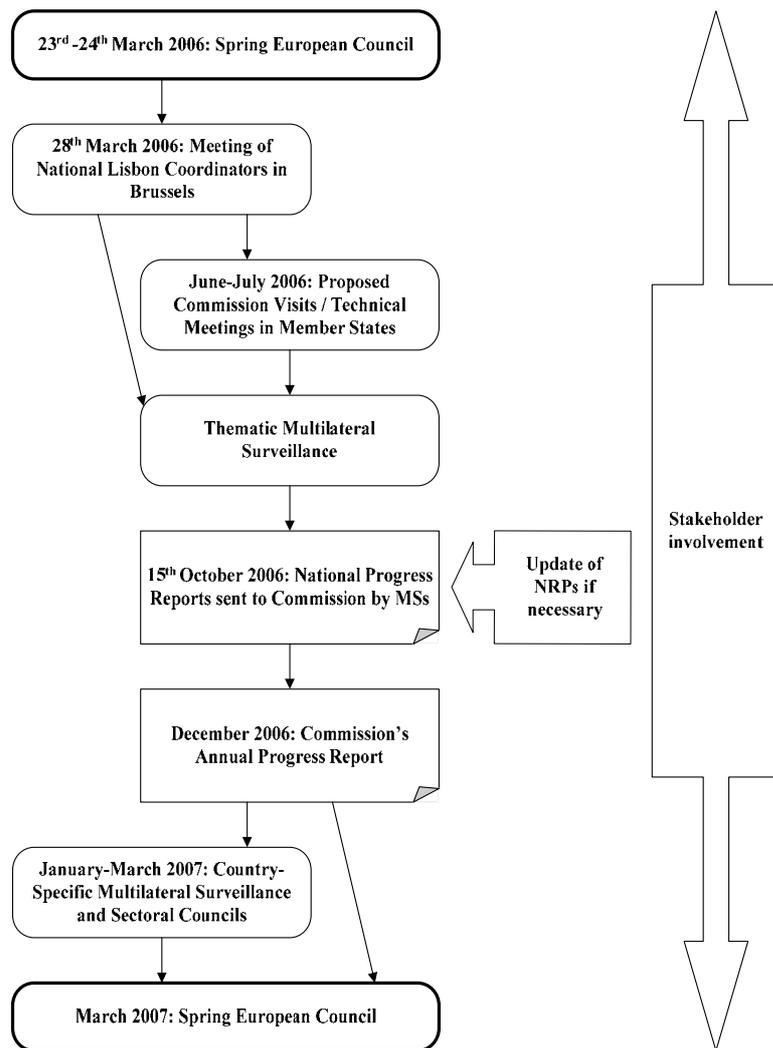
Schedule for implementation of the Programme

The European Commission, on the basis of the European Council decisions, has developed the schedule for implementation of national reform programmes (see Figure 6.6).

¹ http://ec.europa.eu/growthandjobs/pdf/illustrated-version_en.pdf

Figure 6.6

Roadmap for Implementation of the Growth and Jobs Agenda in 2006/2007¹



It is envisaged that the progress in implementation of the national reform programmes will be assessed every year (in autumn), including implementation of the *National Lisbon Programme of Latvia for 2005-2008*.

The Ministry of Economics organises the assessment process of the Programme and will prepare the respective draft progress report. The progress report has to be submitted to the European Commission by October 15, 2006.

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

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

Latvia as EU member state has access to the financial support from the EU Structural Funds, which is an instrument for implementation of the EU regional cohesion policy.

The goals regarding the planned use by Latvia of the financial support from the Structural Funds are set out under the Development Plan or the Single Programming Document (SPD). The Single

¹ Source: Annex III of the Commission's Staff Working Paper „Working together for growth and jobs. Further steps in implementing the revised Lisbon Strategy”: <http://register.consilium.europa.eu/pdf/en/06/st09/st09484.en06.pdf>

Programming Document for the Structural Funds Objective 1 programme 2004-2006 for Latvia was approved by June 17, 2004 decision of the European Commission C(2004) 2121 (see Box 6.1).

Box 6.1

Priorities of the Development Plan

Financing from the Structural Funds will be granted for implementation of priorities set out under the Development Plan:

Priority 1 – promotion of balanced development (269 million EUR), which includes the following measures:

- 1.1. improvement of environmental and tourism infrastructure;
- 1.2. development of accessibility and transport system;
- 1.3. development of information and communication technologies;
- 1.4. development of education, healthcare and social infrastructure.

Priority 2 – promotion of business activity and innovation (209 million EUR), which includes the following measures:

- 2.1. support to development of innovation;
- 2.2. business infrastructure development;
- 2.3. enhancing business support measures for small and medium-sized enterprises;
- 2.4. access to financing for small and medium-sized enterprises;
- 2.5. support to public research;

Priority 3 – development of human resources and promotion of employment (175 million EUR), which includes the following measures:

- 3.1. promotion of employment;
- 3.2. development of education and continuing education;
- 3.3. eradication of social exclusion;

Priority 4 – promotion of development of agriculture and fisheries (170 million EUR), which includes the following sub-priorities:

Sub-priority 4.1 – promotion of development of agriculture and rural areas, which includes the following measures:

- 4.1.1. investment in agricultural enterprises;
- 4.1.2. support for young farmers;
- 4.1.3. improvement of processing and marketing of agricultural products;
- 4.1.4. enhancing development and adaptation of rural areas;
- 4.1.5. forestry development;
- 4.1.6. development of local capacity by providing support to sustainable rural communities (LEADER + measure);
- 4.1.7. training;

Sub-priority 4.2 – promotion of sustainable development of fisheries, which includes the following measures:

- 4.2.1. balancing fishing intensity;
- 4.2.2. fleet renewal and modernisation of fishing vessels;
- 4.2.3. improvement of processing and marketing of fishery and aquaculture products, development of fishing port facilities and aquaculture;
- 4.2.4. development of coastal fishery, socio-economic measures, promotion of conquering new market outlets and support to producer organisations;

Priority 5 – technical assistance (22 million EUR).

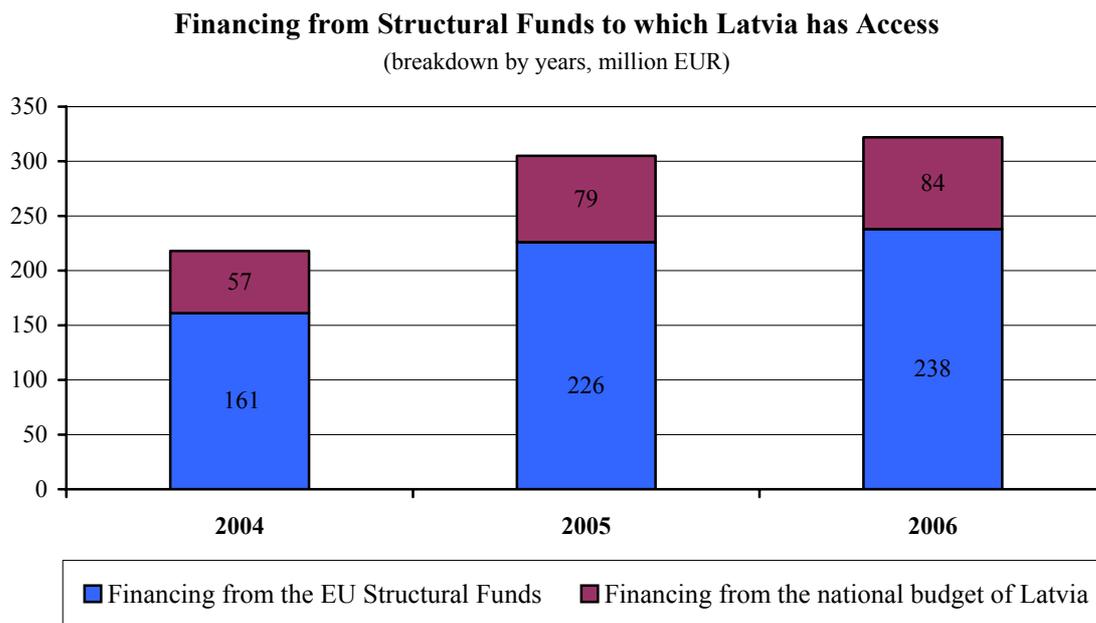
The total funds accessible to Latvia in the Structural Funds framework to which the beneficiaries will be able to apply are made up of financing from the EU Structural Funds and co-financing from the national budget of the Republic of Latvia and budgets of local governments. In almost all cases the financing amount from the EU Structural Funds is 75%, while 25% are financed by the national budget and budgets of local governments. In particular cases (projects of intermediary bodies in implementation of the EU Structural Funds) the percentage is 50% and 50% respectively. In order to apply for the aid from the Structural Funds, the beneficiary will additionally have to provide its own co-financing.

The total financing accessible to Latvia in the framework of the Structural Funds programmes in the period from 2004 to 2006 amounts to 845 million EUR (including 625 million EUR from the EU Structural Funds and 220 million EUR from the national budget of the Republic of Latvia) (see Figure 6.7).

The financing of 625 million EUR from the EU Structural Funds is made up of resources from the following funds:

- European Regional Development Fund (369 million EUR);
- European Social Fund (139 million EUR);
- Guidance Section of the European Agricultural Guidance and Guarantee Fund (93 million EUR);
- Financial Instrument for Fisheries Guidance (24 million EUR).

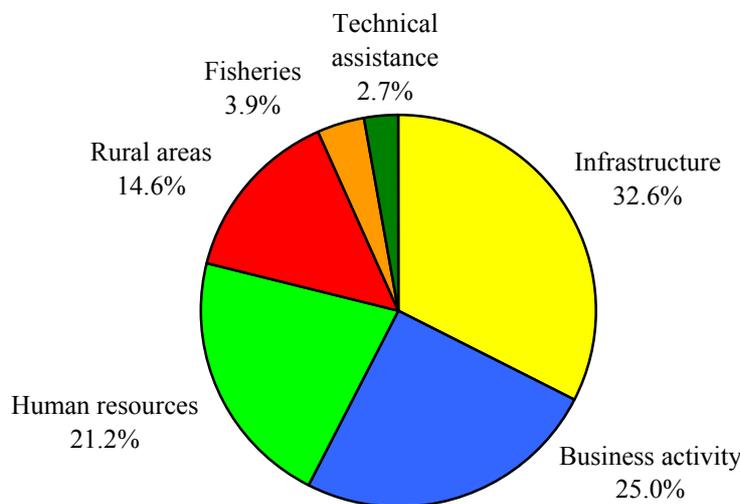
Figure 6.7



Breakdown of support from the Structural Funds shows that the biggest part of financing (32.6%) is envisaged for infrastructure projects and projects for promotion of business development (25%) (see Figure 6.8).

Figure 6.8

Breakdown of Support from the Structural Funds by Sectors for 2004–2006



The informative report of the Ministry of Finance¹ on the implementation process of activities under the Single Programming Document indicates that absorption of the EU financial resources proceeds successfully in Latvia.

As of March 31, 2006, projects for 73.5% of the total available financing from the Structural Funds have been co-ordinated in management committees of the Structural Funds. 15% of the total available financing from the Structural Funds were paid to beneficiaries.

Refunds of Structural Funds financing have been requested from the European Commission for 13.95% of the total financing granted to the country. In these indicators broken down by the Structural Funds, the biggest progress is observed in the framework of the European Agricultural Guidance and

¹ The informative report “On absorption of the European Union financial resources (Structural Funds and Cohesion Fund)” of the Ministry of Finance, May 8, 2006

Guarantee Fund (48.55% of the granted resources from the Structural Funds have been requested in refunds) and the Financial Instrument for Fisheries Guidance (33.33% of the granted resources). 10.7% of the granted resources have been refunded in the state budget revenues from the European Commission (see Table 6.1).

Table 6.1

Progress in Absorption of the Structural Funds as of March 31, 2006

	SF financing	Projects co-ordinated in SF management committees		Paid to beneficiaries of SF financing		Payments received from the European Commission	
	million LVL	million LVL	% of financing	million LVL	% of financing	million LVL	% of financing
ERDF	263.63	187.04	70.95	19.61	7.44	8.73	3.31
ESF	93.29	64.67	69.32	6.86	7.35	2.17	2.32
EAGGF	64.55	60.14	93.17	33.30	51.58	30.35	47.02
FIFG	17.11	10.55	61.70	6.02	35.18	5.70	33.33
Total	438.58	322.40	73.51	65.79	15.00	46.95	10.70

Implementation of ERDF activities on the whole is assessed as satisfactory. Part of the projects has been completed and several open tenders of project applications have been concluded, which means that implementation of many projects will begin in the middle of 2006.

Implementation of ESF activities has become more active in comparison with the previous quarters, which may be explained by the fact that several open tenders of project applications and grant scheme project applications were concluded at the end of 2005 and the implementation pace of ESF national programmes has accelerated.

Implementation of EAGGF and FIFG activities takes place successfully, which is confirmed by the financial progress as of March 31, 2006 in comparison with the previous quarter.

In order to increase activity of potential project applicants in regions, the Ministry of Finance in co-operation with the institutions involved in management of the Structural Funds initiated establishment of one-stop information points – Regional Structural Funds Information Centres (RSFIC) – on the administrative basis of five planning region development agencies, which would promote access to information about the Structural Funds and encourage active participation of the target groups in preparation of EU Structural Funds projects and their implementation in regions. The ESF national programme “Establishment and Operation of Regional EU Structural Funds information centres” was worked out for the time period from March 2006 to December 2006 and will be financed from ESF technical assistance resources. RSFIC are being established in Saldus, Alūksne, Jelgava, Daugavpils and Rīga. Financing of the national programme amounts to 195 thousand LVL, of which 146 250 LVL are granted from ESF but 48 750 LVL is a co-financing from the Latvian state budget.

Measures and priorities of the Development Plan, which are supervised by the Ministry of Economics, are characterised in the Box 6.2 and Table 6.2.

Box 6.2

Measures and priorities provided by the Development Plan, supervised by the Ministry of Economics

Being one of the branch ministries, the Ministry of Economics is responsible for management of the measures and activities, which are under its supervision. The following measures and activities are under supervision of the Ministry of Economics:

Activities of Measure 1 “Environmental and tourism infrastructure development” under Priority 1 “Promotion of balanced development”:

- development of heat supply systems;
- improvement of heat supply system by lowering the content of sulphur in heating fuel;
- creation of tourism products and improvement of tourism infrastructure as well as preservation of cultural heritage and expansion of its economic potential;

Measures under Priority 2 “Promotion of business activity and innovations”:

- support to development of innovations;
- development of business infrastructure;
- strengthening the measures to support the small and medium-sized business activity;
- access to financing for small and medium-sized enterprises;

Box 6.2 continued

Activities of Measure 1 “Promotion of employment” under Priority 3 “Development of human resources and promotion of employment”:

- enhancing improvement of the retraining of employees;
- providing required training and consultations for launching a business.

Measures and activities of the Development Plan’s Priorities 2 and 3, falling under responsibility of the Ministry of Economics, are aimed at providing support to non-agricultural business activity. Resources within these priorities will be allocated through state support programmes in accordance with provisions of the Law on Control of Aid for Commercial Activity.

As on May 23, 2006 all activities falling under responsibility of the Ministry of Economics have been approved.

Regarding the progress in implementation of ESF activities under responsibility of the Ministry of Economics, in the 1st quarter of 2006 a decision was taken to implement also the ESF national programme for the initially planned grant scheme in the activity “Support to raising skills, retraining and further education of employees”, hence ensuring at least partial absorption of resources of the activity “Enhancing skills and retraining of employed persons” falling under responsibility of the Ministry of Economics. In addition, the ESF national programme for the second Ministry of Economics activity “Training and consultations for beginners of commercial activity and self-employment” considered problematic previously was co-ordinated in the 1st quarter of 2006.

The programme envisages promotion of access to training and consultation services for beginners of commercial activity as well as their access to financial resources that are necessary for launching a successful commercial activity or self-employment. The programme will be implemented by the SJSC “Latvijas Hipotēku un zemes banka” (Mortgage and Land Bank of Latvia). In the framework of the programme, support is foreseen for people willing to start a commercial activity. Participants of the programme will have to acquire training on start-up and development of commercial activity. Completing the training, participant will have to prepare a business plan for launching a commercial activity, which will be assessed by experts of the Mortgage and Land Bank of Latvia. In case of a positive decision, the participant of the programme will get financing for implementation of the business plan (payment for mentor services, grants for start-up of company’s operation, loan up to 18 thousand LVL).

On September 5, 2005 the tender of open projects under responsibility of the Ministry of Economics, announced by the Central Finance and Contract Agency (CFCA) in the framework of the SPD Activity 1.1.5 “Improvement of tourism infrastructure, creation of new tourism products, efficient use of cultural and historical heritage in development of tourism”, was concluded. Administrative assessment of the submitted projects is currently under way. The accessible public financing is 6.48 million LVL.

On February 28, 2006 the assessment of administrative conformity of project applications in the open tender of projects “Efficient use of cultural and historical heritage in tourism” was concluded. 85 of 112 received project applications were submitted to the project assessment commission established by the Ministry of Economics for assessment according to qualitative and specific assessment criteria. Assessment of project applications is planned to complete by June 2006.

As of August 12, 2004 the Latvian Investment and Development Agency (hereinafter LIDA) has announced a tender of project applications for receiving co-financing from the EU Structural Funds in the following state support programmes and sub-programmes:

1. support for modernisation of the business infrastructure:

1.1. support to investment in private infrastructure for access to public networks (reception of project applications for this sub-programme is suspended as from May 8, 2006 in view of the big activity of companies);

1.2. support to shared private infrastructure (laboratories) development (reception of project applications for this sub-programme is suspended as from May 10, 2006 in view of the big activity of companies);

1.3. support to private infrastructure modernisation in line with standards (in view of the big activity of companies, reception of project applications for this sub-programme is suspended as from May 15, 2006);

2. support to development of new products and technologies;

3. support to consultations and participation of commercial companies in international exhibitions and trade missions:

3.1. consultation services;

3.2. participation of commercial companies in international exhibitions, fairs and trade missions.

As from November 1, 2004 the LIDA accepts project applications from companies for co-financing from the EU Structural Funds in the state support programme (SSP) “Support for training, re-training and further education of the employed”. After March 27, 2006 the projects are accepted according to the new rules, which envisage the simplified procedure for submission of project.

As on May 15, 2006, 536 projects have been submitted to the LIDA, of which the largest part (307 projects) make an infrastructure grant scheme “Support to private infrastructure modernisation in line with standards” (82 projects by March 17, 2006 and 225 projects after March 20, 2006), and 261 projects make a grant scheme “Consultation services”. The total required financing comprises 140.96 million LVL, while the total amount of contracts concluded for receiving support equals to 42.38 million LVL and the amount of paid projects comprises 22.41 million LVL (see Table 6.2).

As on May 1, 2006 the most active businesses were in Riga and Riga district (381 projects submitted for 44.83 million LVL). As for the other regions: 85 projects for 23.13 million LVL were submitted from Zemgale, 101 projects for 21.43 million LVL were submitted from Vidzeme, 86 projects for 23.98 million LVL were submitted from Kurzeme and 68 projects for 14.88 million LVL were submitted from Latgale. As the activity of businesses from Latgale region is very low, the Ministry of Economics has conducted a public procurement resulting in choice of the consulting firm, which will consult Latgale businesses on opportunity to receive co-financing from the Structural Funds, including preparation of the project.

One task of the new state support programme “Support to modernisation of commercial company infrastructure” was to achieve bigger activity of businesses in the regions. As on May 15, 2006 one can conclude that the task is fulfilled successfully, as the required support amounts broken down by regions did not differ substantially, i.e., 28% of the total amount of the required support fell on Lielrīga (Rīga), 16% fell to Kurzeme, 17% – to Zemgale, 23% – to Vidzeme, and 16% – to Latgale.

Table 6.2

**Projects Submitted to the LIDA for Receiving the Structural Funds Financing
by Types of Grant Schemes as of May 15, 2006**
(million LVL)

Grant scheme	Amount planned in SSP 2004-2006	Accepted project applications		Concluded contracts		Paid contracts	
		Number	Amount of support planned by applicant	Number	Amount of support	Number	Amount of support
Support to infrastructure development: connection and reconstruction (by March 17, 2006)	5.00	30	5.81	15	1.97	6	0
Support to infrastructure development: connection and reconstruction (after March 20, 2006)	1.50	8	1/86	0	0	0	0
Improvement of commercial activity according to the requirements of international standards (by March 17, 2006)	37.69	82	40.15	73	35.15	47	20.81
Improvement of commercial activity according to the requirements of international standards (after March 20, 2006)	57.00	225	81.72	0	0	0	0
Support to shared infrastructure development (by March 17, 2006)	5.00	8	2.82	6	1.75	1	0.06
Support to shared infrastructure development (after March 20, 2006)	1.5	6	1.67	0	0	0	0
Support to development of new products and technologies	10.27	35	3.01	19	1.70	2	0.05
Consultation services	3.00	261	2.38	155	1.39	85	0.74
Participation of commercial companies in international exhibitions, fairs and trade missions	3.00	33	0.20	19	0.11	14	0.06
Support for training, re-training and further education of the employed (by March 24, 2006)	10.05	49	0.77	29	0.42	12	0.10
Support for training, re-training and further education of the employed (after March 27, 2006)	2.00	32	0.56	0	0	0	0
Total		536	140.96	316	42.38	167	22.41

In order to level out differences between EU member states, Latvia after accession to the EU has access to resources from the **Cohesion Fund**, which replaces the ISPA funds that were available for Latvia before the accession. Support from the Cohesion Fund is available to those EU member states, where GDP per capita is below 90% of the EU average. The main goals of the Cohesion Fund are to provide support to environmental protection measures and improvement of transport infrastructure.

Similarly as with the Structural Funds, the resources from the Cohesion Fund are only granted as a co-financing for measures supported financially by the member state. The EU co-financing from this fund has been set at 80-85%. Furthermore, the contribution from the EU may even reach up to 90% of the total project costs, if financing is received from the Structural Funds as well. The total project costs have to reach at least 7 million LVL (10 million EUR).

The utilisation of resources from the Cohesion Fund is set out under the Reference Framework Document co-ordinated with the European Commission in December 2003. In contrast to the Single Programming Document that only sets out priority areas of support, the Reference Framework Document defines specific projects, to which the financing will be granted. The Cohesion Fund has broader range of financing as compared to ISPA:

- transport sector – roads, railways, ports, airports, public transport;
- environmental sector – management of household waste (regional waste landfill sites), sewage treatment, drinking water supply.

The total financing from the Cohesion Fund accessible to Latvia in the period of 2000-2006 amounts to 710 million EUR, of which 310 million EUR comprise the financing for projects under implementation at present (former ISPA projects), 230 million EUR are earmarked for the Cohesion Fund project applications of 2004, 170 million EUR comprise the financing for the Cohesion Fund project applications to be submitted in 2005 and 2006.

By March 31, 2006 – 43 projects for 656.1 million EUR or 92.31% of the available Cohesion Fund financing were approved. 193 million EUR (29.41% of the approved Cohesion Fund financing for Latvia in 2000-2006) were received from the European Commission, while 132.7 million EUR (20.22% of the financing) were paid to executors in the framework of the concluded contracts (see Table 6.3).

Table 6.3

Progress in Absorption of the Cohesion Fund as on March 31, 2006

	Cohesion Fund financing	Projects approved by the European Commission		Paid to beneficiaries of Cohesion Fund financing		Payments received from the European Commission	
	million LVL	million LVL	% of available financing	million LVL	% of approved projects	million LVL	% of approved projects
Ministry of Environment		298.96	42.06	54.02	18.07	73.00	24.42
Ministry of Transport and Communications		353.53	49.74	78.12	22.10	119.45	33.79
Ministry of Finance		3.63	0.51	0.52	14.29	0.52	14.29
Total	710.77	656.12	92.31	132.65	20.22	192.97	29.40

In the environmental sector, 20 Cohesion Fund projects have been approved, including 17 infrastructure projects and 3 technical assistance projects with the total financing from the Cohesion Fund at 217.6 million EUR (the total financing for the projects amounts to 366.2 million EUR).

In the transport sector, 14 Cohesion Fund projects have been approved, including 11 infrastructure projects and 3 technical assistance projects with the total financing from the Cohesion Fund in the amount of 312.2 million EUR (the total financing for the projects equals to 563.6 million EUR).

Implementation of Cohesion Fund projects takes place steadily. Part of projects is completed, but start of several projects has been delayed for two years. Implementation of some Cohesion Fund projects is foreseen until 2008-2009 in accordance with decisions or financial memoranda of the European Commission. The main problems in implementation of projects in the environmental and transport sectors are still created by essential rise of prices in the construction sector, which has increased costs of a majority of projects that were planned and started in the previous years. This substantial rise of prices is explained by rapid increase in prices of both fuel and construction materials as well as increased labour costs determined by the total increase of demand in the construction sector.

Next planning period of 2007 – 2013¹

Application for funding from the all mentioned financial sources is possible in the time period of 2004-2006. This multi-year budget-planning period (also called financial perspective), lasting from 2000 till 2006 for the old EU member states, expires in 2006 and so the plans for EU expenditures,

¹ Source: the Ministry of Finance website: www.esfondi.lv section "2007-2013"

laws and regulations, and other documents determining the use of EU financial resources are no longer applicable for distribution and absorption of the new funding after the end of 2006. The period of financial perspective usually lasts five to seven years. At present, planning of EU expenditures and preparation of documents for the next period of 2007-2013 takes place.

In order to ensure high-quality absorption of the Structural Funds and the Cohesion Fund, all required planning documents and normative acts have to be prepared by 2007, which would ensure starting absorption of the Structural Funds and the Cohesion Fund as from January 1, 2007.

In order to start efficient absorption of resources from the Structural Funds and the Cohesion Fund as from January 1, 2007, it is offered to carry out the programming at 3 levels in accordance with the draft general regulation of the Structural Funds and the Cohesion Fund – the EU level strategy or the Community Strategic Guidelines, the strategy of member states or the National Strategic Reference Framework Document, and the Operational Programmes of member states (hereinafter OP).

The National Strategic Reference Framework Document (hereinafter NSRFD) for the period of 2007-2013 is the main Structural Funds and Cohesion Fund planning document at the level of Latvia, which ensures tying of the cohesion policy with national priorities and substantiates the choice of these priorities as well as determines the funds absorption strategy and the management framework and ensures co-ordination between OP and other financial instruments.

The draft NSRFD has been prepared, taking into account the goals and lines of action set in the National Development Plan (the Ministry of Regional Development and Local Government is responsible for its development) and in the National Lisbon Programme of Latvia (the Ministry of Economics is responsible for its development) as well as observing the provisions of the long-term conceptual document “People First: A Growth Model for Latvia” approved by the Saeima.

The general management framework and planning documents of the Structural Funds and the Cohesion Fund are being developed, mutually co-ordinating them with institutions involved in management of EU funds and consulting with partners (social partners, representatives of regions, NGO) about a response acceptable for all parties. During preparation of NSRFD at the end of 2005 also a public discussion was held, in whose framework every inhabitant of Latvia could express his vision of this document. Public discussion about the developed OP takes place from May 16 till June 2, 2006.

The Ministry of Finance is appointed the institution responsible for implementation of NSRFD. As from 2007 the ministry has to submit informative reports on implementation of NSRFD to the Cabinet of Ministers quarterly.

NSRFD stresses that in 2007-2013 the most important task (to be fulfilled with help of the Structural Funds and the Cohesion Fund) is to create the necessary preconditions and directly achieve changes that would ensure formation of knowledge-intensive economy in the country. Hence the investments from the Structural Funds and the Cohesion Fund in the period of 2007-2013 in Latvia have to be channelled mostly to those measures that develop knowledge as the main resource of growth and create favourable conditions of life for human being as the holder of this resource.

In order to reach this goal, investments from the Structural Funds and the Cohesion Fund are being planned in accordance with three thematic axes:

- development and efficient use of human resources;
- increase of competitiveness and progress towards knowledge-intensive economy;
- improvements of public services and infrastructure as a precondition to balanced development of the country and its territory.

Balanced development of territory, macroeconomic stability, equal opportunities, sustainable development, and information society are determined as horizontal priorities.

For achievement of these goals, it is planned to manage investments from the Structural Funds and the Cohesion Fund, using three operational programmes:

- “Human Resources and Employment”, operational programme of the European Social Fund;
- “Enterprise and Innovation”, operational programme of the European Regional Development Fund;
- “Infrastructure and Services”, operational programme of the European Regional Development Fund and the Cohesion Fund.

On December 17, 2005 the European Council agreed on the EU financial framework for the period of 2007-2013. According to calculations of the Ministry of Finance and using the methodology of the European Commission, financing from the Structural Funds and the Cohesion Fund for Latvia in the framework of NSRFD equals to approximately 4 billion EUR. Co-financing from the state budget has to be ensured for it.

Sources of financing OP are the European Regional Development Fund (52.65% of the total amount granted from the Structural Funds and the Cohesion Fund), the European Social Fund (10% of the total amount granted), and the Cohesion Fund (37.35% of the total amount granted). Along this, co-financing from the state budget and private co-financing have to be ensured.

6.2.2. Foreign Trade Policy

EU foreign trade policy issues are discussed and co-ordinated at weekly meetings of the Article 133 Committee of the EU Council in Brussels. The European Commission, after consulting with the Article 133 Committee, submits proposals to the Council on how to implement the common trade policy both multilaterally and bilaterally.

EU supports promotion and strengthening of the multilateral trading system. At the same time, the EU establishes and constantly maintains a network of bilateral relations in the framework of various preferential, regional and free trade agreements.

Multilateral relations

The World Trade Organisation (WTO) has a considerable influence on improvement of the multilateral trading system and simplification of trade rules. The global trading system currently is in a transition period and has to be adapted to the new economic situation determined by scientific achievements, development of technologies and involvement of new participants in the global economy. In order to promote development of all countries of the world and liberalisation of multilateral trade, a new round of trade negotiations or the so-called Doha Development Agenda (DDA) of the WTO was started in 2001. In order to reduce various trade restrictions and ensure balanced redistribution of gains between the developed and the developing WTO member countries, integration of developing countries into international trading system was set as the central target of the DDA. It has to be noted that the round envisages preferences for the least developed countries, i.e. they do not have to undertake new commitments in addition to the existing ones.

On December 13-18, 2005, the WTO 6th Ministerial Conference took place in Hong Kong, where trade ministers of WTO member countries agreed to reach a comprehensive agreement in the main areas of negotiations by April 30, 2006 in order to reduce tariffs and subsidies for agricultural products and ensure freer access to market for industrial goods. Simultaneously continuing negotiations in other fields (e.g., trade of services, trade facilitation and assistance to trade), DDA negotiations have to be concluded by 2007.

The aim of the trade facilitation negotiations is to speed up the movement of goods, simplifying customs procedures and formalities, as well as ensure technical assistance and increased capacity.

In order to achieve the set targets of the round, the programme “assistance to trade” was started; in the framework of this programme, a financial assistance in the form of investment and loans is provided to the countries which lack resources for development activities.

Although, both at the informal ministerial meeting during the World Economic Forum in Davos on January 27-28, 2006 and at the informal meeting of G6 ministers in London, WTO member countries had expressed determination to reach the ambitious DDA targets, they failed to reach agreement in the main areas of negotiations by April 30, 2006. Therefore an active work is still going on, so that the DDA negotiations round would be concluded by the set term as planned. It is possible if agreement between WTO member countries is reached by July of this year.

From liberalisation of the multilateral trading system, Latvia will get freer access to goods' and services' markets of third (non-European Union) countries due to reduction of tariffs and equalisation of high tariffs, and to more transparent setting of non-tariff barriers limiting import (rules of origin, pre-delivery inspection, import licensing procedures, investment measures and rules on determination of customs value of goods, etc.). Freer access to markets of other countries will encourage expansion of potential export markets of Latvia and further growth of economy of the country.

Bilateral relations: economic dialogue with Russia, Ukraine, US

EU member states, including Latvia, support entry of Russia in the WTO as soon as possible, but results of negotiations are more important than the speed of the entry.

Russia still has not solved several issues, e.g., the ones concerning sanitary and phytosanitary measures, technical barriers to trade, rail tariffs, agriculture, etc.

17th EU-Russia summit took place in Sochi (Russia) on May 25, 2006. Discussions focused on the practical implementation of the roadmaps for the Four Common Spaces (Common Economic Space; Common Space of Freedom, Security and Justice; Common Space on External Security; Common Space on Research, Education, Culture); agreement on these Common Spaces was reached at the EU-Russia summit on May 10, 2005.

The principal issues were EU-Russia relations, including creation of the Four Common Spaces, international and regional issues, and co-operation in energy sphere was also mentioned among priority issues.

Creation of the Four Common Spaces of the EU and the Russian Federation, including establishment of the Common European Economic Space (CEES), is especially substantial in order to promote and diversify trade between the EU and Russia, provide new opportunities for economic integration and convergence, and encourage market accessibility and development of infrastructure.

Economic co-operation between the EU and Russia is regulated by the Partnership and Co-operation Agreement (PCA), which is due to expire in 2007. During the 17th EU-Russia summit the parties agreed to keep the PCA in force after 2007 if a new agreement will not come into force by that time. The next EU-Russia summit will take place in Finland in the 2nd half of 2006.

Entry of **Ukraine** to the WTO is also significant for Latvia as it is expected that it will deepen the commercial and economic co-operation between the EU and Ukraine. Latvia has special economic interests in conclusion of EU Free Trade Agreement with Ukraine, taking into account that such agreement with Ukraine existed before Latvia's accession to the EU and encouraged development of transit and international trade.

Latvia is especially interested in considerable reduction of bureaucratic requirements and elimination of other non-tariff barriers to get into Ukrainian market.

In December 2005 Ukraine acquired market economy status in anti-dumping probes of the European Community. Latvia was one of the most energetic supporters of granting this status to Ukraine and appreciates persistence of Ukraine and its success in carrying out the reforms.

Co-operation between the EU and US takes place in the framework of the Transatlantic Dialogue. The EU-US initiative to enhance economic integration and growth, which was accepted at the EU-US summit on June 20, 2005, is topical. The initiative envisages to promote co-operation between high-level regulators, build more open and competitive financial markets, encourage investment for long-term development, co-operate in protection of intellectual property rights (including third countries), support and spur innovation and technological development, enhance security of trade not limiting the trade flow and applying visa-free regime to all EU member states, carry out negotiations in aviation sphere on conclusion of a new contract, strengthen co-operation in the services sector, and ensure bilateral access to public procurement markets.

Latvia will continue supporting implementation of the initiative, paying attention to foreign trade promotion, investment sphere and co-operation of entrepreneurs.

Bilateral economic co-operation agreements of Latvia

In order to continue and activate bilateral economic co-operation after accession to the EU, Latvia has concluded bilateral economic co-operation agreements with **China, Belarus, Ukraine, Kazakhstan, Azerbaijan** and **Georgia**. The Ministry of Economics holds negotiations on bilateral economic co-operation agreement with **Uzbekistan**. Work is started to conclude economic co-operation agreements with **Russia, Armenia** and **India**.

These agreements are the most important umbrella agreements which regulate bilateral economic co-operation and comprise co-operation in industry, tourism, transport, pharmaceuticals, agriculture, financial services, communications, professional training, investment policy, technologies and innovation and other spheres, thereby promoting development of economic co-operation.

Economic co-operation agreements concluded between Latvia and third countries envisage establishment of Intergovernmental Commission and/or Joint Committee, which in turn ensure

supervision of validity of these agreements and opportunities of analysis as well as improve further co-operation.

The 1st meeting of the **Latvia-Kazakhstan** Intergovernmental Commission was held on May 24, 2006, and the protocol of the meeting was signed, where co-operation opportunities in such areas as trade, transit, finances etc. were formulated.

It is planned to hold the 1st meeting of the **Latvia-Ukraine** Intergovernmental Commission, the 6th/3rd meeting of the **Latvia-China** Joint Committee and the 2nd meeting of the **Latvia-Belarus** Intergovernmental Commission in the 2nd half of 2006.

Box 6.3

On the trend of the further bilateral trade policy

Despite the negotiations on further liberalisation of multilateral trade in the framework of the World Trade Organisation (WTO) negotiations (DDA), trade partners of the EU increasingly often start negotiations on conclusion of mutual free trade agreements (hereinafter FTA). EU still maintains the previous priority support to liberalisation of multilateral trade and takes a stand not to start negotiations on conclusion of new FTA now while the result of DDA negotiations is unclear. More and more questions about this EU stand are asked, especially by individual industrial sectors, which urge to carry out more active bilateral trade policy with emerging economies. Concern of representatives of industrial sectors is caused by a growing network of FTA between third countries and its influence on the competitiveness of EU exporters. In parallel to this, also a question about the balance of the geographical coverage of the EU free trade agreements, which are in force, has been put.

Multilateral liberalisation is still a goal of the EU, and successful result of DDA negotiations is the main priority of the EU. In the current situation, taking a decision in favour of a more active bilateral trade policy may pose the question about the position of the EU as a driving force in respect of the result of DDA negotiations. On the other hand, it would be useful to discuss alternatives if the result of DDA negotiations would not be successful.

Within the EU framework, discussions about the trend of the further bilateral trade policy have been started. For Latvia, the main motives to conclude FTA are export interests and competitiveness as well as relations with the neighbouring countries, strategic partnership, and political and economic stability. Before taking decision about start of negotiations with regard to conclusion of new FTA, it would be necessary to identify economic interests and be sure that results of the negotiations would be sufficiently ambitious and balanced as well as reached in a reasonable time period and that the potential partners are ready to undertake obligations in respect of the main EU export and investment priorities.

In order to fulfil obligations of Latvia to the EU by May 1, 2004, it was necessary to denounce all concluded trade agreements, including all free trade agreements, i.e., free trade agreements of Latvia with the Republic of Bulgaria, Czech Republic, European Free Trade Association countries, Republic of Estonia, Republic of Lithuania, Republic of Poland, Slovak Republic, Republic of Slovenia, Republic of Turkey, Ukraine and the Republic of Hungary were denounced.

Since May 1, 2004, trade relations of Latvia with third countries are regulated by agreements concluded by the EU.

So far the EU has concluded the following agreements:

- Europe agreements with Bulgaria and Romania;
- FTA with the Faeroe Islands, Switzerland, and Mexico;
- Association Agreements with Chile, Mediterranean countries (Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestinian Authority, Syria and Tunisia) and several overseas countries and territories;
- Customs unions with Turkey and Andorra;
- European Economic Area agreements with Norway, Liechtenstein and Iceland;
- Stabilisation and Association Agreements with Macedonia and Croatia;
- Trade, Development and Co-operation Agreement with South Africa.

In 2005, trade with EU member states comprised approximately 75% of Latvian foreign trade. The biggest trade partner of Latvia among third countries was Russia (8.4% of total turnover of Latvia), followed by Belarus (4.4%), Ukraine (1.7%), USA (1.7%), Norway (1.5%), Switzerland (1.3%), China (1%), Japan (0.5%), Turkey (0.4%), Korea (0.3%) and Canada (0.3%).

Steel

Taking into account the changes in the steel sector, growing globalisation trends in steel markets and changes in these markets, it is necessary to forecast clear directions of the further development, at the same time envisaging an adequate legal base. Analysis of the mentioned issues and adoption of respective decisions take place in the working groups of the Article 133 Committee/Steel of the EU Council of Ministers.

At present, the EU, including Latvia as EU member state, applies provisions of double control system with quantitative restrictions to import of several steel products from Russia, Kazakhstan and Ukraine, and adequate agreements on steel trade are concluded with these countries. The quantitative restrictions (quotas) define a fixed amount of steel product import from these countries to the EU. The quota for import from the respective countries in 2006 is defined in the amount that ensures maintenance of traditional import flows.

Double control system without quantitative restrictions is applied to particular steel products from Moldova, Macedonia and Romania, and prior surveillance system is applied to imports of several steel products from all third countries.

Textile

The textile sector takes an essential place in international trade. During the last years the role of several third countries such as China, India and Pakistan in textile trade has grown particularly. Textile trade issues in the European Union are examined by the Article 133 Committee/Textile of the EU Council of Ministers.

Taking into consideration the sensitivity of the textile sector characterised by high number of employees, until January 1, 2005 the trade of textiles and clothing between WTO member countries was regulated by the Agreement of Textiles and Clothing, which foresaw gradual abolishment of quotas between WTO member countries.

At present, textile trade between WTO member countries is integrated in a common trading system (GATT). Latvia as EU member state applies the double control system with quantitative restrictions (quotas) to imports of textile products from Belarus, Montenegro and North Korea, while the double control supervision system without quantitative restrictions is applied to imports of textiles originated in Uzbekistan.

Taking into account the rapid increase of imports from China, on June 10, 2005 the EU and China concluded agreement on textile trade until 2008. It prescribes import restrictions for 10 categories of goods of Chinese origin (gradual annual import growth in the amount of 8 – 12.5% is taken into account in calculation of quotas).

Taking into consideration the expected changes in this sector, a high-level working group of the EC was set up, which includes representatives of the government, industry and textile associations. The working group developed the EU action plan for promotion of development and competitiveness of the sector and defined the following principal lines of action: research and development, education, expanded opportunities in trade with third countries, structural funds, deepened regional integration with Mediterranean countries, protection of intellectual property, strengthening the dialogue between China and the EU. The European Commission has started solving the above-mentioned issues, but the work in the high-level working group has to be intensified in order to efficiently ensure development of the sector and promote competitiveness.

Trade defence instruments

Trade defence instruments (anti-dumping, anti-subsidy, and safeguard measures, hereinafter TDI) in the European Community are applied by European Community institutions in accordance with unified principles, as TDI are a constituent part of the common trade policy of the European Community. Individual EU member states represent their interests regarding TDI in advisory committees of the European Commission, namely, the Anti-dumping and Anti-subsidy Committee and the Safeguard Committee. Interests of Latvia in these advisory committees are represented by the Ministry of Economics.

Anti-dumping and anti-subsidy measures are aimed at protection of local producers of the European Union against losses caused by unfair competition of third countries companies or government subsidies. Determinant for application of the safeguard measures is such import growth that causes losses for local producers but does not constitute an unfair competition.

134 anti-dumping and 12 anti-subsidy measures against various goods in the European Community were in force as of March 31, 2006. At present, the European Commission examines 96 cases. Data of 2005 show that trade defence measures applied by the European Community affected mere 0.5% of all European Community imports.

In Latvia, there are both producers and consumers of the goods affected by TDI procedures, but the most essential interests of Latvia involve industrial usage of goods subjected to TDI. The following trade defence cases are most essential for Latvia from the standpoint of import and user interests:

- anti-dumping procedure and measures concerning imports of potassium chloride originating in Belarus and Russia;
- anti-dumping procedure and measures concerning imports of ammonium nitrate originating in Russia and Ukraine;
- anti-dumping procedure and measures concerning imports of certain iron or non-alloy steel seamless pipes and tubes originating in Croatia, Romania, Russia and Ukraine;
- anti-dumping proceeding concerning imports of farmed salmon from Norway.

So that interests of companies would be considered as effectively as possible in proceedings carried out by the Commission¹, also the interested parties in Latvia (producers, importers, exporters and consumers) have to inform the Commission and the Ministry of Economics about their interests. The Commission is the most important body in these procedures, and all proofs and arguments in TDI procedures are to be submitted to the Commission, but it is also important for the Ministry of Economics to know problems and interests of Latvian companies. They will be taken into account not only by working out the national position of Latvia, but also practically defending state interests in TDI proceedings carried out by the European Commission. Only through co-operation and active participation in the proceedings carried out by the Commission, it is possible to achieve more effective protection of their interests.

6.2.3. EU Internal Market

On May 1, 2004 Latvia became a participant in one of the biggest internal markets of the world, which includes 28 countries (EU member states plus European Economic Area countries Norway, Iceland and Liechtenstein) with more than 450 million consumers. The EU policy is aimed at development of the single internal market, where free movement of production factors is ensured (the 4 freedoms that apply to goods, services, persons and capital) in order to promote sustainable and stable development of EU economy and prosperity of EU population.

Implementation of the principles of the free movement of goods and services and the right of establishment, which are set up in Articles 28-30 and Articles 43-55 of the Treaty establishing the European Community is supervised and co-ordinated by the Ministry of Economics in Latvia, constantly identifying the norms that may potentially hinder implementation of EU internal market freedoms, inter alia assessing normative acts still in the development stage.

In the framework of the procedure of notifying draft technical regulations (Directive 98/34/EC), which specifies obligation of EU member states to submit draft technical regulations to the European Commission and other EU member states and European Economic Area countries (Norway, Iceland and Liechtenstein) for assessment in order to preventively avert inclusion of such requirements in normative acts, which have the potential to create barriers to free movement of goods as well as free movement of information society services, Latvia has submitted 3 draft Cabinet of Ministers regulations to the European Commission in the 1st half of 2006. Objections of the European Commission that the draft regulations have the potential to create barriers to free movement of goods in the EU internal market were received in one case. From May 1, 2004 until June 1, 2006 Latvia has informed the European Commission about 32 draft technical regulations and received objections of the European Commission in 7 cases. In most cases the European Commission's objections pertained to the fact that draft normative acts did not include the principle of mutual recognition, which prescribes that products manufactured or legally put into circulation in some EU member state or Turkey or legally manufactured in some European Free Trade Association country, which is a contractor of the European Economic Area Treaty, are recognised in Latvia. The European Commission also repeatedly indicated that requirements set in draft technical regulations create doubts about their necessity and compliance with the proportionality principle.

¹ Information on TDI procedures carried out by the Commission is available on the EC website http://ec.europa.eu/comm/trade/issues/respectrules/anti_dumping/stats.htm or at the Ministry of Economics.

As from the 2nd half of 2005 Latvia has essentially improved the statistics of implementation of internal market directives. As of December 1, 2005, 98.9% of internal market directives were transposed in normative acts of Latvia, which fully ensures reaching the Lisbon goal to transpose requirements of at least 98.5% directives or to allow deficit of transposition of directives in the amount of 1.5%. Latvia is also among those 6 EU member states that have implemented all financial services' directives that were to be transposed by December 1, 2005. Since Latvia's accession to the EU on May 1, 2004, seven violation procedures have been brought against Latvia for inadequate application of internal market legislation acts (*Internal Market Scoreboard No. 15, December 2005*).

In order to encourage business activity and innovation, one of priorities of Latvia in the EU is promotion of free movement of services. Among initiatives of EU legal acts, the draft directive of the European Parliament and the Council related to services in the internal market is the most substantial for Latvia. The draft directive is aimed at creation of the legal regulation required to promote implementation of right of establishment and free movement of services in the EU internal market. It is likely that the directive will be adopted in the 2nd half of 2006, and the member states will have to implement it in 2-3 years. Although essential elements (e.g., country of origin principle, norms on prevention of administrative obstacles in the field of posting of workers) were crossed out from the draft directive so that it would be possible to reach a compromise acceptable to all 25 member states, the directive will make a positive contribution in the context of the provision of cross-border services as well as to improvement of business environment, especially to reduction of administrative obstacles. The draft directive envisages such measures for prevention of administrative obstacles as creation of single contact points ("one-stop shops"), opportunities to carry out administrative procedures electronically, unified requirements for issuance of licences, as well as obligation of EU member states to submit information about the existing restrictions in provision of services to the European Commission for assessment, etc.

In the 1st half of 2006 the Latvian SOLVIT Centre which reviews complaints of inhabitants and entrepreneurs on violations of EU legal acts against institutions of Latvia and other EU member states has initiated 4 cases and has received 5 cases against Latvian authorities from SOLVIT centres of other member states for review. Essential increase in the amount of cases at Latvian SOLVIT Centre was already observed in 2005. Number of inhabitants and entrepreneurs who have turned to the Centre has increased approximately 2 times, while the number of solved cases has grown even three times. In 2005 the Latvian SOLVIT Centre initiated 9 cases on the basis of complaints about non-observance of EU legal acts, while SOLVIT centres of other member states initiated 12 cases against Latvian authorities (in comparison with 4 cases and 3 cases respectively in 2004). Most cases (about two-third) were submitted by Latvian companies that complained about violations of free movement of goods (e.g., non-observance of the CE conformity marking) or by foreign companies over discriminatory rules or practices in public procurement tenders (e.g., complaint of a Swedish company about unequal treatment in waste management sphere at the local government of Riga). Inhabitants have mostly complained about border control, visas, state fees related to entry and stay, and raising different requirements for students of Latvia and other EU member states.

6.3. Sector-Specific Development Policies

6.3.1. Industrial Development Policy

One of the main goals of the national economy development in Latvia is to create an efficient and competitive industry that would ensure high and stable growth. Industrial policy in Latvia is being shaped in accordance with the policy development directions of the European Union, at the same time identifying and solving issues that are urgent for local industrial enterprises in co-operation with organisations that represent industrial enterprises. Industrial policy is closely connected with innovation, business activity, education and other policies. The most substantial documents formulating industrial policy in Latvia are as follows:

- Single Strategy of National Economy (approved by the Cabinet of Ministers on August 17, 2004);

- National Lisbon Programme of Latvia for 2005-2008 (approved by the Cabinet of Ministers on October 19, 2005);
- Long-term Economic Strategy of Latvia (accepted by the Cabinet of Ministers on July 17, 2001);
- Industrial Development Guidelines of Latvia for 2004-2013 (accepted by the Cabinet of Ministers on February 24, 2004);
- National Innovation Programme for 2003-2006 (accepted by the Cabinet of Ministers on April 1, 2003).

In 2005 the National Lisbon Programme of Latvia for 2005-2008 was developed (see Chapter 6.1), which defines the measures to create preconditions for development of knowledge-based economy in Latvia. The most important priorities in the field of industry are orientation to high value-added production and increase of the share of high technologies in the export structure as well as the rise of productivity level. Development and implementation of the programme for promotion of enterprise clusters as well as solution of sector-specific issues, which is based on conduction of studies about development prospects of individual industrial sectors, are set as measures to be taken in the field of industrial policy within the framework of the National Lisbon Programme.

Several studies on development of individual industrial sectors in Latvia have been conducted. In December 2004, a study on the textile and clothing production sector was completed, studies on development of the machine building and metalworking sector and the chemistry and pharmacy sector were conducted in 2005, and a study on further development prospects of the information and communication technologies sector was conducted in 2006 (see Box 6.4).

Box 6.4

Studies on development of Latvian industrial sectors

The **machine building and metalworking sector** has an important place in the manufacturing structure. Moreover, the machine building and metalworking sector is closely related to productivity increase in other sectors, because it operates as supplier of equipment and technologies. With the rapid development of the sector in the recent years, it has developed efficient networks of co-operation with Latvian and foreign partners, which include markets of raw material supplies and sales, especially in export. Several projects for improvement of educational system and study programmes are being implemented and new professional training centres are being established. The current problems include the productivity level, which lags behind the respective indicators of EU member states, insufficient modernisation of enterprises and introduction of new technologies, lack of new specialists and low share of innovative enterprises. The following key groups of activities to ensure development of the sector are identified:

- ensuring the required labour force of adequate skills to the sector, which is to be considered as the most substantial factor determining development of the sector in the following 10 years;
- continuing modernisation of equipment, technologies and production infrastructure;
- keeping and expanding the sales markets;
- providing the financing and improvement of the respective legislative conditions.

The study on further development opportunities of the **chemistry and pharmacy sector of Latvia** analyses several sub-sectors of the chemical industry, such as production of chemical substances, paints, pharmaceutical preparations, detergents and cosmetic, rubber and plastic products. Sub-sectors of the chemical industry in total constitute approximately 5% of the total value added of the manufacturing industry in Latvia, which is a lower indicator than in the 15 old EU member states on average. At the same time it has been concluded, that the sector has a good potential for development in Latvia, because there is a strong scientific base, good and lasting traditions, low material input inherent to the sector and competitive ratio of the product quality and price. Development of the sector is hindered by such factors as the availability of financial resources, threat due to the outflow of scientists and skilled labour force abroad, lack of new specialists as well as insufficiently developed link between enterprises and research institutions.

In the study on further development opportunities of the **information and communication technologies (ICT) sector of Latvia**, two sub-sectors of ICT are analysed: production of office equipment and computers and computer services, which comprise part of the ICT sector and are denoted as information technologies (IT). In the period of 2000-2004 the IT sector in Latvia has considerably increased and most indicators have doubled in this time period. Turnover of IT companies has grown from 60 million LVL in 2000 to 110 million LVL in 2004, the value added has increased from 25 million LVL to 49 million LVL and the number of employees has gone up from 4.2 thousand to 5.8 thousand. Exports make a substantial share of turnover in companies of the IT sector, the biggest IT companies in Latvia are export-oriented, and volumes of their exports increase every year, constituting also a substantial share of the total export volume of the country. Analysis of export dynamics and volumes is complicated by the fact that the official statistics include only information about the exports of products, but no official accounting is done about foreign trade volumes of services. This makes difficult a foreign trade analysis about a considerable segment of Latvian IT sector, namely, the IT services, which constitute about 70% of the total IT exports.

Successful development in Latvian ICT sector is greatly promoted by stable growth of the sector, considerable experience of companies of the sector, which is gained through operation in foreign markets, capability of entrepreneurs to adapt fast to the changing conditions of the market economy, high development rates of e-commerce. Development of the sector may be negatively affected by the lack of highly skilled specialists, which is the most important necessary resource of the sector, as well as by uneven availability of electronic communications in the territory of Latvia.

Co-operation between Nordic and Baltic Sea countries in the sphere of innovation and industrial policy continues in 2006. In 2006 the Nordic Council of Ministers organised the inter-state co-operation project “Working Group for Cluster Development Policy of the Northern Dimension” as a continuation of the project “Working Group for Innovation of the Northern Dimension” implemented in 2005. Baltic and Scandinavian countries as well as Russia, Germany and Poland participated in the project. In the framework of the project, exchange of experience about implementation of cluster development policy in various countries was organised, focussing on such aspects as development and implementation of programmes, role of the public sector, results of programmes and systems for assessment of programmes. Cluster promotion programmes from Scandinavian and Baltic Sea countries and examples from other regions of the world were presented during the meeting.

The work performed in the working group of the Northern Dimension and other co-operation platforms of the Nordic and Baltic Sea countries has encouraged development of a joint concept of the project for further co-operation in the field of cluster development. A joint application of project has been developed, which is approved by the European Commission and envisages implementing a wide-ranging inter-state co-operation in promotion of cluster development during the next three years. The *BSR InnoNet* project or the innovation network of the Baltic Sea region will be financed from the 6th Framework Programme of the EU and will be oriented on co-operation in the field of creation of the cluster policy, promotion of contacts, exchange of experience and co-operation between clusters, training, as well as analytical study and analysis of clusters in the region. The Nordic Innovation Centre is the institution co-ordinating the project. The Latvian Investment and Development Agency as a project partner represents Latvia, involving also representatives of other public institutions and the private sector into various activities of the project.

6.3.2. Energy Policy

Main directions of the energy policy are promotion of competition, raising level of energetic independence, increasing security of energy supply, encouraging use of renewable and local energy resources, diversification of usable energy resources, and environmental protection.

The Ministry of Economics in co-operation with representatives of energy companies, scientists, economists and representatives of associations has worked out the policy-planning document “Guidelines for Development of Energy Sector for 2007-2016”. The guidelines include the governmental policy, development targets and priorities in energy sector both in medium term and long term. On June 27, 2006 the policy-planning document “Guidelines for Development of Energy Sector for 2007-2016” was approved by the government.

The dominant role in **electricity supply** is played by state JSC “Latvenergo” that generates more than 90% of all electricity generated in Latvia and ensures import of electricity, its distribution and supply to consumers. As from September 1, 2005 all functions of electricity transmission system operator are performed by JSC “Augstsprieguma tīkls” fully owned by SJSC “Latvenergo”. In addition, there are more than 100 small power plants and 15 licensed distribution and sales companies. Natural gas is only supplied by JSC “Latvijas Gāze”, but about 70 companies compete in the supply of natural gas.

Latvia as EU member state has to ensure compliance with unified requirements set in EU legal acts. In the electricity supply sector it means that the electricity market in Latvia must be opened gradually and operate in accordance with provisions of Directive 2003/54/EC of June 26, 2003 concerning common rules for the internal market in electricity.

On July 23, 2004 the Cabinet of Ministers approved the draft policy-planning document “Guidelines for Creation of Preconditions for Electricity Market in Latvia” prepared by the Ministry of Economics. It defines the basic principles for model of opening the electricity market in Latvia, necessary preconditions for the market opening, market participators and their basic functions, duties and rights, principles of perspective structure and regulation of the sector. It also formulates the problems that currently hinder opening the Latvian electricity market and implementation of electricity users’ rights of choice. The draft guidelines have been prepared, taking into account Directive 2003/54/EC of the European Parliament and of the Council concerning common rules for the international market in electricity. In order to create legal environment for efficiently functioning and competitive electricity market, basing on the guidelines, the Saeima passed the Electricity Market Law on May 5, 2005.

The most important precondition for creation of market relations in the electricity supply sector is the changes in the sector's structure, separating elements of a natural monopoly (transmission and distribution services) from competing elements (generation and trade). Creation of the sector's organisational structure correspondent to market conditions takes place in accordance with requirements of the new wording of Section 20¹ of the Energy Law and requirements of the Electricity Market Law.

Creation of mechanisms for market operation in the electricity sector is necessary and constitutes one of the government priorities. This will be accomplished through approval by the government of legal acts that ensure equal rights for all electricity users in Latvia to freely choose their electricity suppliers and to be qualitatively and securely supplied with energy in the necessary amount for lowest possible prices.

At present, JSC "Latvijas Gāze" is the only merchant in the **natural gas market** of Latvia. In compliance with licences issued by the *Public Utilities Commission* (see Chapter 6.9), "Latvijas Gāze" carries out transmission, distribution, storage and sales of natural gas.

Amendments to the Energy Law made on May 26, 2005 envisage main conditions for opening the natural gas market and were developed, taking into account Directive 2003/55/EC of the European Parliament and the Council concerning common rules for the internal market in natural gas. The law includes issues concerning operation of systems, duties and rights of market participants, and competition opportunities in the natural gas market.

By choosing regulated procedure of access, member states carry out the necessary measures to confer rights of accessing the system to natural gas companies and qualified users inside or outside the area, which contains an interconnected system, on the basis of published tariffs and other conditions and obligations that are to be complied with, when the system is used.

Box 6.5

Harmonisation of normative acts with EU directives

The key fields in harmonisation of legal acts with EU legislation are oil and oil product reserves, security of supply, energy efficiency, and continued introduction of market principles in the energy sector:

- **security of supply and creation of oil product reserves.** The Concept on Formation of the State Oil Product Reserve was approved by the Cabinet of Ministers Regulation No. 492 of June 27, 2006. On June 27, 2006 the Cabinet of Ministers issued Regulation No. 541 "Amendments to the Cabinet of Ministers Regulation No. 853 "Procedure for the Establishment and Storage of Petroleum Product Reserves" of November 8, 2005", which lightens the administrative and financial burden for merchants that operate in the oil product market. With approval of the new concept by the Cabinet of Ministers, the Concept on Formation of the State Oil Product Reserve adopted by the Cabinet of Ministers on August 14, 2001 and according to which a package of normative acts and amendments to the current legislation were drafted has lapsed.
- **electricity sector.** On May 5, 2005 the Saeima passed the Electricity Market Law (in force as from June 8, 2005) with the aim to create preconditions for operation of efficiently functioning electricity market, so that electricity would be supplied to all electricity users safely, qualitatively and for justified prices, ensure all electricity users' rights to choose electricity merchant freely, and promote electricity generation by use of renewable energy resources. On March 17, 2005 the Saeima passed the law "Amendments to the Energy Law" (in force as from April 15, 2005), by which the previous electricity sector regulation was excluded from the law and Section 20¹ of the Energy Law was expressed in a new wording according to the market requirements. On June 13, 2006 the Cabinet of Ministers accepted the regulation "Regulations on the Special Connection to Electricity Transmission System" that defines procedure for establishment of special connection to electricity transmission system or increasing the capacity of a current connection. On April 25, 2006 the Cabinet of Ministers approved Regulation No. 322 "Regulations on Annual Assessment Report of Transmission Operator" that determines the procedure, by which a transmission system operator develops and submits assessment report to the Ministry of Economics and the Public Utilities Commission, as well as requirements regarding the content of assessment report;
- **gas sector.** On May 26, 2005 the Saeima passed the law "Amendments to the Energy Law" (in force as from June 29, 2005) that determines principles for operation of natural gas market. The aim of the law is to create conditions for competition in the natural gas market in Latvia and harmonise regulatory normative acts with requirements of EU legislation. Transitional provisions of the law prescribe that time and procedure for coming into force of legal norms, which regulate principles for operation of natural gas market, are determined by a special law. On June 20, 2006 the Cabinet of Ministers accepted the regulation "Regulations on Annual Assessment Report of Natural Gas Transmission Operator" that determines the procedure, by which a natural gas transmission system operator develops and submits assessment report to the Ministry of Economics and the Public Utilities Commission, as well as requirements regarding the content of assessment report.

Investment in energy sector

State support in the energy sector is only given to projects that are linked to adjustment of heat supply systems.

In the framework of utilisation of the EU Structural Funds (see Chapter 6.2.1), support to public and non-governmental sector is envisaged. The priorities for use of the Structural Funds are listed in the

Development Plan. These priorities are sub-divided into measures, which in turn are sub-divided into activities. Priority 1 (Promotion of territorial cohesion) includes Measure 1 (Improvement of environment and infrastructure and promotion of tourism), which includes several activities that are in the competence of the Ministry of Economics. One of these activities is aimed at provision of support for public sector institutions in modernisation of heat supply systems according to environmental requirements and improvement of energy efficiency of heat supply systems both in production and distribution and for the end consumers. In the framework of the EU Structural Funds for 2004-2006, 14.96 million LVL will be allocated for the mentioned projects.

87 projects are submitted for financing from the EU Structural Funds – European Regional Development Fund (ERDF). The projects envisage modernisation of heat supply systems according to environmental requirements and improvement of energy efficiency of heat supply systems both in production and distribution and for the end consumers. At present, the projects are qualitatively assessed at the Ministry of Economics.

Supporting reconstruction of district heating systems, construction of heat sub-distribution units and other heat regulation equipment and reduction of heat losses in buildings, the Cabinet of Ministers Regulation No. 433 “Distribution of the Appropriation Envisaged in the Ministry of Economics Programme 29.00.00 “Energy Policy” within the Framework of the State Heat Supply Sector Programme” was issued on June 12, 2006, which envisages support to 61 projects for the total amount of 7 million LVL.

6.3.3. Construction Policy

Construction influences life of an individual and all society as well as environment and the ecological balance of nature, it creates a base for other sectors of the national economy and clearly characterises the economic development and culture of a state. Therefore the goal of the state policy in construction is creation of conditions to meet demand of the national economy for environmentally friendly, healthy, energy-saving and resources-saving, aesthetic and modern buildings.

By planning the development of construction in the Republic of Latvia, the Cabinet of Ministers has accepted the following political documents:

- the Concept for State Strategy in Construction on November 5, 1996,
- the Concept for Strategy on Terms for Converting the former USSR Technical Norms of Construction and on Financing on September 28, 1999 and
- the National Programme on Construction on August 30, 2002.

The *National Programme on Construction* is an integrated target programme for development of the construction sector for 2002-2012, and its main goal is to achieve development of competitive construction by providing the Latvian construction sector with a technical and organisational normative base harmonised with EU legislation, encouraging high-quality and energy-efficient construction, obtaining increased competitiveness of construction specialists and promoting development of Latvian construction science.

Action Plan for implementation of the National Programme on Construction for the period until 2012 is updated every year. All ministries, Latvian Association of Local and Regional Governments, and non-governmental organisations of the construction sector involve in this process, giving and evaluating proposals on activities before their inclusion into the plan.

One of the main work goals of the Ministry of Economics is improvement of business environment, inter alia in the construction sector. For this purpose, amendments to the Construction Law and to the General Construction Rules were made in 2005, specifying obligations and responsibility of construction participants in the construction process, expanding competence of building inspectors, simplifying the procedure for cases of renovation and reconstruction of buildings, and determining the procedure for demolition of buildings and the action of local government for demolition of illegal structures. Amendments to the Construction Law, which were made in 2006, specify issues of harmonisation and public discussion of construction objects, obligate local government to inform society about received construction proposals, and specify the action of building inspector and local government in cases of unwarranted construction.

Licensing of legal persons for business activity in construction is replaced with the Register of Construction Businesses, simplifying registration and reducing the number of documents to be submitted and hence economising time of entrepreneurs. 2890 firms engaged in construction in various

fields were registered in the period from July 1, 2005 to June 1, 2006. In the transition period until June 30, 2006 also the licences still in force worked in order to ensure gradual transition to the new system.

Certification of specialists in various construction spheres is conducted by 8 building specialist certification centres of non-governmental professional organisations, which are accredited by the Latvian National Accreditation Bureau (LATAK), and the Latvian Architects Society. Information on approximately 4500 certificates of construction practice and architectural practice are included in the general register.

Three registers are available on the website of the Ministry of Economics, namely, the Register of Construction Businesses, register of enterprises licensed by June 30, 2005 and the database of the Register of Certificates of Construction Practice and Architectural Practice.

Construction is a complicated process full of risks, therefore big attention is paid to improvement of the normative base so that safety of buildings and people is guaranteed along with simplification of procedures. In parallel to reduction of administrative obstacles, amendments to the Code of Administrative Violations specify and raise penalties for non-observance of requirements of laws and other normative acts in construction. Compulsory insurance of civil liability is introduced in construction. Regulations of the Cabinet of Ministers “On Compulsory Insurance of Civil Liability of Holders of Hydraulic Structures of Hydroelectric Power Stations” and “Procedure for Issuance and Annulment of Safety Certificates of Hydraulic Structures of Hydroelectric Power Stations” were issued in 2006. The Latvian construction norm LBN 229-06 “Hydraulic Structures of Hydroelectric Power Stations” is under harmonisation.

Improvement of Latvian construction norms and the National Standardisation System for construction continues, new draft normative acts are prepared, harmonising requirements of the existing normative acts with EU positions, and adaptation of EU standards takes place. Review of supervision system is also continued, improving the normative base, harmonising it with European requirements and adapting European standards.

Box 6.6

Development of construction in 2005

In 2005 the volumes of construction reached 818.1 million LVL or by 15.5% more (in average prices) than in 2004. Volumes of new construction (in average prices) in 2005 have increased by 27.8% or by 86.4 million LVL in comparison with 2004. Living houses with total space of 552.2 thousand square metres were commissioned in 2005, including 324.7 thousand square metres at expense of residents (452.3 thousand and 257.0 thousand square metres respectively in 2004). In the 1st quarter of 2006 the volumes of construction have increased by 17.5% in comparison with the respective period of the preceding year. Living houses with total space of 135 thousand square metres were commissioned.

Development of national economy sectors is also indicated by the increased demand for construction services, so in 2005 construction boards of local governments have issued:

- 136 permits to start construction of new hotels and other short-term accommodation buildings with total space of 89.8 thousand square metres;
- 38 building permits for construction of new office buildings;
- 122 building permits for new wholesale and retail trade buildings;
- 68 building permits for new transport and communications buildings;
- 188 building permits for new structures and warehouses of industrial production;
- 63 building permits for new buildings of establishments of mass entertainment activities, education or health care;
- 157 building permits for construction of new highways, streets and roads;
- 2 building permits for construction of railway tracks;
- 151 building permits for construction of new main pipelines and main lines of communications and electricity transmission with total length of 280.8 kilometres;
- 1398 building permits for construction of new local pipelines and cables with total line length of 873.8 kilometres.

Along with development of the national economy, the prosperity level of population increases and is directly reflected by demand for adequate dwelling. In 2005 there were issued:

- 4928 building permits to start construction of one flat houses with total space of 1064.9 thousand square metres, of which 3810 or 77% were issued for construction of new one flat houses and 56% of them in Riga;
- 370 building permits for construction of houses with two or more flats with total space of 782.3 thousand square metres, of which 229 were issued for construction of new houses with total space of 594.5 thousand square metres;
- 1075 building permits for construction of cottages and garden houses, of which 526 or 49% were issued for construction of new cottages and garden houses.

Despite the stability of the sector (see Box 6.6), territorial distribution of investment and construction activities in the country is still very uneven (it is the highest in Rīga, Rīga district, Ventspils and Liepāja), level of corruption possibility in local governments is comparatively high, development rates of scientific potential in the sector are insufficient, the growing demand for skilled specialists in construction is still not fully met.

The rapid growth of construction not always keeps pace with adequately dynamic increase of quality. Conclusions made by the State Construction Inspection and non-governmental professional organisations indicate that insufficient attention is paid to the quality of construction designs, and as a result also the quality of buildings not always matches up to the desired level.

Deficit of construction specialists is caused both by the fact that the optimal number of students in construction specialities at higher educational establishments was not completed in a long time period and by the outflow of specialists to foreign countries in search of higher wages.

Non-governmental organisations, which unite specialists in different spheres of the sector have a good knowledge of the labour force situation, its skills and demand for it in the market, and try to respond timely by organising training of employees, as well as propose training of students in the desirable specialities in view of the special technological and EU requirements.

Development of the construction sector is still hindered by interpretation of the requirements of normative acts by institutions involved in preparation of construction, frequent changes of normative acts regulating construction, shortage of territorial planning and building rules, and intransparency of processes in local governments, which creates suspicions on possible corruption.

Capacity of state supervision institutions of the construction product conformity assessment system is insufficient. A full-fledged institution, which would be responsible for issue of European Technical Approvals (ETA) in Latvia and for analysis of documents prepared by ETA issue bodies of other EU member states as regards their compliance with Latvian national interests is not established.

Division of functions of the organisational structure of the sector is inefficient, because the general supervision and co-ordination of construction in the country is carried out by the Ministry of Economics, while supervision of particular areas is under competence of other ministries. The competence of the Ministry of Transport and Communications includes road construction (Road Directorate of Latvia), railways, ports and telecommunications; territorial planning and housing development are within the scope of competence of the Ministry of Regional Development and Local Government. Ministry of Welfare, Ministry of Justice, Ministry of the Interior, Ministry of Environment, Ministry of Health and Ministry of Agriculture determine particular requirements for buildings or their construction. State Inspection for Heritage Protection that is subordinate to the Ministry of Culture sets up requirements for reconstruction and restoration of cultural monuments.

Direct supervision of construction in their administrative territories is carried out by 556 local governments (7 cities, 53 towns, 29 amalgamated local governments (novads), 441 rural municipalities) that have established their construction boards for this purpose or have delegated their supervision powers to other construction boards. 156 construction boards (boards of cities, towns, districts, amalgamated local governments, rural municipalities or united boards) operate in Latvia.

Single construction information system is being developed in 2006, which will include not only the already existing registers (the register of construction businesses and the register of construction practice and architectural practice), but also the register of all building permits and commissions of buildings issued by construction boards of local governments as well as other information topical to the sector.

With introduction of the Construction Information System:

- transparency of decision-making and construction process will increase and the possibility of corruption will decrease;
- the business and investment environment will improve;
- efficient exchange of information will increase, which will promote implementation of state policy in the construction sector.

Adaptation of European standards continues both in construction product conformity and in designing of the building structures as well as in raising the energy efficiency of buildings.

In co-operation with the German Institute of Building Machinery, a project of training the higher education institutions' teachers and specialists of the sector is started for introduction of Eurocode standards in designing of the building structures.

The following tasks are to be considered as important ones for development of the sector and to be solved urgently:

- improvement of the educational system for training of highly skilled construction specialists,
- improvement of the organisational structure and the construction control and supervision system of the sector to increase efficiency;
- improvement of market surveillance of construction products;
- promoting development of scientific disciplines related to construction.

To increase awareness of construction participants and the public, seminars on topicalities of the sector in areas of normative regulation, construction products, designing, technologies, quality, labour protection and other areas are planned in addition to current information on the Ministry of Economics website and monthly information days.

Also social partners are involved in shaping and implementation of the construction policy: Latvian Architects Society, Latvian Civil Engineers Society, Latvian Construction Contractors Association, Latvian Building Inspectors and Supervisors Association, Latvian Heating, Gas and Water Technology Engineers' Union, Latvian Building Materials Producers' Association, Latvian Window and Door Manufacturers' Association, Latvian Building Materials Traders' Association, Latvian Builders' Trade Union, Technical Experts Association, Latvian Association of Local and Regional Governments, Latvian Travellers' Association, Latvian Land Reclamation Specialists Society, Latvian Shipping Association, Latvian Railwaymen Society, Latvian Geotechnical Union, Latvian Association of Energy Construction, Latvia's Electricians' Brotherhood, Latvian Electricians' Society, Latvian Consulting Engineers' Association, as well as Society of People with Disabilities and their Friends "Apeiron".

6.3.4. Tourism Policy

The main goal of Latvian state tourism policy is to improve competitiveness of the tourism sector and, through promotion of sustainable growth of tourism, create new jobs, encourage balanced development of regions, preserve cultural and natural heritage, and foster social integration of the society.

Successful implementation of this goal requires involvement of all interested parties at international, European, national, regional and local levels as well as comprehensive co-operation of public and private sectors.

For determination and implementation of state tourism policy development, a system of tourism policy planning documents and normative acts is created and is being improved on a regular basis in Latvia. Guidelines of Tourism Development Policy of Latvia for 2004-2008 (hereinafter Guidelines) adopted by the Cabinet of Ministers Regulation No. 559 on August 11, 2004 define basic principles of tourism development policy, set goals of tourism development and identify main lines of action for attainment of these goals (see Box 6.7).

Box 6.7

Guidelines of Tourism Development Policy of Latvia

Guidelines of Tourism Development Policy of Latvia is a medium-term policy-planning document that defines basic principles of tourism development policy and the **goal of Latvian tourism development policy for 2004-2008 – increase of tourism share in GDP of Latvia.**

To achieve this, the following lines of action are identified:

1. **Positioning of Latvia as a distinctive, safe and recognised tourist destination:**
 - strengthening the tourism image of Latvia,
 - identifying "new" visitors to Latvia,
 - presence in priority and prospective tourism markets;
2. **development of incoming and domestic tourism:**
 - providing a favourable business environment,
 - building a corresponding and high-quality tourism infrastructure,
 - promoting development of diverse products and services,
 - using achievements of ICT and e-commerce,
 - introduction of quality management,
 - development of human resources,
 - research and development;
3. **promotion of co-operation:**
 - optimisation of co-operation between public and private sectors,
 - international co-operation,
 - participation and representation of state interests.

To ensure achievement of objectives set in the Guidelines, the Tourism Development Programme of Latvia for 2006-2008 was developed (approved by the Cabinet of Ministers Regulation No. 505 on July 5, 2006). Specific activities promoting tourism development within the allocated state budget are determined in the annual action plan. Action Plan of Latvian Tourism Development for 2006 was approved by the Cabinet of Ministers Regulation No. 425 on June 6, 2006. The mentioned plan and

programme include horizontal activities for tourism development, which are implemented by the Ministry of Economics, Latvian Tourism Development Agency, other ministries and public institutions in co-operation with local governments, the private sector and non-governmental organisations.

On February 16, 2006 the Saeima adopted the Law “Amendments to the Tourism Law”. The amendments to the law prescribe that, as from January 1, 2008, tourist guide services in Latvia will be provided by persons with a certificate of professional qualification. Due to the planned Latvia’s joining the Schengen Treaty, as from January 1, 2007, the foreigners staying in tourist accommodation establishments will have to fill out declaration forms and to show an identity document. The amendments also include a new norm on classification of tourist information providers and on conformity assessment and certification of tourist accommodation establishments, prescribing that it is voluntary. At the same time, the terminology used in the Tourism Law is harmonised with the terminology used in the Commercial Law and the Law on Associations (Societies) and Foundations. In order to ensure the mentioned changes, the Ministry of Economics has started drafting the respective normative acts.

On March 17, 2006 the European Commission adopted the Communication in the field of tourism policy “A renewed EU Tourism Policy: Towards a stronger partnership for European Tourism”, which defines that the main aim of the renewed European tourism policy is to improve the competitiveness of the European tourism industry and to create more and better jobs inducing sustainable growth of tourism in Europe and globally (see Box 6.8).

Box 6.8

Communication „A renewed EU Tourism Policy: Towards a stronger partnership for European Tourism” of the European Commission.

The Communication indicates that the European tourism industry has to be formed responding to challenges of today and the necessity of sustainable development. Through implementation of the tourism policy outlined in the Communication, the EC will develop closer partnership between the EU, institutions of member states, and the tourism industry. The policy will be focussed on the following main fields:

1. **integration of measures affecting tourism:**
 - better legal regulation;
 - co-ordination of tourism policy;
 - improved use of the available European financial instruments;
2. **promotion of sustainable tourism:**
 - development of the European Tourism Agenda for the 21st century;
 - special support measures for sustainability of the European tourism;
3. **raising the awareness and visibility of tourism:**
 - improving awareness of the European tourism;
 - development of European tourist destinations;
 - forming complex vision of the tourism industry.

Latvia as EU member state will have to pay a special attention to integration of the renewed EU tourism policy. This concerns further activity both in public and private sectors.

2005 should be considered a record year in respect of tourism growth in Latvia (see Box 6.9).

According to the set priorities, measures supporting tourism development in the previous period were improvement of tourism infrastructure, promotion of development of new tourism products and services, and strengthening positions of Latvia as a tourist destination. However, the supply of tourism products is still insufficient and unbalanced in all country, it is one-sided and unattractive and thereby does not contribute to increase in the tourist flow.

The rapid development of tourism motivates to solve the issue of quality of the provided tourism services. Nonconformity of supply of tourist accommodation, catering, transport, tourist guides and other services as well as provision of the services with the rapidly growing demand has reduced competition and negatively affected the quality of provided services.

Along with the positive influence of the EU enlargement on development of tourism in Latvia, which cannot be overestimated, also some negative traits are observed. Competition has increased remarkably, therefore some small and micro enterprises may face insolvency or even bankruptcy. High inflation has caused rise of prices for tourism services thereby deteriorating correspondence of the value of provided services with the price, which until now was one of attractiveness factors. The partially opened EU labour market has resulted in outflow of specialists (especially young and skilled ones) to developed EU member states. On this account, the lack of skilled labour in the sector becomes even more pronounced along with the growing demand for labour force.

Evaluating the current situation and trends of tourism development, the following main priorities are set for the further period:

- to promote competition in the tourism sector and improve competitiveness of tourism companies;
- to develop Latvian tourism product and tourism information system;
- to encourage compliance with sustainable development principles in planning and implementation of the tourism policy.

Box 6.9

Indicators of Latvian tourism development

In 2005 the share of the tourism sector in Latvian GDP¹ was 1.8% just as in 2004. In the period from 2000 to 2003 a stable increase in the incoming tourism had taken place – by 9.3% on average annually. After Latvia's accession to the EU the tourist flow to Latvia has increased rapidly: in 2004 the increase in number of foreign travellers was 22.8% in comparison with 2003, while in 2005 the increase amounted to 24.4% in comparison with 2004 and the number of foreign travellers reached 3.774 million. Expenses of foreign travellers in Latvia were 190 million LVL in 2005 (increase by 33.9% in comparison with 2004). This trend of growth continues in 2006 as well. Statistical data for the 1st quarter of 2006 show that 845 thousand foreign travellers visited Latvia, which is by 30% more than in the corresponding quarter of 2005. The amount of expenses of foreign travellers has also grown by 32%. However, in spite of these positive trends, the indicators of tourism balance of payments have deteriorated considerably (expenses of Latvian residents during their trips abroad exceed expenses of foreign travellers in Latvia) and the number of foreign travellers staying more than 24 hours in Latvia has not increased (they still make merely about 30% of all travellers).

The number of hotels and other tourist accommodation establishments reached 418 in 2005 (increase by 22% in comparison with 2004), the number of beds rose to 24045 (increase by 13% in comparison with 2004). The number of nights spent in hotels and other tourist accommodation establishments has risen considerably, and the number of persons served has reached 1612671 (growth by 34% in comparison with 2004).

Results of a survey of Latvian residents about domestic travels indicate that 2.199 million people in Latvia went on recreation trips in 2005 (increase by 51.8% in comparison with 2004), while 97.2 thousand went on business trips (growth by 156.8% in comparison with 2004). Expenses of domestic travellers amounted to 158.3 million LVL (increase by 201.9% in comparison with 2004), making 45% of the total expenses of foreign and domestic travellers, and show the economic importance of the local tourism.

Growth of tourism sector in 2005 was mostly promoted by the following factors:

- Latvia's accession to the European Union (on May 2004);
- measures of Latvian tourism marketing in priority and prospective tourism markets;
- increased number of direct flights;
- expansion of low-cost airline services;
- increased number of tourist class hotels.

In order to popularise tourism products and local tourism and encourage potential travellers to visit Latvian regions as well as improve co-operation between tourism services providers and mass media, in April 2006 the Latvian Tourism Development Agency started the action „Latvian Travel Marathon”. Informative and instructive activities (among them the programme “Holiday Guide” on Latvian television), events-performances, sport and health-promoting activities, and other activities are conducted in the framework of this action in all regions of Latvia. The action will last until November, urging to visit more than 30 various tourism objects in total. For additional stimulation of business creativity, the competition “Tourism Merchant of the Year ‘2006” of the Ministry of Economics and the Latvian Tourism Development Agency competition of the best new tourism product will be conducted this year.

Latvian Tourism Development Agency continues improving the official Latvia tourism portal www.latviatourism.lv, and it is also envisaged to link it with the emerging state portal www.latvija.lv. The range of available information will be expanded (for example, with route planner and cartographic material), operativeness of information will be improved, and inclusion in the European tourist destinations portal www.visiteurope.com with its target audience in the distant tourism markets outside Europe will be continued. Through the use of the mentioned portal, Latvia is positioned not only as a new and attractive part of European tourist destinations, but also wider audience is attracted to the official Latvia tourism portal.

Latvian Tourism Development Agency carries out Latvian tourism marketing activities (participation in international tourism fairs, advertisement campaign in internet portals, publication of informative tourism materials, organisation of working seminars and visits of foreign tour operators and journalists) in the main tourism markets (Estonia, Finland, Germany, Lithuania, Russia, Sweden, United Kingdom), and several activities are also conducted in the prospective distant markets – USA and Japan.

¹ Preliminary results.

Attraction of investment to development of tourism infrastructure (including from EU pre-structural funds (PHARE) and structural funds (ERDF and EAGGF)), which was started in the previous years, continues. Latvian Tourism Development Agency continues to implement the project “Establishment of parking network and tourism information screens and booths” started in 2005, envisaging to put up 363 traffic signs and 35 tourism information stands during this year.

The Ministry of Economics will carry out quality assessment of services provided by tourist accommodation and servicing companies in order to determine what measures are to be taken in the future for improvement of the situation. Through analysis of conditions for provision of tourist guide services in other EU member states and their compliance with EU legal norms, the Ministry of Economics has envisaged to prepare an adequate base of normative acts for introduction of professional qualification requirements.

In order to ensure further international integration of Latvian tourism sector, representation of state interests and acquiring better practice, it is envisaged to develop international co-operation by taking part in the work of the UN World Tourism Organisation and the European Travel Commission as well as in the work of the Tourism Advisory Committee and the Tourism Sustainability Group of the European Commission in the framework of the EU. Most likely, Latvia will also participate in the European Commission’s demonstration project “European Tourist Destinations of Excellence” aimed at focussing attention on diversity of European tourist destinations and on their different and common values as well as supporting the final aims where economic growth is ensured by sustainable development of tourism. At the Baltic Sea region level, by participating in the work of Baltic 21 Tourism Task Force and in the Interreg III B project “AGORA – Network of Sustainable Tourism Development in the Baltic Sea Region”, in 2006 the Ministry of Economics will start a study “Tourism for all” and will begin drafting the national Agenda 21 of the tourism sector as well as will organise a meeting of project partners in Latvia on June 14-17 of this year.

From the point of view of Latvian tourism development perspective, the most important work in 2006 is related to preparation for the next programming period. The Ministry of Economics is working out the activity “Tourism” of the thematic axis “Improvements of public services and infrastructure as a precondition to balanced development of the country and its territory” of the draft National Strategic Framework Document for 2007-2013. This activity is aimed to promote strengthening and increased competitiveness of Latvia as a tourist destination, creating favourable conditions to complex development of tourism products and services. The EU SF financing allocated indicatively by the Cabinet of Ministers amounts to 42.3 million EUR. Planned investment directions are development of tourism products with national importance and development of tourism information system.

6.4. Business Environment

Business environment in Latvia is being consistently improved through development of the legal framework, harmonizing it with EU requirements and monitoring the effects of administrative procedures on business activity.

Reforms for improvement of business environment are estimated positively in various surveys, for example, in the survey “*Doing Business in 2006: Creating Jobs*” conducted by the World Bank Group, business environment of Latvia takes the 26th place among 155 countries. Besides, Latvia is among 12 countries, where the reforms have been introduced most actively, and this is a very positive estimation of measures conducted by Latvia for improvement of business environment, however, there are several procedures, where additional measures are necessary.

Since 1999 the **Action Plan for Improvement of Business Environment** (hereinafter – Action Plan) is worked out annually. The *Action Plan* is an inter-ministry policy planning document setting out directions for implementation of business environment policy as well as tasks, measures to be carried out, responsible institutions, indicators for assessment of how the tasks have been accomplished and their accomplishment terms. Problems included in the *Action Plan* and their solutions are identified through close co-operation with organisations representing entrepreneurs (Council of the Small and Medium-Sized Enterprises and Crafts, National Economy Council, Foreign Investors Council in Latvia) as well as through assessment of problems identified in business environment surveys. The *Action Plan* covers amendments to legal acts, revision and simplification of procedures, improvement of

co-ordination between various institutions, preparation and publication of information, as well as training of employees of public institutions. The *Action Plan* is based on a “reform cycle” that consists of: 1) identification of a problem, 2) dialogue between government/entrepreneurs, 3) decision-taking and 4) supervision and assessment of influence.

The Cabinet of Ministers has charged the Latvian Investment and Development Agency with supervision of implementation of the *Action Plan* and with institutionalisation of the dialogue between the government and business circles.

Directions and tasks of the *Action Plan* cover such spheres as tax policy and administration of taxes, improvement of legal environment for business, reduction of the number of procedures and the required time, and improvement of information accessibility.

Approximately 180 tasks in total have been contained in the *Action Plan* since start of its implementation, of which 90% are implemented, but the rest have become tasks to be carried out permanently. However, as data of the business survey show, substantial problems in development of production are created by costs of infrastructure services and certificational and environmental requirements.

The latest *Action Plan* for 2006 includes 23 measures structured in 5 sections:

- tax policy and administration;
- improvement of the legal environment of business activity;
- prevention of administrative obstacles in business activity;
- improvement of business support instruments;
- continuation of tasks of the previous *Action Plan*.

With the help of the *Action Plan* for 2006, it is planned to find solutions to such issues as reduction of time for settlement of issues with State Revenue Service, reform of the tax penalty system, development of e-government services, improvement of regulation of real estate transactions, and simplification of construction procedures.

In August-December 2005, the Ministry of Economics and the Latvian Investment and Development Agency in co-operation with the *Marketing and Public Opinion Research Centre SKDS* and the World Bank’s Foreign Investment Advisory Service (FIAS) conducted their regular (already the fourth) *survey to assess the measures of improvement of the business environment*. These surveys have served as one of stimuli for improvement of Latvian investment climate, and as a result of this the efforts of Latvia have become a source of experience for other countries and are highly appreciated both by the European Commission and the World Bank. Innovative methodology developed in Latvia has been used, also carrying out similar studies in other transition economy countries.

The survey consists of three main elements: *business survey, self-appraisal of the influence on business environment exerted by national and local government institutions and report of policy recommendations*. The business survey was conducted by the *Marketing and Public Opinion Research Centre SKDS*, by using methodology jointly improved by the World Bank/FIAS, Central Statistical Bureau, LIDA and SKDS. 701 company managers in Latvian cities and regions were interviewed in the survey.

The survey covered such spheres as starting business, licensing, environmental requirements, foreign trade, observance of working regulations, inspection activities, tax administration, state assistance to business activity and electronic services. The survey contained questions about administrative costs and time spent fulfilling requirements of supervision institutions during entrepreneurs’ daily business activity in phases of start-up, choice of location, and operation.

Results of the surveys allow to compare development trends of business environment, to identify spheres, where new reform programmes are needed, and to measure effectiveness of various activities for improvement of business environment. The survey helps both to develop measures of assistance to small and medium-sized enterprises and to find out the opinion of entrepreneurs about operation of state and local government bodies.

It is important to continue improving the **legal framework of entrepreneurship** through creation of uniform business-promoting legislation, stimulating the initiative of entrepreneurs, lessening the risk and enhancing the legal predictability.

On February 7, 2006 the government accepted the *Action Plan for Prevention of Problems in the Sphere of Real Estate Transactions*. The main problems, which are foreseen to be solved with the help of the *Action Plan* in the sphere of real estate, are:

- real estate transactions are not timely registered in the State Cadastral Register of Real Estates and in the Land Register;

- transaction value is artificially reduced, because the state fee is calculated from it;
- Land Register requires documents, which it could receive from other public institutions without making customer spend extra time for getting them;
- data bases do not contain the updated information about real estate, encumbrances, etc.;
- pre-emption rights of state and local governments are often circumvented in real estate transactions, etc.

The government has also accepted amendments to the Law “On Book-keeping”, which prescribe that, as from 2007, individual businessmen as well as peasant and fisher farms, whose turnover from economic transactions in the previous year does not exceed 200 thousand LVL, will not have to do book-keeping by double entry system.

Amendments to the Commercial Law prescribe to cross out the norms determining that an auditor has to be appointed in every capital company. Auditors will continue operating in those capital companies, whose statutes provide for this.

One of the priority goals of the government is the *reduction of tax burden* and simplification of tax administration procedures. According to Eurostat data published in February 2006, in 2004 the total tax burden in Latvia, made up from all taxes and social security payments, constituted 29.1% of GDP, which was the 2nd lowest indicator among all 25 EU member states.

On February 14, 2006 the Cabinet of Ministers conceptually supported gradual decrease of the personal income tax rate to 15% by 2009.

On May 15, 2006 a committee of the Cabinet of Ministers supported amendments to the Law “*On Taxes and Fees*”, which prescribe improvement of the tax penalty system by making it more effective and envisaging an opportunity to introduce flexible amounts of tax fines so that they would be proportionate to particular tax violations. It is foreseen, that the amendments will come into force from January 1, 2007.

Since April 2006, a system of electronic declaration has started operating at the State Revenue Service. It is possible to submit electronically to the State Revenue Service about 90% of all documents to be submitted, not submitting them in a paper form. In order to use these advantages, an agreement with the State Revenue Service has to be concluded.

6.5. Research and Innovation

In the National Lisbon Programme of Latvia for 2005-2008 (see Chapter 6.1), research and innovations is one of the main priorities for promotion of competitiveness of Latvia. Priority directions to increase the national innovation capacity are as follows:

- to create favourable institutional environment for innovative activity;
- to promote co-operation of science, education and the private sector;
- to support transfer of knowledge and technologies;
- to encourage development of new products and technologies, including promotion of entrepreneurs’ awareness of the intellectual property and its protection.

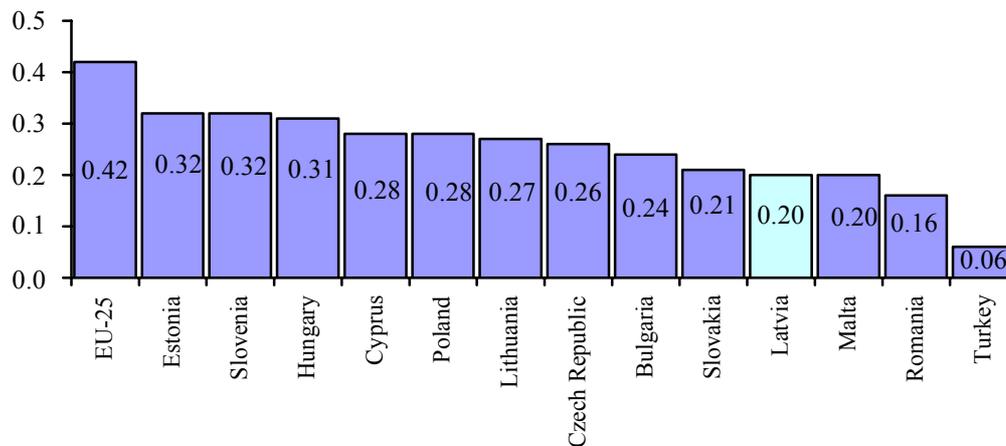
Amount of investment of the public and private sectors into research and development in Latvia is among the lowest in the European Union, and this is one of the main factors hindering development of applied research, commercialisation of research results and development of innovative commercial activity. In 2004 the total financing for research and development in Latvia equalled to mere 0.42% of GDP (1.93% of GDP in the EU on average). Research financing by the public sector made 0.23% of GDP, at the same time the existing system of research financing does not act as a catalyst that would attract private sector investment in research. In 2004 the private sector investment in research equalled to mere 0.19% of GDP (0.73% of GDP in the EU on average).

Assessing the progress achieved by EU member states in implementation of the innovation policy, the European Commission has published the new European Innovation Scoreboard 2005¹. Sweden and Finland have the best performance indicators in the EU, while Estonia and Slovenia score the best in implementation of the innovation policy among the new member states.

¹ The scoreboard includes 20 indicators which characterise development of human resources, processes of creation and application of new knowledge, and provision of the necessary funding. The indicators in the aggregate make the summary innovation index that allows to compare achievements of member states in implementation of the innovation policy.

Figure 6.9

The 2005 Summary Innovation Index of the New EU Member States and Candidate Countries



Source: European Commission, European Innovation Scoreboard 2005

The innovation index of Latvia has not changed substantially in the recent years, and Latvia takes the 30th place among the 33 surveyed EU member states and associated states. This is the fourth lowest index and indicates that the national innovation system of Latvia is poorly developed at present and considerably lags behind the average level of EU member states.

In 2003-2005 mere 18.6% on average of all companies in Latvia were innovative, while at the same time this indicator was 45% on average in EU countries. As hindering factors to innovation development in companies one would mention lack of entrepreneur awareness of the innovation role in the development of the company and in ensuring its competitiveness, insufficient availability of financial resources, especially the seed capital and risk capital, and the poorly developed mutual co-operation between companies both on local and international levels and co-operation between educational, research and industrial sectors.

In order to promote transfer of technologies and knowledge, in 2006 the support to operation of technology transfer contact points is continued at the University of Latvia, Riga Technical University, Latvia University of Agriculture, Rēzekne Higher Educational Institution and Ventspils University College.

The goal of contact points of technology transfer is to encourage co-operation of scientists and entrepreneurs and ensure efficient introduction of research results of state research institutions into production. Contact points of technology transfer accomplish the following main tasks:

- explore opportunities of the respective university and scientific institutes to provide research and product development services according to the needs of entrepreneurs;
- explore demand of companies for research results and co-operation opportunities;
- promotes co-operation of entrepreneurs and scientists in order to attract financing of the private sector for research work;
- ensures patenting for intellectual property created as a result of state financed research, ensures its protection and promotes its usage in the national economy;
- encourages establishment of new high technology companies on the basis of results of research conducted by Latvian scientists.

It is planned to grant 588 thousand LVL for financing of the mentioned projects in three years, including 240 thousand LVL granted for implementation of these projects in 2006. In the framework of contact points of technology transfer it is planned to prepare 95 commercialisation offers, initiate at least 70 co-operation agreements with entrepreneurs, and prepare 15 patent applications.

In order to encourage co-operation of science, education and the private sector, the Programme of Development and Improvement of the Applied Research Infrastructure was developed and its implementation has started. The aim of the programme is to support improvement of such research and development infrastructure, which would promote co-operation of commercial companies and scientific institutes. The following activities are supported in the framework of the programme:

- purchase and installation of new scientific equipment;
- design, repair and adjusting of the laboratory premises where the purchased scientific equipment will be placed.

Submitters of project applications of the programme may be state scientific institutes as well as higher educational establishments and scientific institutes founded by higher educational establishments, which may submit their projects to the ministry by July 15, 2006. In the framework of the programme it is planned to support at least 15 infrastructure development projects for the total amount of 2 100 000 LVL.

It is also envisaged to start implementing an innovation incubator support programme in the 2nd half of 2006 with a goal to promote establishment and development of new competitive companies. In the framework of the programme, support will be given both to the incubator management company and to new entrepreneurs and innovative companies, which are not older than four years. Incubator management companies will be able to receive a non-repayable grant for establishment, development and operation of incubator. Businessmen will be able to get support services free of charge or at a reduced fee from incubator management company. Businessmen will be provided with fully equipped office, seminar, laboratory or production premises and will be able to receive infrastructure services, consulting services on issues involving start-up of business and issues related to development of new products and technological processes. For implementation of the programme, the Ministry of Economics has developed the Cabinet of Ministers Regulation “Regulations on Procedure for Implementation of Support Programme of Establishment, Development and Operation of Innovation Incubators”.

6.6. Information Society

Information society is a social development phase based on free mutual exchange of information and developing a knowledge-based economy. Information society consists of the technological base (infrastructure, software), range of information services available to the society, and the level of individual skills and knowledge. As a result of development of information and telecommunications technologies, information and knowledge are more and more widely used in work and labour relations, education and everyday life.

With Latvia's accession to the EU, the European Union initiatives with regard to building the information society (see Box 6.10) have become binding for Latvia.

Box 6.10

European Union initiatives in building the information society

In December 1999 the European Union launched the initiative “*eEurope – an Information Society for All*”. In June 2000 the initiative was harmonised with Lisbon Strategy objectives and the *eEurope 2002 Action Plan* was worked out. The main three goals of this action plan were:

- cheaper, faster, secure internet;
- investing in people and skills;
- stimulate use of the internet.

As a result of implementation of the action plan in EU member states, in 2002 more than 90% of schools and companies had internet connection and more than half of all population used internet on a regular basis. However, the majority of individual users used dial-up access that is an internet connection with small speed. Therefore, the main goal in the *eEurope 2005 Action Plan* is a wide distribution of broadband data transfer in networks, which by 2010 should embrace at least 50% of all networks. The goals of the *eEurope 2005 Action Plan* are:

- development of public online services;
- development of e-government (broadband connections; interoperability; interactive public services; public procurement; public internet access points; culture and tourism; good practice framework);
- development of e-learning (broadband connections; eLearning programmes; virtual campuses for all students; university and research computer-supported co-operation system; life-long learning; exchange of best practice);
- development of e-health (health cards; health information networks; online health services; interoperability);
- development of e-business (legislation; SME; e-Skills; interoperability; trust and confidence; the “eu company”; M-payments; Digital Rights Management);
- promotion of e-inclusion;
- fostering security (cyber security task force; culture of security; secure communications between public services);
- distribution of broadband data transfer (spectrum policy; broadband access in less favourable regions; reduce barriers to broadband development; multi-platform content; digital switchover; national broadband strategies; introduction of the new Internet Protocol IPv6);
- benchmarking (adoption of indicators and methodology; evaluation of eEurope 2002 results; evaluation of eEurope 2005 results);
- funding of activities (European Commission programme e-Ten; European Commission strategic initiative IDA; cyber security programmes Promise / Modinis and ENISA; e-Learning programme; market-oriented programme eContent; market-oriented programme eContent plus; Safer Internet Action Plan);
- evaluation and review (contribution to Lisbon Strategy goals).

Box 6.10 continued

To boost development of digital economy, on June 1, 2005 the European Commission launched a new initiative “i2010: European Information Society 2010”, which is a strategy for the next 5 years. Its goal is to foster growth and jobs in the information society and media industries. 3 policy priorities are outlined in the initiative:

- to create and open and competitive single market for information society and media services within the EU;
- to increase EU investment in research on information and communication technologies by 80%;
- to promote an inclusive European information society.

To stimulate development of IT and use of advantages provided by them in all spheres of life, the government has set building the information society as an essential priority, envisaging to:

- 1) promote free competition in the market of information and electronic communication services, and ensure availability and wide choice of modern and efficient communication services for customers in the whole Latvia, implementing regulation of activity of dominant enterprises;
- 2) ensure rational and efficient use of limited national resources (radio frequency spectrum, numbering and addressing);
- 3) encourage education of the society in the area of information technologies, including as wide as possible mastering of computer usage skills, and stimulate acquisition of computers and internet connections, especially for small and micro enterprises and population, in order to promote computer skills and raise productivity;
- 4) implement public e-government, including electronic signature, at the same time aligning the public administration structure, eradicating unnecessary stages, ensuring transparency and increasing efficiency as well as broadening participation of the society in the public administration process;
- 5) ensure strong co-ordination in creation of various information systems with national importance;
- 6) promote growth of Latvian IT industry in areas of software and electronic devices development, production, supply and maintenance, as well as encourage export of these products.

Building the information society is set as a priority in the National Lisbon Programme of Latvia for 2005-2008 (see Chapter 6.1). The main planned activities for promotion of ICT and building the information society are the following:

- to encourage widespread use of ICT in public services, SMEs and households (see Box 6.11);
- to ensure the security of networks and information, as well as convergence and interoperability in order to establish an information area without frontiers;
- to encourage development of broadband networks, including the poorly served regions, in order to develop the knowledge economy.

Box 6.11**Computer and internet usage in Latvia**

According to data of the CSB survey “Computer and Internet Usage in Households”, 32% of all households¹ had computers and 31% of households had internet connection in 2005. 56% of inhabitants had ever used a computer and 49% of inhabitants had ever used internet. 42% of inhabitants² used computer on a regular basis and 36% of inhabitants used internet on a regular basis. 14% of all households had broadband internet connection.

At the beginning of 2005, 55% of all companies had computers, 42% of companies had internet connection, 11% of companies had their own internet website. 25% of all employees of companies used computer on a regular basis, while internet was used regularly by 18% of employees.

At the beginning of 2005 academic year, number of computers per 100 students at higher educational establishments and colleges was 10.7 (7.5 at professional education establishments and 6.2 at comprehensive schools). 100% of higher educational establishments and colleges, 87.4% of professional education establishments and 95% of comprehensive schools had internet connection.

On May 10, 2005 the Cabinet of Ministers approved the By-law of the Latvian e-Government Co-ordination Council, where promotion of updating the e-government strategic guidelines and fostering implementation of e-government projects are set as the main task of the Council. The functions of the Council also include providing information to state and local government institutions about activities in the area of e-government. According to the by-law, the Council will give opinions and recommendations on issues related to e-government to state administration bodies that are implementing e-government and will prepare proposals for solution of issues related to e-government.

¹ Households where at least one person in the age of 16-74 lives

² Inhabitants in the age of 16-74 years

On September 29, 2005 the Cabinet of Ministers approved the “Electronic Government Development Programme for 2005-2009”. The goal of the Programme is, through introduction of information technologies and optimisation of processes in the public administration:

- to improve quality and accessibility of state administration services and reduce the administrative and financial burden on the society;
- to create an efficient and economic state administration;
- to form an open and democratic administration enjoying confidence of population and involving them in its work.

On October 18, 2005 the Cabinet of Ministers approved the draft concept on selection of the bearer of safe electronic signature and on introduction of safe electronic signature in Latvia submitted by the Secretariat of the Special Tasks Minister for e-Government Affairs. The concept envisages that smart card is chosen as the bearer of safe electronic signature in Latvia. Secretariat of the Special Tasks Minister for e-Government Affairs has started developing criteria and proposals for distribution of 50 000 safe electronic signature certificates to employees of state and local government bodies, and has started activities required for carrying out the procedure of procurement of safe electronic signature certificates.

On February 28, 2006 the Cabinet of Ministers charged the Secretariat of the Special Tasks Minister for e-Government Affairs with preparing agreement on amendments to the contract on implementation of activities for introduction of safe electronic signature, which was concluded between the Republic of Latvia, SJSC “Latvijas Pasts” and LLC “Lattelecom” on June 15, 2005. These amendments to the contract specify the schedule of testing the electronic signature system, foreseeing that full-fledged operation of the system will be ensured as from September 2006.

In parallel with the establishment of safe electronic signature infrastructure, it is planned to create electronic services that would allow to implement circulation of electronic documents both in the private and the public sector, ensuring wide use of them. Great attention is paid to integration of safe electronic signature with the intended electronic services.

Electronic procurement is one of the electronic services. The Cabinet of Ministers has approved the following documents for implementation of electronic procurement (e-procurement) system in Latvia:

- on January 29, 2004, the concept “Use of Information Technologies in Improvement of Public Procurement System”, which envisaged to implement pilot project of centralised procurement (development and putting into operation of e-catalogue infrastructure);
- on October 5, 2005, the Concept of Electronic Procurement System, envisaging to establish an electronic procurement state agency in order to separate the functions of centralised procurement institution (provider of e-procurement system) from the supervisory functions of the Procurement Supervision Bureau;
- on December 6, 2005, the instruction on establishment of electronic procurement state agency and the by-law of this agency. The main tasks of the agency are to ensure for state and local government institutions an opportunity to use the system for carrying out procurement of standardised goods and services, organise activities in order to conclude general agreement on participation in procurement of standardised goods and services, and supervise fulfilment of general agreements;
- on April 6, 2006, the Saeima adopted the Public Procurement Law that sets the procedure for carrying out electronic procurement.

As from May 26, 2006, the Electronic Procurement State Agency ensures operation and development of e-procurement system.

On December 27, 2005 the Cabinet of Ministers adopted Instruction No. 839 “On the Concept “Broadband Network Development Strategy for 2006-2012””, supporting the concept’s A option, which envisages by 2012 to provide opportunity of broadband access to all target audience (for example, physical persons, state administration institutions, entrepreneurs, schools, hospitals, health centres) for acceptable price, embracing 85-95% of the territory of the country. Providing opportunity of broadband access includes improvement of the current electronic communication infrastructure, building the required infrastructure and maintenance of infrastructure.

On August 17, 2005 the Cabinet of Ministers approved the Basic Guidelines “e-Health in Latvia”. The Basic Guidelines is a single strategic document for various e-health projects. The Basic Guidelines envisage,

by using IT opportunities, to ensure operative exchange of healthcare information between the society, patient, healthcare specialists and policy builders and implementers, improve efficiency of healthcare services provision, and ensure credibility and safety of healthcare data.

On November 10, 2005 the Saeima adopted the Law “Amendments to the Law on Information Society Services”. The goal of the Law is to define what the electronic mail is as well as specify the ban on sending a commercial message, providing that it is banned to use (for sending a commercial message) automatic dialling (terminal) systems operating without human participation (automatic call equipment), electronic mail or fax machines (facsimiles) whose usage makes feasible an individual contact with service provider if the service recipient has not given a free and unambiguous agreement beforehand.

The Law designated the Data State Inspection as additional supervision institution for practical supervision of observance of norms of the Law on Information Society Services.

On June 6, 2006 the Cabinet of Ministers adopted the Regulations of Computer Games Distribution, which define the procedure of computer games distribution, envisaging to start labelling of computer games as from January 1, 2007.

On July 18, 2006 the Cabinet of Ministers approved the Guidelines for the development of the Information Society for 2006-2013 worked out by the Secretariat of the Special Tasks Minister for e-Government Affairs, setting lines of action for building the information society in Latvia.

Short-term priority tasks are:

- to develop territorial coverage of ICT access infrastructure;
- to make ICT more accessible financially for households and SME;
- to provide basic skills of ICT usage to individuals and incite them to use ICT;
- to create electronic services of state administration and use ICT in order to optimise administrative functions; ensure access to public information for local governments and entrepreneurs for provision of services and develop centres for provision of state administration services;
- to introduce e-signature and develop infrastructure of its usage;
- to support creation of online services and innovative, knowledge-intensive and environmentally friendly products.

Lines of long-term action for development of information society are:

- to expand the access infrastructure and promote ICT accessibility;
- to develop knowledge and skills of users;
- to develop services and content;
- to develop ICT usage in commercial companies and in innovation;
- to develop ICT science and research;
- to promote creation of export-capable ICT products and services.

Financing from EU structural funds and resources from the state and local government budget will be used for implementation of the development programme.

Conference “Information and Communication Technologies for Inclusive Society” took place in Riga on June 11-13 of this year. Ministerial Declaration was signed during the conference; this declaration is a joint political agreement of 34 countries to implement e-inclusion goals: to solve the needs of aged employees and other aged people, reduce the geographic digital divide, improve access to electronic services and promote the ICT usability, improve ICT usage skills and competence of the population, and encourage cultural diversity and development of inclusive electronic government. The first meeting of the e-inclusion subgroup of the EU initiative “i2010 – A European Information Society for growth and employment” also took place during the conference.

6.7. Small and Medium-Sized Enterprises

Small and medium-sized enterprises (SME) comprise a major part of national economy and play a significant role in the GDP growth and employment in Latvia like elsewhere in Europe (see Box 6.12).

Box 6.12**Number of small and medium-sized enterprises in Latvia**

According to provisional data, in 2005 there were 55 632 economically active businessmen and commercial companies in Latvia (excluding agricultural and fishing farms and self-employed persons, which perform economic activity), of which more than 99% fell in the category of SME. The distribution of economically active SME in Latvia according to their size is similar to the one in EU member states: micro enterprises – 78.1%, small enterprises – 17.8%, medium-sized enterprises – 3.6%. 69.9% of private sector employees are employed in SME, which create 63.2% of GDP.

Important indicator characterising economic activity is the number of performers of economically active businessmen and commercial companies per 1000 inhabitants. The indicator in Latvia has constantly grown in the last 5 years from 17 in 2001 to 23 in 2005.

It is of the same importance to accentuate the number of performers of individual piece-work (self-employed persons), which amounted to 36 344 in 2004 (16 per 1000 inhabitants), and the number of agricultural and fishing farms, which equalled to 13 850 in 2004 (6 per 1000 inhabitants). Taking into consideration the fact that among EU member states there is no single methodological practice for calculation of such indicator characterising economic activity as the number of enterprises per 1000 inhabitants, it is difficult to conduct objective comparative analysis of this indicator. The current practice of responsible EU institutions shows that calculation of the number of enterprises per 1000 inhabitants includes not only businessmen and commercial companies, but also performers of individual piece-work, agricultural and fishing farms, etc. Accordingly applying an analogous practice, Latvia had 44 performers of economic activity per 1000 inhabitants in 2004, which is close to the EU average.

Statistical data of the recent years indicate positive trends in growth of the number of newly founded enterprises. Lursoft data show that 10 221 newly founded enterprises were registered in 2004, while 11 009 newly founded enterprises were registered in 2005, which is by 8% more than in 2004. It is also forecasted that the number of newly founded enterprises in 2006 will grow by 10% in comparison with 2005, which on the whole may indicate efficiency of measures taken to ensure improvement of business environment and promotion of business development.

However, it is important not to forget that constant natural growth is inevitable in any free market conditions under certain objective positive circumstances, as in the case of Latvia, where favourable conditions for equable growth of the number of newly founded enterprises are already ensured with accession to the EU and substantially increased opportunities of local enterprises. Nevertheless, promoting establishment of newly founded enterprises does not suffice to ensure sustainable development. In order to ensure the rise of competitiveness, these newly founded enterprises have to be viable. Increase of the number of newly founded enterprises by years is variable. In 2004 it increased by 32.9%, which was greatly due to the necessity to reregister in the Commercial Register of the Register of Enterprises of the Republic of Latvia. In 2003 it increased by mere 19%, while in 2002 it even decreased by 15%. Statistical data show that the total number of enterprises increases by approximately half of the growth of the number of newly founded enterprises, hence indirectly indicating problems of their viability.

Assistance to SME in Latvia is regulated by the Law on Control of Aid for Commercial Activity, which is in force since January 1, 2003.

Box 6.13**Definition of SME**

The **Law on Control of Aid for Commercial Activity** lays down the definition of small and medium-sized enterprises (according to the European Commission Regulation No. 70/2001 and amendments to the European Commission Regulation No. 364/2004):

Medium-sized enterprises:

- number of employees from 50 to 249;
- annual turnover does not exceed 50 million EUR;
- total balance sheet value is under 43 million EUR.

Small enterprises:

- number of employees from 10 to 49;
- annual turnover does not exceed 10 million EUR;
- total balance sheet value is under 10 million EUR.

Micro enterprises:

- number of employees from 1 to 9;
- annual turnover does not exceed 2 million EUR;
- total balance sheet value is under 2 million EUR.

The main problems hindering development of SME in Latvia are the following:

1. Business environment. Competitiveness of the SME sector cannot develop without favourable environment to business activity, and this is greatly determined by competitiveness of the state tax policy, efficiency of the capital market, infrastructure, educational system and state aid, as well as alignment and stability of business legislation. Results of business surveys and discussions of meetings and conferences of non-governmental organisations representing SME interests allow to come to a conclusion that many of these factors in Latvia are unfavourable to business development.

2. Availability of finances. Although opportunities to receive external financing have recently increased to a considerable extent, access to current and capital financing is a significant obstacle to increase in business activity and competitiveness of small and medium-sized enterprises and among business beginners. Guarantee and investment funds are still insufficiently developed. Problems in the field of external financing availability are more pronounced outside Riga, problem of availability of finances have an explicit territorial dimension.

3. Human resources. SME often face problems in the choice of personnel: insufficient business management skills, knowledge on management and business and technical knowledge, to be able to develop business plans of high quality and value; insufficient level of knowledge about financial and money flow management; and poor culture of business organisation while working in the global economy. Shortage of highly skilled labour force is observed in most sectors of the national economy.

4. Competitiveness of SME. Latvian enterprises, working with EU directives on quality, lack information about product standards and new production methods, and also this is a topical issue. Product quality assessment instruments are not available in Latvia.

5. Regional differences. In the last ten years, negative trends are observed in socio-economic development of Latvia, namely, rapid development of Latvian economic centres and stagnation or even regress in development of the other territory at the same time. This has created increased differences between cities and rural areas as well as between the central part and periphery of the country. Integrated development of rural areas, including development of non-agricultural business activity, is a necessary precondition for balanced development of the country.

6. Administrative capacity of public and non-governmental organisations for development and implementation of SME policy and for absorption of the EU Structural Funds is insufficient at present. The main reasons for that are: insufficient opportunities of financing from the state budget, lack and high changeability of human resources, insufficient competence and qualification of policy developers and implementers, as well as lack of training of the existing and potential specialists.

On January 27, 2004 the Cabinet of Ministers approved the “**Basic Guidelines of the SME Development Policy in Latvia**” (hereinafter – Basic Guidelines). This document lays down the basic principles of activity of the government, long-term objectives and tasks, as well as the main directions of the SME development policy. The goal of the *Basic Guidelines* is to ensure promotion of favourable environment for business activity, spur initiative of entrepreneurs and lessen the total risk, prevent obstacles to business activity, and foster stability and efficiency of the financial system and capital market, in order to improve competitiveness of enterprises in the market.

The *Basic Guidelines* foresee implementation of policy based on the best practices of companies of the developed countries in accordance with the activities outlined in the European Charter for Small Enterprises (see Box 6.14), at the same time also taking into account the specifics of SME development problems in Latvia.

Box 6.14

European Charter for Small Enterprises

On June 19-20, 2000 the European Council meeting in Feira approved the **European Charter for Small Enterprises**, thereby its member states affirmed their commitment to work according to 10 lines of action of the Charter by integrated promotion of establishment of conditions and factors, which determine development of business activity. These lines of action are:

1. education and training for entrepreneurship;
2. cheaper and faster establishment of enterprises;
3. more efficient legislation and regulation;
4. availability of training;
5. improving internet access;
6. gaining more out of the Single Market;
7. taxation and financial matters;
8. strengthening the technological capacity of small enterprises;
9. making use of successful e-business models and developing top-class small business support;
10. developing stronger, more effective representation of the interests of small enterprises at the EU and national level.

For implementation of the *Basic Guidelines*, the Cabinet of Ministers approved the “**Programme on Development of Small and Medium-Sized Enterprises of Latvia in 2004-2006**” on May 25, 2004.

To implement the *Programme*, the following actions are envisaged:

- creation of favourable environment for entrepreneurial activity, especially in relation to SME;
- promotion of availability of finances for development of small and medium-sized business;

- development of human resources and new business initiative;
- promotion of competitiveness of SME;
- analysis of the business environment and development of additional measures for areas with a relatively low index of socio-economic development. Implementation of these measures is planned in close connection with the plans for absorption of the financial resources from the EU Structural Funds.

For the majority of the entrepreneurial activity assistance measures envisaged in the *Programme*, attraction of **co-financing from the EU Structural Funds** is planned (see Chapter 6.2.1). It is possible for Latvian businessmen to submit their projects to the following state support programmes for 2004-2006 administered by the Latvian Investment and Development Agency:

1. support to consultations and participation of commercial companies in international exhibitions, fairs and trade missions;
2. support to development of new products and technologies;
3. support to modernisation of commercial activity infrastructure;
4. support to raising qualification of employees, their retraining and further education.

The *Mortgage and Land Bank of Latvia* (MLBL) plays an important role in the SME support system. Since 2000 MLBL helps to introduce and implement the **Programme of Crediting Latvian SME Development**. The insofar implementation of the programme has substantially promoted accessibility of capital to SME and has encouraged more active involvement of commercial banks in offering loans to SME.

On November 26, 2002 the Cabinet of Ministers approved the Programme of Crediting Latvian SME Development (second phase) for the next three years, foreseeing state guarantees in the amount of 20 million LVL to MLBL in order to enable the bank to borrow the necessary resources for crediting SME in the financial market. On January 21, 2004 MLBL started crediting in the framework of the Programme of Crediting Latvian SME Development (second phase). Funding projects of specific SME (business beginners, rapidly growing SME, SME in regions requiring special assistance, and female SME) supported in the framework of EU programmes is continued in the framework of the Programme of Crediting Latvian SME Development (second phase).

By the 1st April of 2006 in the framework of the Programme of Crediting Latvian SME Development (first phase), MLBL has granted 998 loans for the total amount of 48.5 million EUR, which promoted creation of approximately 2800 new jobs. By the 1st April of 2006 in the framework of the Programme of Crediting Latvian SME Development (**second phase**), MLBL has granted 960 loans for the total amount of 48.4 million LVL, which promoted creation of 2990 new jobs and establishment of 158 new enterprises.

At the beginning of 2005 a separate structural unit, the Administration of Support Programmes ALTUM, was established in the framework of MLBL operation for consolidation and growth of business support functions. ALTUM implements support programmes financed by the state and the EU, granting high-risk loans to viable and perspective projects of SME and business beginners, which are not financed by commercial banks due to insufficient collateral and other risks of the project. ALTUM also implements other support programmes, among them the programme of training and consultations for business beginners and the housing guarantee programme. In 2005 ALTUM operated in a test regime, implementing a pilot programme of SME crediting. By the 1st April of 2006, ALTUM has granted 47 loans for the total amount of 4.39 million LVL in the framework of the pilot project.

Crediting Programme for Beginners was started in March 2006, which is co-financed from finances of the state and EU Structural Funds. So far, 5 million LVL from the state budget have been granted for implementation of the programme. Through attraction of bank resources it will be possible to grant loans to business beginners for the total amount of 10 million LVL during 2006.

By the 1st April of 2006, special assistance loans in the framework of special programmes have been granted to 510 SME for the total amount of approximately 23 million LVL. Most of special assistance loans were granted to SME in the regions requiring special assistance (approximately 10.3 million LVL), business beginners (about 4.7 million LVL), female enterprises (approximately 3.7 million LVL) and rapidly growing SME (about 4.3 million LVL).

Since 2003 a full-fledged work is being done by the *Latvian Guarantee Agency* (LGA). LGA is a state-supported institution with a goal to support development of business activities of small and medium-sized enterprises (commercial companies) registered in Latvia by promoting availability of

credit resources and issuing medium-term and long-term loan guarantees in its name to financial institutions registered in Latvia or abroad, which are financing these enterprises.

During 2005 the LGA participated in 34 informative seminars (about 1500 participants in total) in order to inform both entrepreneurs and credit structures about loan guarantees. In the framework of improvement of the loan guarantee system, the procedure for review of applications was optimised, speeding up review of guarantee applications within the LGA. In 2005 the LGA issued guarantees to 20 enterprises for the total amount of 894 900 LVL. This enabled entrepreneurs to attract investments in the form of credit resources for the total amount of 1 810 999 LVL. In the 1st quarter of 2006 the LGA has issued guarantees to 8 enterprises for the total amount of 471 957 LVL, and this enabled entrepreneurs to attract investments in the form of credit resources for the total amount of 1 218 585 LVL. In total, guarantees to 28 enterprises were issued for the total amount of 1 366 857 LVL, which enabled entrepreneurs to attract investments in the form of credit resources for the amount of 3 029 584 LVL.

In 2005 the European Commission (EC) approved the State Support Programme for development of risk capital, which was worked out by the Ministry of Economics. In 2005 LGA announced a tender for selection of risk capital fund management companies in the framework of the State Support Programme: 3 winners of the tender were chosen and contracts were concluded with them; the contracts foresee to establish 3 risk capital funds co-financed by the state, which could start investing in the 4th quarter of 2006 already.

Training of businessmen and business beginners and their providing with information about issues topical to them was continued in 2005. Support was provided to consultations rendered to entrepreneurs of Latgale about preparing applications for finances from the Structural Funds, preparing project applications and submitting them to the Latvian Investment and Development Agency. A study about identification of administrative procedures hindering SME development and identification of tax burden was conducted, indicating the development-hindering factors in this area. Analysis of business development was performed, broken down by sectors and regions. Research and analysis of situation in development of female business activity in Latvia were done, conducting the study “Woman in Business”, and introduction of the Mentoring Programme to Encourage Female Entrepreneurship was supported in Latvia. In order to inform businessmen about the practical support opportunities of the EU Structural Funds for raising professional skills and improvement of technology processes in enterprises and about software used by enterprise management for optimisation of work and increase of competitiveness, the conference “Day of Knowledge for Entrepreneurs 2005” was organised in Riga and business forums were held in Kuldīga, Jelgava, Aizkraukle, Rēzekne, Gulbene and Limbaži, as well as 10 regional seminars on availability of financial instruments were organised in Alūksne, Madona, Talsi, Tukums, Saldus, Jēkabpils, Bauska, Līvāni, Krāslava and Balvi.

On June 19-20, 2000, EU member states approved the European Charter of Small Enterprises at the European Council meeting in Feira. This is one of the most important political documents of the EU for achieving the Lisbon goal. It recognises the great role of small enterprises in development of competitiveness, innovation and employment spheres, and they also constitute the driving force for social and local integration in Europe and the base of national economy growth. Latvia joined the Charter on April 23, 2002 by signing the Maribor Declaration in Slovenia together with other EU candidate countries, thereby pledging to work in accordance with 10 lines of action of the Charter. In September of the same year Latvia joined the Multiannual Programme for Enterprise and Entrepreneurship, and in particular for Small and Medium-Sized Enterprises (2001-2005). In the framework of the multiannual programme, a complex set of activities within the mentioned three lines of action was performed in Latvia, hence effectively overcoming obstacles that hinder development of the small and medium-sized business activity in Latvia.

6.8. Competition Policy

Competition is one of the key elements of the market economy, but market participators' actions that hinder, restrict or distort competition and contradict interests of the society are possible in the market economy as well. Competition policy is made by a set of normative acts and policy instruments implemented by the state, which prescribe to protect market participators and consumers against actions that are turned against competition.

The Competition Law of Latvia defines norms to be observed by market participants, and the Competition Council has to exercise control in order to protect, maintain and develop free, fair and equal competition in all sectors of national economy to public benefit. The Competition Law norms applicable to market participants consist of four blocks:

- characteristics and prohibition of prohibited agreements;
- characteristics and prohibition of the abuse of dominant position;
- rules of supervision and control of company merger;
- characteristics and prohibition of unfair competition.

The Competition Council, within scope of its mandate, also assesses possible violations of the Advertising Law, namely, if norms set for misleading and comparative advertising are observed in advertisements distributed by market participants.

Functioning of the Competition Law – procedure for examination of law violations, merger procedure, etc. – is ensured by several regulations of the Cabinet of Ministers. Regulation “Regarding Exemption of Individual Horizontal Co-operation Agreements from the Agreement Prohibition Specified in Article 11, Paragraph One of the Competition Law” accepted in April 2006 regulates types of agreements (decisions and concerted action) of individual market participants. This regulation sets the criteria, according to which individual horizontal co-operation agreements concluded between two or more market participants are exempted from the agreement prohibition, namely, are permitted, as well as envisages to exempt market participants from the obligation to notify to the Competition Council individual horizontal co-operation agreements if they will correspond to criteria set in this regulation, thereby simplifying the administrative procedures. The exemption may be applied to specialisation agreement, agreement on co-operation in production of common goods, agreement on co-operation in research and development, and agreement on common standards of goods between market participants. Conclusion of such agreements fosters increased competitiveness of small and medium-sized enterprises, but competition may be hindered, restricted or distorted if such agreements or network of agreements covers a big share of the market. The regulation specify that the mentioned agreements are permitted only if market shares of the market participants involved in the agreements do not exceed the specific thresholds of market shares mentioned in regulations of the Cabinet of Ministers. Such regulations regarding horizontal co-operation agreements have not been before.

The Competition Council has developed the medium-term action strategy for 2007-2009 and, from 2006 already, develops its activity purposefully in three basic directions. Directions of activity and priorities will give an opportunity not only to apply more efficiently the competition legislation for prevention of possible or existent distortions of competition, but also to preventively protect the market from possible distortions in the future.

The 1st direction of activity is related to more effective protection of competition. Prohibited agreements and abuse of dominant position, which do the biggest harm to competition and consumers, are considered the gravest violations of the Competition Law, so more attention will be paid to these violations. In compliance with EC positions on competition protection issues, the fight against cartel agreements is defined a priority also in Latvia.

The 2nd direction of activity is related to promotion of competition. Promotion of competition is especially important in various sectors of national economy, where a deficit of competition occurs or competition is difficult due to various administrative and other obstacles. This is one of the fields, where competition policy is of essential importance not only in economic processes, but also in political processes, because distortions in individual national economy sectors are frequently initiated as a result of political decisions. Promotion of competition requires, firstly, to establish what kind of restrictions hinder development of particular sectors, and only afterwards one can assess how to prevent them. Prevention of competition distortions is impossible without involving sectoral policy builders, market participants and the society. In the next years, the Competition Council plans to direct its activities more towards the supervision of market sectors and building the competition culture in the society. Action strategy of the Competition Council envisages increasingly active operation of the institution through intensified observation of markets and identification of those sectors, which are tended towards market distortions, preventively excluding the possibility of emergence of competition distortions already at the level of normative acts developed and activities accepted by public administration or local government. The Competition Council will primarily supervise those sectors that most directly affect purchasing power of consumers and where market liberalisation processes continue.

The 3rd direction of activity is directed towards strengthening the role of the Competition Council in development and implementation of EU legal acts and in international organisations and networks. The Competition Council will use the opportunities provided by its participation in competition institution networks of the EU and the world, ensuring full-fledged operation of Latvian and EU internal market and existence of free competition. Co-operation with competition protection bodies of the EC and other countries in examination of common cases and exchange of experience will continue in order to ensure unified approach to implementation of competition protection measures in Latvia as well as in the EU internal market and in relations with third countries.

In the 1st half of 2006 the Competition Council has established several significant violations of competition rights, which limit competitiveness of other market participants.

In May 2006 the Competition Council has established prohibited agreement in actions of 12 advertising agencies in advertising market of Latvia. It was discovered, that representatives of advertising agencies have exchanged information about minimal and maximal prices of services and products provided by advertising agencies and about rules of their sale. According to the Competition Law, exchange of the mentioned information between market participants is prohibited. The Competition Council imposed fines in the amount of 169 639 LVL to 12 advertising agencies for the mentioned violation (Decision No. E02-41 adopted by the Competition Council on May 8, 2006). Agreement between competitors about exchange of information regarding prices or sale conditions is considered a horizontal cartel agreement and qualified as especially grave violation of competition rights. Such actions unambiguously create unequal conditions of competition for other entrepreneurs, because exchange of information on prices allows to form partially or fully concerted price policy, e.g., maintain prices higher than in case if market participants implemented competitive price policy.

In May 2006 the competition supervision body imposed fine in the amount of 33 154.16 LVL to the SJSC “Latvijas pasts” for the abuse of dominant position because the company has included provisions distorting competition and fostering exclusion of competitors from the market into contracts with press publishers concluded in 2005 and 2006. Taking into account that “Latvijas pasts” has a dominant position in the market of provision of press subscription and delivery services (its market share remarkably exceeds 40%), the SJSC “Latvijas pasts” has to observe several restrictions specified in the Competition Law so that actions of the company would not restrict and distort competition to disadvantage of consumer or other participant of the market. The Competition Council came to conclusion that the SJSC “Latvijas pasts” has included such provisions into contracts with press publishers that conclusion, alteration or termination of a contract with press publishers depends on whether this press publisher assumes additional obligations that by their essence and commercial usage do not refer to the particular deal, namely, such actions are to be assessed as tying (Decision No. E02-40 adopted by the Competition Council on May 2, 2006).

The Competition Law also provides the obligation that market participants, who have decided to merge, shall, prior to merger, submit a notification of the planned deal to the Competition Council if one of the following conditions exists: (1) the combined turnover of the participants in the merger during the previous financial year was not less than 25 million LVL; (2) the combined market share of market participants involved in the merger exceeds 40% in the particular market. In the 1st half of 2006 the Competition Council has allowed six mergers notified by market participants as it acknowledged that the merger would not result in negative consequences in any particular market, thereby there is no reason to restrict the merger. Companies merged in the market of retail trade in medicines (pharmacies), market of retail trade in mobile phones, market of wood particle boards, market of production and sale of metal and steel products, and market for bread. Decision has been also taken to impose fine in the amount of 20 250 LVL to a company that did not notify the planned merger to the competition supervision body in time. The Competition Law provides the obligation to notify the deal prior to merger, and the company did it already after conclusion of the actual deal (Decision No. E02-17 adopted by the Competition Council on March 15, 2006). The Competition Council forecasts that, with trade acquiring a global character and aggravation of competition, the number of company merger cases examined by the competition supervision body will continue growing.

Merger of companies frequently provides a positive economic effect and evident benefit not only to the involved market participants but also to consumers and the society on the whole, for example bigger production units can create cheaper products than smaller ones, at the same time not reducing the quality of products, because purchase of raw materials in bigger amounts for lower prices reduces costs and thereby also the price of the end product. As a result of company merger, also production and

distribution methods can be improved, production can be streamlined and administration costs can be reduced, which in turn ensures internal economy and decline of production costs to consumer's benefit.

In the 1st half of 2006 the Competition Council has established several violations of the Advertising Law in advertisements distributed by mobile telecommunications operators, namely, three advertisements were recognised misleading. The competition supervision body has imposed fine in the amount of 8000 LVL for the established violations (Decisions of the Competition Council No. 1, 7 and 20). According to practice of the Competition Council, an advertisement is recognised misleading, firstly, if it provides information not conforming to actual conditions and not based on evidence. Secondly, an advertisement, where information essential to consumers has been concealed, is considered a misleading one. Thirdly, also an advertisement presented in a way, that may mislead directly or indirectly, is misleading.

Fines imposed by the Competition Council to market participants have to be transferred into the state budget.

In 2006 the Competition Council has focussed more actively on protection of various markets for goods and services. With aggravation of fight between market participants, prohibited means are often used, which may negatively affect opportunities of equal competition between entrepreneurs, e.g., companies agree about setting prices or tariffs or about distribution of markets. The aim of supervision is to explore competition conditions in particular markets in order to establish whether fair and efficient competition functions in the market and, in case of necessity, to give proposals for promotion of competition and market development. If, in the framework of market protection, facts of possible violations of competition rights in actions of companies become known, the Competition Council starts investigation of a particular case on its own initiative.

At the end of 2005 and in 2006 the Competition Council summarised results of market supervision, e.g., in the bread market (see Box 6.15) and the fuel market (see Box 6.16). The mentioned markets have a similar market structure – remarkably bigger market share is taken by merely three or four market participants, while the rest of the market is shared between many small market participants. Supervision of several other markets important for the society is started, e.g., the Competition Council has conducted surveys in the market of pharmacy and pharmacy services, market of cement production and wholesale trade, dairy market, press market, market of repair works of the means of transport, market of compulsory insurance of civil liability of owners of road transport vehicles, market of hotel services, etc.

Box 6.15

Competition trends in the bread market

In the last years, many consumer goods markets in Latvia are influenced by new forms of consumption and growing cross-border competition, which could reduce prices and consumers could benefit. However, the bread market is little influenced by competition from other EU member states, because the bread market is a local one in its essence. Also the consumption of bread in Latvia is not growing in the recent years, thereby the bread market is to be characterised as a static one.

High concentration of the market is one of the main conditions influencing competition and is an indicator of insufficient competition. In the structure of Latvian bread market, more than half of the market is taken by four biggest bread producers – JSC “Hanzas maiznīca”, LLC “Fazer maiznīca”, JSC “Maiznīca Dinella” and LLC “JLM Grupa”, while the second half is taken by almost 100 small and medium-sized enterprises. The Competition Council admits that the bread market may not be considered concentrated, because the total market share of the four biggest market participants in 2005 fluctuated in the range of 50 to 60%, thereby the Competition Council assesses the competition level in the bread market as satisfactory.

In 2005 concentration process began in the bread market. Information about merger of the JSC “Jelgavas Maiznieks” and the JSC “Liepājas Maiznieks” was submitted to the Competition Council. In this case, merger notification criteria specified in the Competition Law were not reached, thereby agreement of the competition supervision body to the deal was not necessary.

The concentration process in the bread market also continues in 2006. New deals of market participant mergers are being implemented and some participants leave the market, e.g., two bakeries were closed in the 1st half of 2006. The competition supervision body forecasts that competition between the four biggest bread producers will intensify but, at the same time, an oligopoly may develop in the market. The Competition Council indicates that, with involvement in bread production, also supermarkets gradually become participants of the bread market.

It has to be noted that in 2006 the Competition Council has also established violation of agreement prohibition in actions of the bread market leader JSC “Hanzas maiznīca”. By carrying out supervision of the bread market, the Competition Council acquired information that in 2004 and 2005 the JSC “Hanzas maiznīca” organised promotional campaigns in all territory of Latvia and during them individual types of bread were sold to retailers with a retail price label already on the product's wrapping. Retailers undertook to resell products of the JSC “Hanzas maiznīca” to consumers for such fixed price, which allowed the bread producer to control retail prices and increase its influence in the market. In March 2006 the Competition Council took decision to impose fine in the amount of 11 709 LVL to the JSC “Hanzas maiznīca” for the established violation of the Competition Law in actions of the company, which were manifested as fixing resale prices in the retail market for bread in the territory of Latvia (Decision No. E02-25 adopted by the Competition Council on March 29, 2006).

Box 6.16

Competition trends in the fuel market

Trend of decreasing number of market participants is also observed in the retail market for fuel. Both in 2005 and 2006 in Latvia there is a situation that big traders take over filling stations of small companies, hence networks of big retailers often expand at the expense of driving out small fuel traders, for example the biggest market participants LLC “Latvija Statoil” and LLC “Neste Latvija” buy over petrol stations of smaller participants.

Decrease in the number of market participants is also encouraged by the entry of big fuel traders into small towns of Latvia, where small traders cannot compete with the big companies. A striking example was February and March of 2006, when considerable fuel price fluctuations took place and the big fuel traders could maintain prices lower than in wholesale trade, thereby the small traders were forced to reckon with it and incur losses. Fuel in wholesale trade also costs more for the small companies, because they purchase it from intermediaries unlike the big companies, which buy fuel from its producer in big amounts thereby achieving lower fuel price.

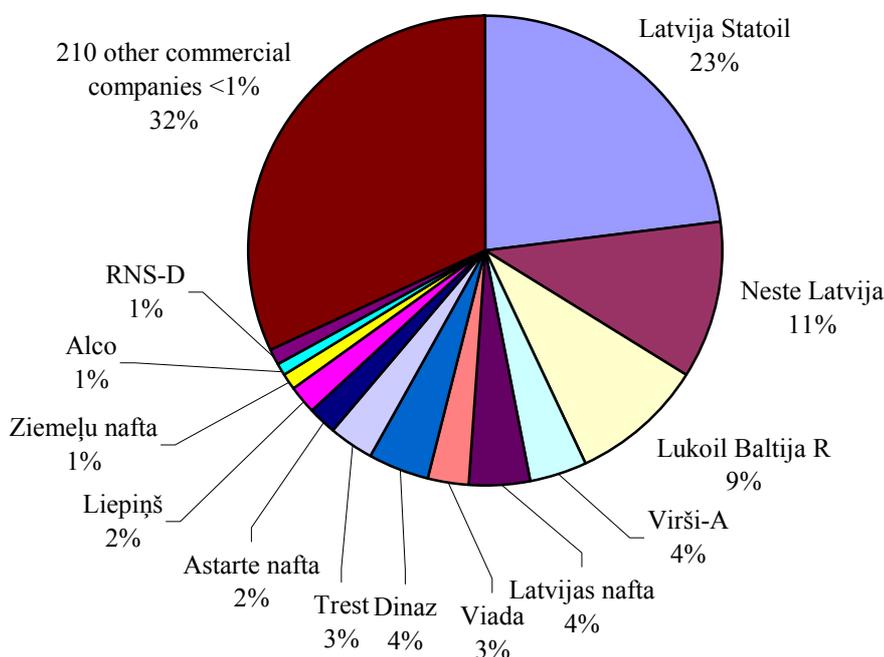
In the framework of fuel market supervision, the Competition Council has concluded that 22% of all petrol stations in the territory of Latvia are situated in Riga while one-third or 34% of petrol stations are concentrated in the biggest cities of Latvia.

Participants of fuel retail market of Latvia may be divided relatively in three big groups: (1) “market leaders” – LLC “Latvija Statoil”, LLC “Neste Latvija”, and LLC “Lukoil Baltija R” with their total market share of 43%; (2) medium-sized market participants – 10 commercial companies with their total market share of 25%, while a market share of each commercial company makes 1% to 4% of the particular market; (3) other commercial companies – small market participants with their total market share of 32%, while a market share of each commercial company does not reach 1% of the total market (see Figure 6.10).

Through analysis of fuel amounts sold by each commercial company, it was discovered that a marked main leader of the retail market is the LLC “Latvija Statoil”, whose market share (taking into account the amount of sold fuel) is 23%, while the market shares of the next two biggest competitors are about two times less. If to compare market shares of traders involved in fuel retail trade and their changes from 2003 until 2005, one can conclude that the LLC “Latvija Statoil” has kept its leading position with 23% of the market in this period, while the LLC “Neste Latvija” has increased its market share from 9% to 11% and the LLC “Lukoil Baltija R” has increased its market share from 8% to 9%. The Competition Council concludes that market shares of the “market leaders” tend to grow.

Figure 6.10

Fuel Market Shares of Commercial Companies in 2005



6.9. Regulation of Public Utilities

According to the Law “On Regulators of Public Utilities”, a two-tier regulation system of public utilities is established in Latvia and the sectors regulated at the state level are separated from the sectors regulated at the local government level.

The Public Utilities Commission (hereinafter the Commission) regulates public utilities at the state level, while the local government regulators regulate local providers of services in the respective municipal territories and supervise sectors of municipal waste management (with the exception of municipal waste processing), water supply, sewage, and heat supply (except combined heat and power). It has to be noted that the Commission does not supervise the local government regulators and is not authorised to influence their operation.

The Commission is a multi-sector regulator that performs regulation functions in energy, electronic communications, postal services, and railway transport sectors. The task of the Commission is to ensure to all users the possibility to receive uninterrupted and safe services for economically reasonable prices and to ensure to businesses providing public utilities the opportunity to develop with profitability according to the economic situation. An important part of the Commission's work is promotion of competition in the regulated sectors. The Commission adopts its decisions independently and is not subject to decisions of the government or other state institutions. 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 repeal them. Activities of the Commission are financed from the duty paid by businesses on the basis of the annual net turnover of regulated public utilities.

Functions of the Commission include regulation of regulated sectors and businesses that operate in the regulated sectors, protecting interests of users and promoting development of public utility providers, setting tariff calculation methodologies, approving tariffs, issuing licenses and registering general authorisations, promoting competition in regulated sectors, carrying out extra-judicial settlement of disputes, supervising compliance of the provided utilities with license conditions and specified quality requirements.

On January 4, 2006 the concept on establishment of an efficient public utilities regulation model the best suitable for the situation in Latvia was accepted by the Cabinet of Ministers. In order to reach this goal, a unified system for regulation of public utilities will be established in Latvia. The concept envisages that, in order to ensure uniform consideration of issues related to public utilities regulation in the country, decisions will be taken by the Board of the Public Utilities Commission, while the necessary obtaining and assessment of information, preparation of decisions and control over their execution will be ensured by executive body, which will include regional structural units of the regulator. Regional structural units will be formed on the basis of already existing local government regulators, taking over specialists in this field and optimising the number of structural units as much as possible.

Also operation of the unified regulator Public Utilities Commission will be financed by revenues gained through collection of state duty for regulation of public utilities. Through introduction of the unified regulation system, it is envisaged that the maximum amount of state duty will be reduced from 0.4% to 0.2% of the net turnover of public utilities provided by a business during the previous calendar year in regulated sectors, where public utilities are currently regulated by local government regulators in conformity with normative acts in force.

The situation and policies in the regulated sectors

Energy sector

In the energy sector, electricity supply and gas supply are regulated by the state. The dominant role in the electricity supply is played by the state JSC "Latvenergo" that generates more than 90% of electricity generated in Latvia and ensures import of electricity, its transmission, distribution and delivery to users. Electricity is also generated by about 150 small hydropower stations with the total output of 25 MW and 14 wind power stations with the total output of 25.2 MW. Among 36 independent cogeneration plants, there are three biogas power stations with the total output of 7.77 MW and wood cogeneration plants in Krāslava, Rīga and Sarkanī (Madona district) with the total power of 2.15 MW. Along with the state JSC „Latvenergo”, 10 licensed businesses carry out distribution or sales of electricity.

Since July 1, 2004 all electricity users, with the exception of households, have the opportunity to choose alternative suppliers of electricity, however no user has changed supplier of electricity.

On January 25, 2006 the Commission approved new electricity sales end tariffs (differentiated tariffs) that came into force on March 1, 2006. The increase of tariffs was mainly determined by the rise in prices of natural gas and imported electricity as well as by other factors, e.g., changed tariffs for network services and increased volume of compulsory purchase energy.

Supply of natural gas in Latvia is ensured by vertically integrated JSC "Latvijas Gāze", while about 70 companies compete in supply of liquefied gas.

In view of the lack of competition in natural gas supply, regulation of all consumer tariffs is reasonable also in the future. The regulation process ensures higher stability of tariffs, balancing interests of supplier and users as much as possible.

On March 22, 2006 the Commission approved new natural gas tariffs that came into force on May 1, 2006. The increase of tariffs was determined by the sharp rise in the price of natural gas received from “Gazprom”, which followed the growth of oil and oil product prices in the world.

Electronic communications and post

The biggest market participators in the *field of electronic communications* are the fixed network operator LLC “Lattelecom” and mobile communications operators LLC “LMT” and LLC “Tele2”. 414 companies are registered in the field of electronic communications. According to the information at the Commission’s disposal, at least 360 companies currently provide electronic communications services, of which 122 companies operate or plan operating in the field of domestic/local voice telephony services, 130 companies operate or plan operating in the field of international voice telephony services, 135 companies plan to provide leased line services, 343 companies will offer internet and data transmission services, 15 companies will offer payphone services, 21 companies will offer radio communication services, and 64 companies will offer television and sound distribution services.

The Commission has completed analysis of three priority markets (call origination, call termination, and transit services in the fixed public telephone network). The Commission has estimated that the LLC “Lattelecom” owns more than 90% of the wholesale market for call origination, while in the wholesale trade for call termination 18 electronic communications companies currently providing these services have a significant power in their own networks. In the wholesale trade of call transit the LLC “Lattelecom” owns more than 80% of the market. Analysis of markets once more confirmed that competition in the fixed electronic communications market is not sufficiently effective. In order to promote the competition, the Commission plans to impose obligations on electronic communications companies with significant power in each of the mentioned markets.

The Commission has received the opinion of the European Commission (EC) on the prepared analysis of markets. EC agrees on the whole with conclusions mentioned in the markets’ analysis document of the Commission and with imposition of the proposed obligations on electronic communications companies with significant power in the respective markets.

In the *postal sector* the state JSC “Latvijas Pasts” provides general postal services, while approximately 40 service providers operate actively in the field of express mail.

In accordance with the Postal Law, the amount of monopoly rights of the state JSC “Latvijas Pasts” was reduced as from January 1, 2006 – “Latvijas Pasts” has monopoly rights to accept, send and distribute domestic and international mail correspondence weighing no more than 50 grams within the country borders. New tariffs for general postal services, including separately determined tariffs for domestic priority (class A) mail for the first time, came into force as from January 1, 2006. Introduction of class A domestic mail and setting its tariffs provides an opportunity for postal service users to choose mail items of different quality for different tariffs.

A new Postal Law is being developed in the 1st half of 2006, which will determine unified regulation for all participants of the postal services market.

Railway

In the railway sector, the state JSC “Latvijas Dzelzceļš” ensures maintenance of public railway infrastructure as well as carries out cargo transportation and international passenger transportation. Domestic passenger transportation is carried out by JSC “Pasažieru vilciens” and LLC “Gulbenes-Alūksnes bānītis”. International passenger transportation by rail is also ensured by JSC “Starptautiskie pasažieru pārvadājumi”. In the field of cargo transportation, also several operators independent from the SJSC “Latvijas Dzelzceļš” operate actively.

On April 12, 2006 the Commission set the usage charge of public-use railway infrastructure for transportation during the 2006/2007 period of train traffic timetable. The public-use railway infrastructure charge had not been raised since 2001.

There are two main reasons to raise the charge. Firstly, the increased costs of railway infrastructure maintenance. Secondly, the volume of transportation has decreased in this year but infrastructure costs are divided among actual transportation. The volume of cargo transportation in the 1st quarter of this year has decreased by 8 per cent in comparison with the same period of 2005.

The biggest part of infrastructure costs is covered by cargo carriers, infrastructure usage charge for them is increased by 5.2% and will amount to 4.62 LVL per train-kilometre. Charges for other carriers in LVL per train-kilometre will be as follows: 2.80 LVL for electric passenger trains, 2.36 LVL for diesel passenger trains and railway cars, 2.73 LVL for passenger trains with a locomotive, and 1.09 LVL for narrow-gauge trains. The set infrastructure charge came into force as of May 28, 2006 along with the new timetable of train traffic.

6.10. Export Promotion Policy

The objective of the export promotion policy is to actively promote international competitiveness of Latvian companies and to foster entry into new markets and consolidation in the current ones. **Latvian Export Promotion Programme for 2005-2009** (hereinafter LEPP) was developed and is being implemented to achieve this objective.

Implementation of LEPP takes place in the four main lines of action:

- development of institutional base for export promotion;
- promotion of international competitiveness of Latvian companies and development of export capability;
- support in export marketing and in the entry into new markets;
- financial instruments for export promotion.

The main problems in export are closely linked to implementation of educational, industrial, business policies and innovation as well as to development of the transport sector and infrastructure. Thereby they are being solved not only through implementation of LEPP lines of action, but also by considering them in an integrated way in the framework of other important policy planning documents.

To provide assistance to Latvian companies in export promotion in accordance with LEPP lines of action, several measures are envisaged, which are being implemented in the framework of the annual LEPP action plan.

The **Export Promotion Council** chaired by the Minister of Economics supervises implementation of LEPP. The Council is made up of representatives of public institutions and sectoral associations as well as social partners. The meeting of the Council on February 9, 2006 took decisions on implementation of the LEPP action plan for 2005 and approved the action plan for 2006. Suggestions of sectoral associations for export promotion were taken into account during its development. The most important part in the action plan is provision of information about foreign markets, seminars on export skills related to entry into external markets, and support to participation of companies in the national stands at international exhibitions.

The Ministry of Economics, consulted by sectoral associations, has improved and simplified the state support programme „Support to Consultations and Participation of Commercial Companies at International Exhibitions, Fairs and Trade Missions”, so that sectoral associations and company associations could apply for participation at international exhibitions and missions in 2006, organising participation of companies in joint stands at the exhibitions. Application for individual participation at exhibitions is often too expensive for small and medium-sized enterprises, hence the financing from EU Structural Funds for this programme is not fully used.

The link to the **Development Concept of Foreign Economic Representative Offices of Latvia** is essential for LEPP. Implementation of the Concept substantially contributes to strengthened competitiveness of Latvian entrepreneurs in the global market, especially in the EU internal market. With establishment of a network of foreign economic representative offices abroad and consolidation of the Latvian Investment and Development Agency (LIDA) as its support institution in Latvia, Latvian entrepreneurs are provided with assistance and services similar to those received by their competitors and partners in EU member states.

At present, 10 foreign economic representative offices of Latvia operate abroad – in Germany, United Kingdom, Sweden, France, Russia, Kazakhstan, Netherlands, Norway, Denmark and USA.

Taking into account that economic interests of Latvia are represented in Europe, it is also necessary to enter into new markets, which are interesting for entrepreneurs and geographically distant. On March 1, 2006 the foreign representative office of Latvia in the USA was officially opened, which is

very important for establishment of contacts with potential US investors and provision of new opportunities for co-operation of Latvian entrepreneurs with the USA.

Representative offices constitute an important instrument for export promotion and attraction of foreign investments, so it is essential to ensure expansion and development of the network of these offices.

Representative offices operate in three main directions: identification and channelling of the potential investment and export projects, provision of services for Latvian companies, distribution of information to foreign companies on the economic situation and business environment of Latvia.

The Ministry of Economics and the LIDA organise forums for Latvian entrepreneurs twice a year. Within these forums, Latvian entrepreneurs are acquainted with the foreign markets, where representative offices operate, and bilateral meetings of companies with the leaders of representative offices are organised in order to discuss interests of companies and business opportunities. At the forum, which took place on June 15-16, 2006, presentations were given and informative materials were distributed about the US, Russian and Chinese markets, specific market requirements and useful business contacts, and representatives of companies also had an opportunity to meet individually the leaders of all representative offices.

External marketing is one of the main export promotion instruments. The Ministry of Economics carries out several external marketing measures in co-operation with LIDA and other institutions. Foreign visits of state officials with participation of Latvian business delegations constitute one of these measures. Business seminars, contact exchanges and visits to companies in accordance with enterprise interests are held within the framework of these foreign visits. Visits to Austria, Israel, Russia (Vologda, Pskov), Moldova, Finland and Japan took place in 2006. More than 150 company representatives in total have participated in these visits.

In the 1st half of 2006, 20 Latvian entrepreneurs have participated in the stands organised by LIDA at 3 international exhibitions in Sweden (construction), Norway (wood processing, structures of horizontal logs) and the United Kingdom (machine building, metal working), and representatives of 24 companies and institutions supported by the Ministry of Economics and LIDA took part at the leading exhibition of the machine building and metal working sector "Hannover Messe 2006" with two national stands. LIDA in co-operation with representative offices organised direct marketing campaigns before these exhibitions, addressing potential partners of Latvian companies and inviting them to the stands, thereby ensuring good attendance of the stands and high-quality business contacts. Contact exchanges of companies and seminars on the potential of Latvian sectors were additionally organised within the framework of several exhibitions.

Several trade missions abroad of Latvian companies were organised in 2006. In their framework, an individual business programme was prepared for each entrepreneur.

In 2006 the Customer Service Department of LIDA was established, where Latvian companies can get consultations in one place on issues involving foreign trade, selection of business partners, external marketing activities proposed by LIDA, state support programmes, and other issues.

Survey of companies on the services provided by LIDA was conducted at the beginning of 2006 and showed that Latvian companies are interested in information about external markets also in electronic form. LIDA has formed several electronic bulletins compiling information on topicalities in foreign markets (Netherlands, Kazakhstan). The first LIDA news publication "Ceļvedis" ("Guide") about opportunities of foreign markets was prepared, and the May issue was dedicated to Japan. The publication also contains information about services and opportunities offered by LIDA, which may be of interest to entrepreneurs. The informative bulletins are placed on the website of LIDA. Profiles of six countries (Israel, Austria, USA, Moldova, Japan and Finland) are prepared and placed on the LIDA website in the section "Foreign Markets".

At the beginning of 2006, several studies of foreign markets were completed (Norway – food, packing; Germany – furniture, textile; Netherlands – wood industry, textile) and presented to Latvian companies at several seminars organised by LIDA.

In 2006, according to LEPP, a broad and comprehensive programme of seminars for Latvian companies is planned about issues of specific export conditions for product groups of individual sectors in target markets, promotion of business competitiveness in the EU and other topical subjects such as business opportunities in the EU single market, EU legislation, funding opportunities in the EU, etc. More than 20 seminars in total are planned.

A cycle of export skills seminars for business beginners was developed and started. The cycle contains three seminars (the 1st subject “Are you ready for export? Export strategy”, the 2nd subject “Marketing. Advertising”, the 3rd subject “Logistics”). In the framework of the seminars, both theoretical knowledge and practical examples are given to entrepreneurs, and successful well-known Latvian companies share their experience. More than 40 entrepreneurs attended the first seminar.

Box 6.17**US Business, Investment and Trade Mission to the Baltic States to Explore Opportunities and Develop Contacts for Cooperation**

The US Business, Investment and Trade Mission to the Baltic States to Explore Opportunities and Develop Contacts for Co-operation took place on **May 22-26, 2006** and was opened with the US-Baltic States Business Conference on **May 23, 2006 in Riga**. The mission was organised in order to acquaint US entrepreneurs with the investment opportunities in the Baltic States as well as discuss and specify possible co-operation projects.

The mission was an important stimulus for promotion of economic relations between the Baltic States and USA as well as for promotion of US investments in the Baltic, besides, it **served as a follow-up activity** for the successful US-Baltic States Business Conferences in London in December 2004 and in Washington in March 2005, which were attended by more than 250 US company leaders.

More than 150 company representatives of US and Baltic States as well as dignitaries of these countries took part in the activity.

The central event of the mission was the US-Baltic States Business Conference on May 23, 2006 in Riga, when the official part of the activity started with an address of the State President Vaira Vīķe-Freiberga. US Assistant Secretary of Commerce D.Bohigian, Ministers of Economics of the Baltic States, representative of Moody’s rating agency, Director of the London office of the Wall Street Journal and other dignitaries of the Baltic States and US addressed participants of the conference. Thematic round-table discussions on investment, industry and public private partnership projects were held in the framework of the conference.

On May 24, 2006, individual meetings of companies of the Baltic States and US took place and trips to sights of entrepreneurial interest were organised.

On May 25-26, 2006, in the framework of an optional programme, US entrepreneurs were able to visit Lithuania and Estonia.

6.11. Protection of Consumer Interests and Market Surveillance

The system of consumer rights protection in Latvia gradually strengthens and develops during the recent years (see Box 6.18). Regular drafting and acceptance of normative acts regulating rights and duties and relations between consumers and producers, sellers, service providers and other stakeholders, as well as normative acts stipulating requirements for goods and services and procedure of labelling is an on-going process. At the same time, a lot of efforts are focussed on the institutional capacity building to ensure adequate market surveillance and supervision of the observance of consumer rights.

Box 6.18**Policy planning and development of the normative base**

In October 2004 the Cabinet of Ministers approved the **Basic Guidelines of Consumer Rights Protection Policy**, which define the basic principles of the consumer policy, its goals and main courses of action to ensure high-level consumer rights protection.

The main basic principles of the consumer rights protection policy in Latvia are as follows:

- protection of consumer health and safety;
- protection of economic interests of consumers;
- opportunity for consumers to fulfil their rights, including the opportunity to receive reimbursement;
- consumers’ opportunity to receive information and consumer education in schools;
- opportunity for consumers to represent their interests by organising consumer groups and taking part in decision-making processes.

This policy is aimed at ensuring high-level consumer rights protection, by accentuating consumer rights in the developed normative acts and including consumer rights protection issues into other policies, and at involvement of the society in solution of consumer rights protection issues.

It is envisaged to achieve this through attainment of the following sub-goals of the consumer rights protection policy:

- to ensure inclusion of consumer rights into normative acts, which comprises inclusion of consumer interests protection into other policies;
- to provide effective supervision of observance of normative acts of consumer rights protection;
- to reach high level of consumer and entrepreneur awareness regarding the consumer rights;
- to ensure effective solution of conflict situations concerning consumers;
- to increase the role of public organisations of consumer rights protection.

Box 6.18 continued

The Basic Guidelines have been developed according to the European Commission's Consumer Policy Strategy for 2003-2006. To implement these guidelines, on April 27, 2005 the Cabinet of Ministers approved the **Consumer Rights Protection Programme for 2005-2007**, and the programme will be developed for 2008-2010 as well.

The programme envisages the following lines of action:

- improvement of the normative base for the protection of consumer rights;
- creation of favourable business environment by carrying out adequate and efficient market surveillance and supervision of normative acts of consumer rights protection;
- providing information to consumers and entrepreneurs on consumer rights protection issues, promotion of consumer education;
- improvement of out-of-court procedures for settlement of disputes both in domestic and cross-border context;
- promoting operation of public organisations of consumer rights protection.

In order to ensure co-operation of goods' producers, distributors or service providers with market surveillance and control authorities and thereby achieve a higher level of consumer rights protection, preventing entry of goods, which are unsafe and hazardous to consumer health into market, and promote fair competition, in February 2006 the Cabinet of Ministers approved Regulation No. 119 "Procedure by which a Goods Producer, Distributor or Service Provider Informs Appropriate State Supervision and Control Authorities about Goods or Services, which Create Risk Non-Compliant with General Safety Requirements".

In order to ensure protection of economic interests of consumers, the draft Regulation of the Cabinet of Ministers "Procedure for Review of a Consumer Claim Application about Article or Service that Does Not Comply with the Agreement" has been submitted to the Cabinet of Ministers for approval.

Development of several normative acts in the area of consumer rights protection is taking place at the European Commission, and the Ministry of Economics has engaged in this process.

On October 7, 2004 the European Council adopted the Regulation of the European Parliament and the Council on co-operation between national authorities, which are responsible for enforcement of legal acts in consumer rights protection (Regulation on Consumer Protection Co-operation). This regulation prescribes conditions, according to which the member states' competent authorities that are indicated as responsible for enforcement of consumer protection acts co-operate between themselves and with the Commission in order to ensure observance of the legal acts mentioned in the regulation and successful operation of the internal market and to strengthen protection of economic interests of consumers. Competent authorities of member states are provided with rights to require that the competent authority of the member state, where a violation of consumer rights may have been occurred, provides information at its disposal and investigates the case. The competent authority has to take compulsive measures for prevention of consumer rights violations and ensuring observance of normative acts. Thus a solution of cross-border problems will be provided in cases, when a businessman from one member state has committed violation in other member state. The regulation will come fully into force at the end of 2006.

Directive of the European Parliament and the Council on unfair commercial practices against consumers in the internal market has been adopted. The directive determines uniform regulation for commercial practices in the EU and harmonises EU requirements in relation to unfair commercial practices between business and consumer, preventing barriers created by different national regulations. It is aimed at facilitation of cross-border trade and clarification of consumer rights. At present, work is under way to transpose this directive into national legislation.

Supervision of consumer rights

The Consumer Rights Protection Centre (hereinafter CRPC) under supervision of the Ministry of Economics is the main responsible co-ordinating institution that supervises observance of the normative acts of consumer rights protection. CRPC reviews applications and complaints of consumers about non-compliance of purchased goods or services with agreement terms, helps consumers in solution of conflict situations, protects consumer rights in legal proceedings, represents interests of consumers in the process of drafting normative acts, gives consultations on consumer rights protection legislation and compliance of goods, and co-operates with international consumer rights protection bodies and national institutions of other countries. Information about consumer rights is available on the CRPC website www.ptac.gov.lv as well as on the website www.pateretaja-celvedis.lv of non-governmental organisations of consumer protection. These websites contain information on the consumer rights protection legislation in force, various goods and services, and opportunities to protect legitimate rights of a consumer.

By May 2006, CRPC:

- carried out 879 inspection visits to trade and service companies (sites),
- provided 139 consultations to entrepreneurs,
- provided 7 938 consultations to consumers,

- reviewed 366 cases of administrative offences in the area of consumer rights protection,
- reviewed 451 applications and complaints of consumers.

203 of the received complaints were settled in favour of consumers, while 96 complaints proved to be unfounded. In four months of 2006 the number of consumer complaints has increased by 30% in comparison with the same period in 2005 (334 complaints in four months of 2005).

As a result of the review of consumer applications, consumers got refunds of money paid for goods or services that do not comply with the agreement, and the total amount of refunded money comprised 16 285.72 LVL. In their applications, consumers have presented claims about:

- non-observance of the principle of legal equality of contracting parties – 15 times,
- provision of incomplete information – 17 times,
- incorrectly set payment for purchase and weight or measure – 15 times,
- violations of review of claims – 154 times,
- non-issuance of documents attesting to the transaction, and other offences – 72 times,
- services that do not comply with the agreement – 118 times,
- goods that do not comply with the agreement – 224 times.

Consumer applications mostly include complaints about footwear, electric appliances, mobile phones, textiles, while recently an increasing number of complaints pertain to terms of credit agreements and to various construction services such as window framing and repair work. This may be explained by improving economic situation and increased activity of the population, which allows to invest in voluminous repairs, and by the active real estate market.

During review of applications and complaints, employees of CRPC actively co-operate with employees of other state institutions (State Revenue Service, Public Utilities Commission, Food and Veterinary Service, Rent Board, Latvian National Metrology Centre, Housing Agency, etc.), asking to provide opinion and assessment on specific cases.

In April 2005, draft statute of the Consumer Advisory Council has been elaborated. After co-ordination of the draft with interested non-governmental organisations, it is envisaged to establish the advisory council with its main goal to promote development of the consumer protection policy and increased level of consumer rights protection, ensuring and fostering dialogue and information exchange in the field of consumer rights protection between state institutions and societies and foundations of consumer rights protection and of entrepreneurs.

Supervision of agreements

By May 2006, CRPC has issued 15 administrative acts on unfair terms of agreement, demanding to cease fulfilment of the unfair terms of agreements concluded with a particular consumer and agreements concluded with other consumers, and to alter draft agreements offered to consumers. The number of established violations of the unfair terms of agreements has increased by more than 50% in comparison with the previous year, which is attributable to the activity of CRPC in this field and to increased level of consumer knowledge in assumption of contractual obligations. A big part of the administrative acts on unfair terms of agreement pertain to agreements on purchase, development or management of real estate, and this trend becomes increasingly pronounced.

The most frequent unfair terms in agreements with consumers are as follows:

- terms prescribing settlement of disputes only by the court of arbitration;
- prescribing of disproportionately big penalty to be paid by a consumer in case of non-fulfilment or inadequate fulfilment of contractual obligations;
- infringement upon legitimate rights of a consumer;
- prescribing service provider's rights to alter terms of agreement unilaterally.

In order to prevent deception of consumers concerning credit costs, draft consumption credit agreements offered by the biggest lessors were reviewed during a project implemented from October 2005 until March 2006. Big attention was paid to the fact, whether loan providers have indicated annual interest rates calculated in accordance with the Cabinet of Ministers Regulation No. 257 "Regulations Regarding Consumer Credit Agreement" adopted on June 13, 1999. During this project, specialists of CRPC reviewed and assessed agreements offered to consumers by 11 businessmen, and imperfections or legal offences were established in each of them. Administrative fines in the amount of 100-500 LVL were imposed on 6 businessmen for not indicating the annual interest rate, and 7 decisions on unfair terms of agreement were taken. Several meetings with representatives of the sector took place in order to agree on interpretation and application of normative

acts. Taking into account that many inhabitants of Latvia purchase goods by using consumption credits, it is important that loan providers indicated complete information prescribed by legislation and so a consumer could assess offer terms most advantageous for him and make a well-considered choice.

In the framework of legal assistance, 55 consultations were provided to consumers, decisions to fulfil legitimate demands of consumers were taken and 2 references were given.

Carrying out the supervision of advertising, 1951 advertisements were assessed and 23 applications and complaints about advertising were reviewed in four months of 2006.

Box 6.19

International co-operation of CRPC

In 2006, CRPC started participation in the PROSAFE (Product Safety Enforcement Forum of Europe) project “Best Practice techniques, Enhancement of market surveillance of Consumer Product Safety within the framework of the GPSD”. It is envisaged to implement the project in 2006-2008. 24 countries take part in the project, and its main goal is to share experience about general issues of product safety, improvement of market surveillance strategy and procedures, directing the market surveillance processes for efficient and high-quality development in the EU internal market, summarising the best methods of market surveillance practice into a single handbook.

CRPC continues its work in the ICPEN (**I**nternational **C**onsumer **P**rotection and **E**nforcement **N**etwork) – an international co-operation network, where consumer rights protection and fair trade supervision bodies work, encouraging international co-operation in prevention of unfair and misleading marketing activities. In February 2006, CRPC took part in the Internet Sweep day organised by this network. During this day, systematic search of Internet websites was conducted in all participant countries of the network, supervising observance of consumer rights. Unfortunately, on websites searched in Latvia all normative acts of consumer rights protection were not observed for the greater part.

On May 22, 2006 in Vilnius, the Consumer Rights Protection Centre of Latvia, National Consumer Rights Protection Council of Lithuania and Consumer Protection Board of Estonia concluded the **agreement on co-operation** in implementation of the EU Regulation 2006/2004/EC on co-operation between national authorities responsible for consumer protection.

Cross-border trade

Considering that the number of Latvian inhabitants going abroad and the number of tourists visiting Riga have rapidly increased in the recent time, the cross-border consumer protection becomes increasingly topical. The European Consumer Centre of Latvia, which was established at CRPC with a financial support from the European Commission, started operating in the 2nd half of 2005. In 2005 the website www.ecclatvia.lv of the European Consumer Centre of Latvia was developed, which provides information about consumer rights in the cross-border context, as well as 25 complaints were reviewed and 83 consultations were provided. 28 complaints of consumers were reviewed and 157 consultations were provided in 2006. The biggest number of the received complaints pertained to passenger rights regarding air services.

Market surveillance

In order to ensure that only safe goods complying with certain requirements are available in Latvian market, effective market surveillance is necessary. The goal of market surveillance activities is to ensure that:

- only goods, which are safe and comply with requirements of normative acts are available in the market;
- goods are marked and tested in accordance with the established procedure;
- goods are accompanied by the required technical documentation.

At the same time, the market surveillance also includes actions taken by CRPC against a producer, seller or importer in case, where their goods do not comply with the set requirements, as well as certain measures to prevent presence of non-complying goods in the market.

In order to ensure effectiveness of the carried out inspection visits, in 2006 CRPC has started to introduce new approach to the market surveillance, paying bigger attention to risk assessment and planning of the market surveillance. Annual plan of CRPC was approved for the first time in January 2006. As CRPC cannot carry out complete surveillance of all goods due to lack of resources, the annual plan defines main priorities of CRPC work, which will get particular attention during this year:

- safety of toys;
- compliance of construction materials with requirements;
- compliance of telecommunications end appliances;
- safety of goods for children (bicycles, furniture, helmets, etc.);
- electric appliances;
- means of individual protection.

Box 6.20**Project “Strengthening Consumer Confidence in Safety of Large Range of Products”**

In 2005-2006, CRPC together with the National Association of Consumer Protection implements the project “Strengthening Consumer Confidence in Safety of Large Range of Products” financed by the European Commission and financially supported by the Ministry of Economics. Tests of 10 toy samples and 9 electric appliance samples were conducted in the framework of the project. Only one of the toy samples complied with all set requirements, 7 samples have to be considered as hazardous, and 2 samples were without the required marking and translation of information in the state language. 7 electric appliance samples complied with all set requirements, 1 sample has been considered as a hazardous product, and 1 sample was without the corresponding marking, instructions for use and reference to producer. The hazardous products were withdrawn from the market, agreeing with entrepreneurs and sending a message to consumers by mass media.

Main risks created by the mentioned hazardous toys and established during the testing were the potential of children to choke, asphyxiate or get traumas such as cuts and scratches.

Among the electric appliances, electric coffee grinders were hazardous. Main risk pertaining to the use of electric appliances is the lack of required insulation, which may result in electrical shock to consumer and create damage to health or property of consumer.

As testing results of these products show, safety of products is still a topical problem deserving special attention also in the work of CRPC.

6.12. Quality Assurance

6.12.1. Quality Structural Policy

The main task in the area of quality assurance is to promote observance of requirements of normative acts in the regulated and non-regulated sphere as well as improve the legislative base, hence ensuring compliance of products in trade and the provided services with national and EU requirements and encouraging increased competitiveness of entrepreneurs and reduction of obstacles to inter-state trade.

Quality assurance system in Latvia is regulated by the Law “On Conformity Assessment”, the Standardisation Law and the Law “On Uniformity of Measurements”, as well as Cabinet of Ministers Regulations deriving from these laws.

The main directions of the policy are:

- improvement of the conformity assessment infrastructure (including testing and calibration laboratories, inspection and certification institutions, environmental verifiers) in accordance with the needs of Latvian national economy in order to protect consumers and environment from low-quality products and services, promote growth of competitiveness of entrepreneurs and reliability of products and services provided by Latvian entrepreneurs;
- improvement of the informative and consultative base in order to inform inhabitants of Latvia on the newest national requirements and requirements of EU normative acts;
- participation of national institutions of accreditation, standardisation and metrology in international organisations, ensuring their international recognition and compliance of the Latvian quality assurance system with international requirements;
- maintenance and international comparison of the national base of standards in order to ensure the necessary traceability of measurements and protect the society from inaccurately conducted measurements;
- encouraging introduction of quality management system, environmental and other voluntary quality systems within enterprises in order to ensure manufacturing of higher-quality products and provision of higher-quality services as well as competitiveness of Latvian companies in international markets;
- improvement of market surveillance system in order to provide equal conditions for all market participators and protect consumers from actions performed within unfair competition of entrepreneurs.

Introduction and maintenance of quality management system in a company substantially improves its operation and hence improves quality of the manufactured products or provided services. In 5 months of 2006 the number of certified companies, where quality management systems were introduced, has reached 558. 534 of these companies are certified in accordance with requirements of ISO 9001: 2000 standard, 93 are certified in accordance with requirements of 14000 standard series, and 45 are certified

in accordance with requirements of OHSAS 18001: 1999 standard. It has to be noted that one company may be certified in accordance with requirements of several quality management systems' standards at the same time.

In order to improve the Latvian national quality system, development of Latvian quality assurance strategy was started in 2005. Its goal is to promote competitiveness of companies, stimulating observance of contemporary management principles and introduction of modern technologies. It is planned to complete development of the strategy by the end of the 1st half of 2006.

In order to foster development of Latvian national economy, the following activities were carried out in 5 months of 2006:

- transition to notification of conformity assessment institutions accredited in the regulated sphere to the European Commission and other EU member states in the electronic form, using the “Nando-input” database. Thus it will be possible to notify and receive information about changes in the list of conformity assessment institutions notified on the basis of the New Approach directives more operatively;
- regulations of the measuring instruments subject to the state metrological control have been drafted in accordance with requirements of the Law “On Uniformity of Measurements” and the Law “On Conformity Assessment” in order to harmonise the national legislation with requirements of the EU legal acts;
- meetings of Latvian national accreditation, standardisation and metrology councils have been organised;
- the informative report about solutions corresponding to EU law in regard to transposition of lapsed standards included in EU legal acts and transposition of standards developed by ASTM and other standardisation organisations, which are impossible to translate into Latvian at present, has been worked out;
- publication of Latvian conformity assessment institutions in “Latvijas Vēstnesis” (official newspaper) and their notification to the European Commission and EU member states as well as publication of EU conformity assessment institutions in “Latvijas Vēstnesis” in accordance with requirements of the Law “On Conformity Assessment” have been ensured;
- supervision of measuring instruments offered in the regulated sphere in the market in accordance with requirements set in normative acts has been ensured;
- participation of national accreditation, standardisation and metrology institutions in working groups and conferences of international organisations has been ensured in order to shape unified conformity assessment policy throughout EU, protecting interests of Latvia.

In order to improve the legislative, informative and consultative base as well as infrastructure of the conformity assessment system, it is planned to carry out the following activities in 2006:

- to improve the Latvian national metrology system, at the same time making the necessary changes in normative acts;
- to inform the society about topicalities in the field of quality assurance on a regular basis in order to deepen society's understanding of quality assurance issues;
- to organise the annual National Accreditation Conference in co-operation with the state agency “Latvian National Accreditation Bureau” in order to promote confidence in accredited institutions of conformity assessment;
- to organise the annual international quality conference and the Latvian Quality Award 2005 in co-operation with the Latvian Association for Quality in order to popularise the quality assurance as a way for raising the business competitiveness.

6.12.2. Standardisation, Metrology, Accreditation

Standardisation. The limited liability company “Latvijas standarts” (LVS) is the national standardisation institution in Latvia and operates according to provisions of the Standardisation Law.

The main functions of LVS are as follows:

- to set up the national fund of standards by organising the development of Latvian national standards and adaptation of international and regional standards at the status of national standards;

- to issue and publish Latvian national standards, maintain the informative base of standardisation documents and distribute information of standardisation;
- to participate in work of international and regional organisations of standardisation and ensure regular co-operation with EU institutions.

Since 2004, LVS is a full-fledged member of the European Committee for Standardisation (CEN) and the European Committee for Electrotechnical Standardisation (CENELEC) as well as a corresponding member of the International Organisation for Standardisation (ISO) and the International Electrotechnical Commission (IEC).

On April 27-28, 2006 the 34th plenary meeting of the CEN Technical Committee (CEN TC) 165 “Waste Water” took place in Riga. 46 delegates attended the meeting, issues on development of 30 new draft sectoral standards were reviewed, reports were given about the accomplishment in the period since the previous plenary meeting, and those present had the opportunity to get information on topicalities in the Construction Products Directive and to hear a report of a representative of the European Water Association. CEN TC 165 is responsible for development of European standards in the waste water sector. Standards developed by this technical committee define the general requirements for design and installation of sewer pipes and waste water treatment facilities. Also standards of terms and definitions are being worked out for communicative purposes.

On May 25-26, 2006 a delegation of the Albanian General Directorate for Standardisation (DPS) visited LVS to exchange experience. This visit took place in the framework of the EU project “Support to Standardisation, Certification and Accreditation in Albania”. The aim of the delegation’s visit was to acquaint with experience of LVS in fulfilment of the criteria set by CEN/CENELEC in order to become a full-fledged member of ISO.

In order to develop national standards and adapt international and regional standards at the status of Latvian standard, 42 technical committees of standardisation have been set up and operate in various national economy sectors with wide participation of those organisations of producers, users, consumer interests protection, certification, testing, accreditation, control and supervision, which are interested in establishment of certain standards.

A new technical committee of standardisation LVS/STK 49 “Development, Harmonisation and Standardisation of Terminology”, the working group LVS/DG/02 “Group for Establishment of Broker Practice Standards” and the Working Group for Terminology of Information and Communications Technologies of the technical committee of standardisation LVS/STK 2 “Information Technologies” were founded in 2005.

17 986 standards have been registered as Latvian national standards by May 1, 2006, among them 16649 EU standards were adapted. 535 European standards and 29 international standards were adapted in 4 months of 2006. The number of registered standards has increased by 14% during one year.

On February 14, 2006 the standard LVS EN ISO 22000:2006 “Food Safety Management Systems. Requirements for Any Food Chain Organisation” was registered at the status of Latvian national standard. The standard defines requirements for food safety management systems and serves such generally recognised food safety elements through all food chain till the end consumer as:

- interactive communications;
- system management;
- precondition programmes;
- principles of HACCP (hazard analysis and critical control point).

Since the beginning of 2006, standardisation information services have been provided to 2983 legal and physical persons. Standard search system has been improved and changes in reflection of bibliographical information on standards have been made as well as free automatic information notification system about newly registered Latvian national standards in various fields has been worked out and introduced. On the basis of this system, the LVS Information Fund provides new service to customers, namely, the “Monthly Report on Standards Registered at the Status of Latvian Standard and on Abolished Latvian Standards” in the areas indicated by the customer.

Wider information about LVS, Latvian national standards and technical committees of standardisation is available on the website <http://www.lvs.lv>.

Metrology. The limited liability company „Latvijas Nacionālais metroloģijas centrs” (LNMC) is the national metrology institution, which, according to provisions of the Law “On Uniformity of Measurements”, ensures international traceability and recognition of measurements conducted in Latvia,

in this way encouraging international trade and confidence in conformity assessment of goods carried out in Latvia.

The objective of the national metrology system is to ensure uniformity of measurements in the Republic of Latvia in order to protect human life and health as well as environment and consumer from negative consequences of inaccurate and incorrect measurements and promote development of state economy and international co-operation.

The key tasks of LNMC are:

- to ensure the base of measurement standards of physical quantities and reproduction of measurement units;
- to approve the types of measuring instruments and register them in the State Register of Measuring Instruments;
- to verify measuring instruments subject to the state metrological control;
- to provide calibration services;
- to co-operate with metrology institutions of other countries and engage in work of international metrology organisations.

In the 1st quarter of 2006:

- precision measuring capabilities of the LNMC Electric Measurements Laboratory were internationally appraised and, on March 14, 2006, were approved by including them in the international database of BIPM (Bureau International des Poids et Mesures);
- employees of LNMC attended meetings of the working group of the European Collaboration in Measurement Standards (EUROMET) and the European Co-operation in Legal Metrology (WELMEC);
- activities were carried out in order to ensure accreditation of LNMC laboratories as well as assessment and supervision of their operation.

100 383 measuring instruments were checked in the 1st quarter of 2006, which is by 16 821 measuring instruments less than in the 1st quarter of 2005; among them 90 074 measuring instruments were verified (by 22 469 measuring instruments less than in the 1st quarter of 2005) and 10 309 measuring instruments were calibrated (by 5 648 measuring instruments more than in the 1st quarter of 2005).

Wider information about LNMC, Latvian national standards and approval of a type of standards is available on the website <http://www.lnmc.lv>.

State metrological supervision. In accordance with provisions of the Law “On Uniformity of Measurements”, the state metrological supervision in Latvia is carried out by the State Metrological Inspection (SMI), which is a direct administration body under authority of the Ministry of Economics and operates according to the Regulation No. 174 “Statute of the State Metrological Inspection” adopted by the Cabinet of Ministers on March 8, 2005.

The aim of operation of the inspection is to ensure accuracy and credibility of measurements in areas that affect human life and health, environmental health and safety as well as consumer rights protection. With Latvia’s accession to the EU, the issue of the control of pre-packed goods has become topical. Latvia as EU member state has to guarantee that the actual content of the package of “e”-marked goods produced in Latvia conforms to requirements of the respective EU directives and respective national normative acts. Achievement of this goal requires periodic and efficient control in enterprises producing pre-packed goods.

SMI controls and supervises compliance with requirements set in normative acts of measuring instruments offered in the market in the regulated sphere and performs state metrological supervision of measuring instruments handed over for use in line with the Law “On Uniformity of Measurements”.

SMI officials are authorised to draw up reports regarding administrative violations and impose administrative penalties for non-observance of metrological requirements. In accordance with amendments to the Code of Administrative Violations of Latvia, different punitive sanctions are set for physical and legal persons and it is prescribed that SMI may apply administrative fine of up to 3000 LVL for offering and selling measuring instruments subject to conformity assessment without attestations or confirmations of conformity.

In 5 months of 2005 the State Metrological Inspection has carried out inspections in 968 enterprises, subjecting 15.3 thousand measuring instruments to the state metrological supervision. Control of pre-packed goods was performed in 29 enterprises.

SMI constantly co-operates with metrological supervision institutions of other countries and takes part in WELMEC working groups WG4 “Legal Metrology” and WG5 “Metrological Supervision”.

Accreditation. The state agency Latvian National Accreditation Bureau (hereinafter LATAK) ensures a uniform system for testing and calibration laboratories, certification and inspection institutions and environmental verifiers, so that their results are internationally recognised and corresponding with Latvian national economy needs and give an opportunity to attest conformity of products manufactured and services provided by Latvian entrepreneurs with European and international standards.

According to the Law “On Conformity Assessment”, the main functions of LATAK are:

- to evaluate, accredit and supervise testing and calibration laboratories and certification and inspection institutions in conformity with the prescribed requirements of normative acts, Latvian national standards, EU or international standards;
- to organise and co-ordinate inter-laboratory comparative testing in compliance with Latvian, EU and international requirements;
- to represent Latvia at international accreditation organisations;
- to maintain and update the informative base of accredited institutions.

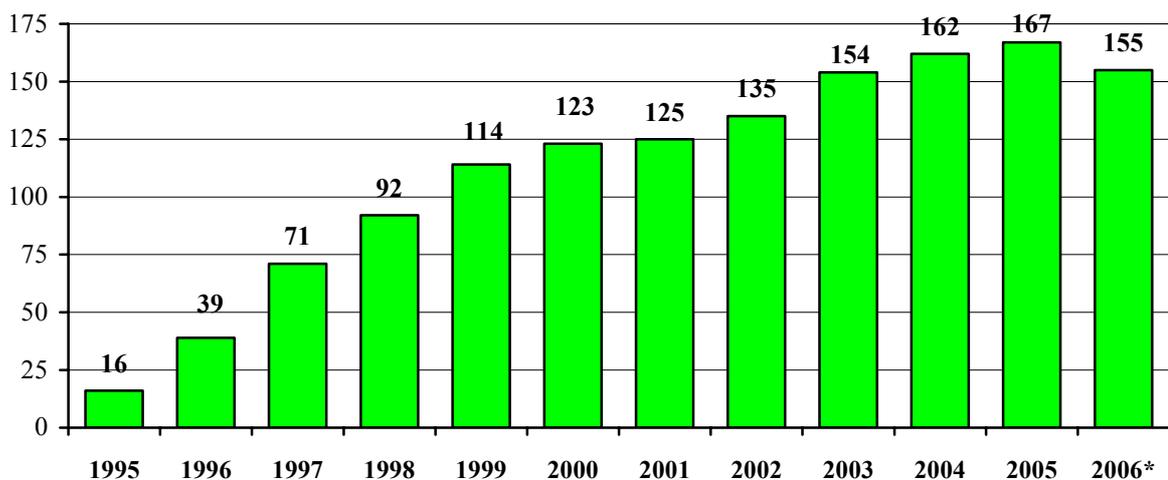
The Cabinet of Ministers Regulation No. 498 “Statute of the State Agency “Latvian National Accreditation Bureau”” adopted on September 2, 2003 defines the legal status of LATAK, its obligations and tasks in the field of conformity assessment. The Cabinet of Ministers Regulation No. 689 “Regulations on Accreditation and Supervision of Testing and Calibration Laboratories, Certification and Inspection Institutions and Environmental Verifiers” adopted on August 3, 2004 determines operation of the national accreditation system.

It was planned for 2005 that the number of institutions assessed in the Latvian national accreditation system will reach 165. This plan was fulfilled and 167 institutions were accredited by the end of 2005. The number of accredited institutions as of April 30, 2006 has decreased by 12 institutions in comparison with the end of 2005 (see Figure 6.11), which is due to changed legal status and structure of several institutions. It is planned that the number of accredited institutions will increase to 165 by the end of 2006.

LATAK also provides accreditation services abroad. At present, two institutions are accredited by LATAK in Ukraine, namely, one testing laboratory and one personnel certification institution.

Figure 6.11

Development Dynamics of the National Accreditation System



* as of April 30, 2006

In order to fulfil functions of methodical management of assessors, in the 1st quarter of 2006 LATAK organised a training seminar for assessors and experts, co-ordinated a proficiency test programme, where 5 laboratories take part, and organised 4 bilateral proficiency tests.

In the 1st quarter of 2006 LATAK participated in several committees – the European Co-operation for Accreditation Laboratory Committee (EA LC), EA Inspection–Certification Committee (EA IC/CC), EUROMET-EUROCHEM Technical Committee – and the working session for establishment of the Centre for Inter-comparison (CFI).

Wider information about LATAK, accreditation procedures and accredited institutions is available on the website <http://www.latak.gov.lv>.

6.13. Privatisation

On September 1, 2005, the Law on Completion of the State and Local Government Property Privatisation and Use of Privatisation Certificates (hereinafter – Privatisation Completion Law) came into force. This law determines how to complete the privatisation process and land reforms and ensure completion of the use of privatisation certificates.

The Privatisation Completion Law determines:

- 1) the term of August 31, 2006 by which every legal or physical person may propose to bring any state or local government property to privatisation;
- 2) the procedure how the privatisation proposal submitted by the person is reviewed and decision is adopted to bring the state or local government property to privatisation;
- 3) that privatisation may be denied and the property maintained in possession of the state or local government if the property is necessary for implementation of public administration functions or commercial activity of the central or local government;
- 4) that the Cabinet of Ministers or a local government may take decisions on bringing the state or local government property to privatisation by February 28, 2007;
- 5) that the state joint stock companies “Latvenergo”, “Latvijas pasta”, “Starptautiskā lidosta “Rīga””, “Latvijas dzelzceļš”, “Latvijas gaisa satiksme” and “Latvijas valsts meži” will not be privatised or alienated;
- 6) terms by which the persons willing to redeem land allocated for permanent use have to submit land redemption application (August 31, 2006) or by which the land boundary plan or confirmation of the land redemption payment done in privatisation certificates before conclusion of the land redemption contract has to be submitted to the State Land Service (September 1, 2008);
- 7) that privatisation certificates do not have an expiry term, but may be only used in the framework of privatisation process;
- 8) the procedure of ending the issuance of privatisation certificates. The final term of April 28, 2006 is set for persons, by which they can submit application for privatisation certificates.

In order to ensure successful and open progress of privatisation completion processes, the Cabinet of Ministers has set the procedure of how the institutions conducting privatisation and land reform have to establish publicly available registers of privatisation proposals and land redemption.

After completion of privatisation process and land reform, it will be possible to sell a property owned by the state or local government in compliance with the Law on Alienation of State and Municipal Property and the Law “On the State and Local Government Capital Shares and Capital Companies”, which include the market-regulated condition to sell to the person offering the highest price and using Latvian currency as a means of payment. Selling a state or local government property, the general pre-emption rights of a person prescribed by the Civil Law have to be observed.

Privatisation of state property

Privatisation of state-owned property units or land is carried out and privatisation proposals are summed up by the state JSC “Privatizācijas aģentūra” (hereinafter Privatisation Agency) under the Law “On Privatisation of Property Units Owned by the State and Local Governments”.

Decision to bring state-owned property unit (including capital shares) or vacant land plot to privatisation is taken by the Cabinet of Ministers, while the decision to bring built-up land plot (on which there are buildings owned by other person) to privatisation is taken by the Privatisation Agency. The decision is taken on the basis of privatisation proposal submitted by any physical or legal person.

A physical or legal person eligible to acquire a movable or immovable property in Latvia can be the subject in privatisation of state-owned property (real estates, capital shares, land). Payments for the property units have to be done in lats (LVL) and/or privatisation certificates.

From April 17, 1994 till April 1, 2006 privatisation rules have been approved in the statutory procedure for 2167 state property units (except land). 94 companies were transformed to public joint stock companies, putting 439.14 million shares into public circulation. The total sales price for state property units (except land) sold for LVL and privatisation certificates was 1.75 billion LVL, including 1.262 billion LVL for privatisation certificates. New owners took over obligations of privatised state companies (enterprises) for more than 179 million LVL. The amount of the specified investments was 130 million LVL, while the amount of investments actually invested reached 253 million LVL.

Privatisation Agency carries out privatisation of the state-owned lands since 1997. 3529 state-owned land plots with the total area of 5598.6 hectares have been privatised (purchase agreements signed) by April 1, 2006. Total sales price for the privatised state lands has reached 108.61 million LVL, including 20.44 million LVL (18.8%) in cash and 88.17 million LVL (81.2%) in property compensation certificates.

Privatisation of the local government property

Decision concerning real estate owned by a local government is taken by the council of the local government (city, amalgamated local government, rural municipality). The decision is taken on the basis of privatisation proposal submitted by any physical or legal person.

A physical or legal person eligible to acquire a movable or immovable property in Latvia can be the subject in privatisation of local government property (real estates, capital shares, land). Payments for the property units have to be done in LVL and/or privatisation certificates.

Privatisation of local government property in the local government area is ensured by property privatisation commission of the respective local government (rural municipality, city, district, amalgamated local government).

Compliance of privatisation projects, rules and announcements approved by a local government with provisions of the Law “On Privatisation of Property Units Owned by the State and Local Governments” and the Privatisation Completion Law is ensured by the Ministry of Economics.

From February 17, 1994 till April 1, 2006 the Ministry of Economics has reviewed and accepted for information 2953 privatisation projects for the total relative price of 93.4 million LVL (including payments in certificates for the nominal value of 55.8 million LVL).

From January 1, 1997 till April 1, 2006 the Ministry of Economics has reviewed and accepted privatisation rules in respect of 1509 built-up and vacant local government lands with the total value of 18 million LVL (of which 12.4 million LVL have to be paid in property compensation certificates).

Privatisation of the apartment houses

Privatisation of the apartment houses in Latvia was started in 1995. By April 1, 2006 the Central Apartment Houses Privatisation Commission (renamed as the state agency “Mājokļu aģentūra” (Housing Agency) as from January 1, 2004) and apartment privatisation commissions of the respective local governments have prepared and put up for privatisation in the procedure laid down in the Law “On Privatisation of State and Local Government Apartment Houses” 28 409 state and local government apartment houses with 492 954 apartments or 99.19% of the total number of apartments (497 000). 193 949 apartments have been handed over to private owners by a resolution preceding privatisation of the apartment house.

There are 412 156 state and local government apartments privatised (purchase agreements signed or handed over to private owners preceding privatisation of the apartment house) in Latvia by April 1, 2006, making up 82.93% of the total number of apartments. Apartment owners so far have taken over management of 8720 apartment houses, including 5 344 local government apartment houses and 3 376 state-owned apartment houses, where more than 50% of apartment properties have been privatised.

Owners of privatised apartments can decide themselves on the most acceptable form for management and maintenance of their apartment house: either organise a co-operative society of apartment owners (CSAO) or sign an authorisation agreement for management of the house. As a result of this process, 330 CSAOs have been founded in Latvia, among them 222 in seven biggest cities and 108 in various districts of Latvia. So far the biggest number of CSAOs has been founded in cities of Rīga and Ventspils and in Kuldīga and Valmiera districts. Authorisation agreements for house management have been signed for 2619 apartment houses.

Land reform

State land reforms include restoration of property rights, privatisation of the state and local government land properties and allocation of free land cognizable to the state for permanent use, and redemption of the allocated land. Land redemption and privatisation of land plots is being carried out in relation to the rural and urban land reform under way in the country.

The reform of the rural and urban land cognizable to the state is close to completion. All claims for the urban land have been basically reviewed and decisions made about granting ownership to land for pay, but conclusion of purchase agreements is continuing (434 agreements in the 1st quarter of 2006). Allocation of rural land for use or change of user and transfer of ownership for pay is continuing. According to the land reform laws, the JSC "Latvijas Hipotēku un zemes banka" (Mortgage and Land Bank of Latvia) has signed a total of 267 200 land purchase agreements (3671 in the 1st quarter of 2006) for sale of 1.518 million hectares of land (23 583 hectares in the 1st quarter of 2006).

As of January 1, 2006 the free (unclaimed) state land area amounted to 15.5 thousand hectares, and 564 thousand hectares of land cognizable to the state were given to 106 thousand physical persons for permanent use.

Privatisation certificates

Privatisation certificate is a state-issued dematerialised security that can be used only once as means of payment for the state or local government property to be privatised.

Privatisation certificates are issued and used according to the Law "On Privatisation Certificates". By April 1, 2006 a total amount of 103.9 million certificates have been issued to 2.45 million people for the time they have lived in Latvia, including 791.8 thousand certificates granted to 41.1 thousand politically repressed persons. 7.89 million property compensation certificates have been issued to 115.3 thousand former owners or their heirs, including 691.7 thousand certificates for property appropriated for state needs at the privatised specialised state agricultural enterprises, 4 819 thousand for land in rural areas, 952.7 thousand for house ownership, 796.1 thousand for urban land, 460.8 thousand for companies and other property units, 89.8 thousand for property taken away from politically repressed persons, and 81.9 thousand for property alienated in illegal manner.

In the 1st quarter of 2006 a total of 29.8 thousand property compensation certificates have been granted to 0.6 thousand former owners or their heirs.

On March 31, 2006 in accordance with the limitation period set in the Law on Completion of the State and Local Government Property Privatisation and Use of Privatisation Certificates, 48 thousand persons (1.85% of all persons to whom certificates have been issued) lost rights to transfer certificates to the account, among them 46 thousand persons (1.91%) regarding certificates for the time lived in Latvia, 0.4 thousand persons (0.87%) regarding certificates granted to politically repressed persons, and 1.1 thousand persons (0.97%) regarding property compensation certificates.

According to the Law "On Privatisation of Land in Rural Areas", 11 072 decisions have been made by April 1, 2006 about payment of cash compensations for former land ownership in rural areas. Compensations in the total amount of 17.45 million LVL have been paid to 8 408 persons, cancelling 0.62 million property compensation certificates.

Table 6.4

Use of Privatisation Certificates
(by April 1, 2006)

Type of property	Number	Number of privatisation certificates (million)	incl. property compensation certificates (thousand)
Apartment houses	425 thousand privatised housing units	36.51	589.8
Companies and other properties	accurate data not available	7.13	109.6
Capital shares (stocks) including:	accurate data not available	44.43	954.0
in a public offering	128.7 million shares	37.14	820.0
Land	259 thousand land plots	15.37	5239.3
Total:		103.44	6892.7
% of total certificates issued		92.5%	87.3%

Cash compensations in the total amount of 4.36 million LVL were paid to 25.1 thousand politically repressed persons as payment for privatisation certificates by April 1, 2006.

103.44 million certificates or 92.5% of the total number of issued certificates have been used for privatisation of state and local government property units by April 1, 2006 (see Table 6.4).

As of April 1, 2006 a total amount of 2.55 million certificates or 2.3% of the total number of certificates issued, including 0.27 million compensation certificates, were on accounts of 436 thousand physical persons.

As of April 1, 2006, accounts of legal persons held 3.67 million privatisation certificates, including 0.06 million property compensation certificates.

Holders of privatisation services in April 2006 could use services of 19 licensed intermediary capital companies for transactions in the market of privatisation certificates. Total monthly transactions with privatisation certificates (selling and buying from physical persons) carried out by intermediary capital companies in the 1st quarter of 2006 fluctuated from 0.19 million certificates in March to 0.14 million certificates in April.

6.14. Public Private Partnership

Public private partnership (PPP) is a co-operation between a state or local government institution and an entrepreneur from the private sector whereby a public service or object is being transferred over to the private entrepreneur for a certain period of time and certain conditions on the basis of agreement in order to ensure public services, such as provision of drinking water, waste management, construction of a road, etc. The state or local government has traditionally provided these services using its own initiative and resources, while in PPP the private capital is involved in provision of these services, accordingly dividing the financial and competence contributions, risks and gains.

In the “old” EU member states PPP has already become a traditional mechanism for implementation of public investment projects, allowing the public sector to carry out a substantial number of infrastructure projects.

PPP policy planning

Purposeful implementation of the policy of development of PPP projects in Latvia was started on January 20, 2000, when the Saeima of the Republic of Latvia adopted the Concessions Law. However, PPP has not been widely used so far, and mere 14 comparatively small concession agreements are registered in the Register of Concessions, which is a very low indicator in view of the huge need for investment projects in Latvia. There are several reasons why the spread of PPP projects in the national economy is small, and the most substantial of these reasons are the lack of experience in implementation of such projects and the general lack of knowledge about PPP. In order to increase the transaction potential of PPP, the Cabinet of Ministers approved the Concept on Promotion of Concessions (Attraction of Private Capital to Perform State Functions) in April 2002.

The most essential problems in the use of PPP mechanism are the following:

- 1) public investment plans do not envisage an opportunity to develop the public infrastructure and services through the use of the private capital, thereby both a successful PPP development is hindered and the opportunities that could be provided by PPP are not used;
- 2) lack of instruments supporting the PPP process as, according to the international experience, there are several instruments supporting the PPP process, such as guidelines, standardised documents and state support in preparation of the projects. In this way it is possible to ensure quality of PPP agreement and reduce administrative costs of preparation of the project, which sometimes comprise 5-12% of the total costs of the project¹;
- 3) shortage of PPP projects conforming to the best international practice;
- 4) lack of general knowledge about PPP mechanism.

In order to prevent these problems, on March 22, 2005 the Cabinet of Ministers approved the policy planning document “Basic Guidelines of Latvian Public Private Partnership Promotion”, which

¹ Michael Klein (ed.): *Concessions for infrastructure. A guide to their design and award*, World Bank, www.worldbank.org

determines governmental policy, basic principles, targets and priorities in promotion of the use of public private partnership.

Taking into account the Guidelines, on November 16, 2005 the Cabinet of Ministers approved the Action Plan for Implementation of the Basic Guidelines of Latvian Public Private Partnership Promotion for 2006-2009, setting the following lines of action for PPP promotion:

- 1) Co-ordinated activity of institutions and organisations involved in the PPP process;
- 2) Examination of PPP by sectors;
- 3) Creation of instruments promoting the PPP process;
- 4) Alignment of the legislative framework;
- 5) Improvement of the knowledge and understanding of PPP.

Improvement of legal environment

In parallel to development of policy planning documents and taking into account that new directives of the European Parliament and of the Council have been adopted, namely, *Directive 2004/17/EC co-ordinating the procurement procedures on entities operating in the water, energy, transport and postal services sectors*, and *Directive 2004/18/EC on the co-ordination of procedures for the award of public works contracts, public supply contracts and public service contracts*, and also taking into account the received instructions of the Internal Market Directorate-General of the European Commission as regards improvement of individual norms in Latvian legislation, the Ministry of Economics has drafted the normative act "Concessions Law".

The draft was supported by the Cabinet of Ministers on February 7, 2006, and at present it is under review by the Saeima.

Support to implementation of potential pilot projects of public private partnership

By fulfilling the tasks set in the Concept on Promotion of Concessions (Attraction of Private Capital to Perform State Functions), the Latvian Investment and Development Agency (LIDA) in co-operation with the Ministry of Economics carries out PPP promotion in two directions:

- 1) promotion of understanding of PPP;

The Ministry of Economics in co-operation with LIDA has carried out several activities to expand understanding on issues related to PPP. Specialists of the Ministry of Economics and LIDA have participated and organised several activities, among them:

- a) passing the knowledge on PPP to a wider society;
- b) development of methodical support instruments;
 - developed project of "PPP project cycle manual" including such issues as preparation, financial management, procurement, supervision of PPP projects.
 - developed methods "Procedure of how the financial and economic calculations are done to take decision on starting the procedure for obtaining rights to conclude concession agreement".

- 2) work with PPP projects.

LIDA and the Ministry of Economics give advisory support to implementers of potential PPP projects, informing them about:

- (a) the applicable type of PPP transaction;
- (b) the applied conduction of procurement procedure;
- (c) financial and economic calculations and procedure of doing them;
- (d) the possible legal solutions of the project agreement;
- (e) other PPP issues.

On October 13, 2005, five co-operation agreements with four local governments were signed at LIDA on starting the development of PPP projects in the public and local government sector. In a tender procedure, pilot projects submitted by local governments and involving possible use of PPP in their implementation were selected, namely, construction of dwellings with social housing in Salaspils, construction of new pre-school educational establishment in Cēsis, reconstruction of heat supply system in Jēkabpils, reconstruction and repair of town streets in Cēsis and renovation of art school in Ogre. It is planned that in the 2nd half of 2006 LIDA will work out guidelines for development of PPP projects on the basis of international experience and conclusions drawn during development of projects supported by LIDA.

6.15. Advisory Councils of the Ministry of Economics

6.15.1. National Economy Council

The National Economy Council of the Ministry of Economics (hereinafter NEC) was established in 1999 and operates as an advisory institution of the Ministry of Economics.

Founders of the NEC are the Ministry of Economics, Free Trade Union Confederation of Latvia, Employers' Confederation of Latvia, Latvian Association of Local and Regional Governments, Latvian Chamber of Commerce and Industry, and Industrial Confederation of Latvia.

NEC consists of the Minister of Economics and 21 experts designated by founders of the NEC, including representatives of entrepreneur organisations, University of Latvia, Riga Technical University, public bodies and other organisations. Representatives of the Council of the Small and Medium Sized Enterprises and Crafts of the Ministry of Economics and of the Foreign Investors Council in Latvia participate in NEC meetings in the status of observers.

NEC meetings are held once per month. The meetings are led by the Chairman elected by the NEC Steering Committee (representatives of the NEC founders). NEC invites the organisations representing national economy sectors to participate in the meetings as observers.

In between the NEC meetings the recommending decisions of the NEC are taken by the NEC Steering Committee, which consists of six representatives of the NEC founders. Work of the NEC is organised by the Secretariat of the National Economy Council.

Representatives of the NEC attend the Meetings of the State Secretaries (hereinafter SSM) with adviser rights and, according to the Roll of Procedures of the Cabinet of Ministers, NEC is empowered to pass opinions on the draft normative acts promulgated by SSM.

NEC also co-operates with the Saeima, ministries and other public bodies in order to incorporate NEC's proposals into normative acts aimed at improvement of business environment.

NEC reviews and monitors settlement of issues and development of normative document drafts, national economy development concepts, state budget and other documents important for development of Latvian economy. NEC prepares proposals and adopts recommending decisions on these issues. NEC also carries out a dialogue between businessmen and the Ministry of Economics, the Single Economic Strategy and Development Council, and other public institutions and non-governmental organisations.

NEC holds a view that it is necessary to encourage business activity in Latvia, creating favourable environment for business activity, lessening administrative obstacles, stimulating initiative of entrepreneurs, promoting availability of finances, improving business support services system and efficiency, at the same time promoting competitiveness of Latvian companies.

Participating organisations of the NEC have identified several provisions governing the corporate income tax and the personal income tax, seen as a hindrance to business development in Latvia and to increase of tax revenues. Experts of the NEC work actively with the working group of the Ministry of Finance dealing with assessment of the national taxation policy in order to reduce the tax burden on entrepreneurs and to enhance business development in Latvia.

NEC has expressed a strong opinion that successful absorption of the EU Structural Funds requires creation of procedures as simple as possible so that maximum number of projects submitted by the small and medium sized commercial companies of Latvia are implemented.

In order to ensure professional representation of the interests of industries in effective dialogue with the Ministry of Economics, NEC and other business organisations and public institutions, a model of co-operation with industries has been set up by the Ministry of Economics, whereby a protocol of agreement on co-operation with the councils of experts of industries and industry associations, which correspond to the functions of the Ministry of Economics and account for the biggest part of Latvian GDP, has been signed.

The Ministry of Economics and the NEC have signed this protocol of agreement with the following councils of experts (CE) of industries: CE of Machine Building and Metal Processing Industry, CE of Chemical and Pharmaceutical Industry, CE of Light Industry, CE of Construction Materials Producers, CE of Timber Industry, CE of Food Industry, CE of Construction Industry, CE of Passenger Carrier Industry, CE of Business Education and Management Advisers, CE of Tourism, and CE of Printing and Publishing Industry.

On signing the protocol of agreement, the parties agreed to unite their resources for development of programmatic documents, take measures towards implementation of the economic development and business environment improvement programmes adopted as part of the governmental declaration, and that the councils of experts will assess draft legislative acts and issue their opinion thereof.

Co-operation partners believe that an important role in this dialogue is played by the ability of bodies representing the industries to define the pressing problems that need to be addressed through efforts of the Ministry of Economics and the NEC as well as by holding regular meetings joined by the NEC, the Minister of Economics and bodies representing the industries, with the aim to discuss implementation of the co-operation mechanism and problem issues.

NEC members and experts work in the following councils, boards, committees and working groups:

- Consultative Board for Development Co-operation Policy Issues at the Ministry of Foreign Affairs;
- Supervision Council of the National Lisbon Programme of Latvia at the Ministry of Economics;
- Construction Council at the Ministry of Economics;
- Advisory Council on Latvian Tourism at the Ministry of Economics;
- Export Promotion Council at the Ministry of Economics;
- National Standardisation Council at the Ministry of Economics;
- EU Structural Funds Supervision Committee at the Ministry of Finance;
- Working group of the EU Structural Funds Steering Committee at the Ministry of Finance;
- Working group for national taxation policy assessment at the Ministry of Finance;
- Working group on issues of draft law “Amendments to the Commercial Law” for introduction of regulation of commercial deals at the Ministry of Finance;
- Information Society National Council of Special Assignments Minister for Electronic Government Affairs;
- Advisory Council of the Latvian Investment and Development Agency;

as well as participated in the Working group for drafting the Insolvency Law at the Ministry of Justice.

NEC members and experts also work in the Single Economic Strategy and Development Council chaired by the Prime Minister, which is a co-ordinating institution with an aim to ensure implementation of tasks for promotion and better co-ordination of economic development set in the Governmental Declaration on the planned activity of the Cabinet of Ministers, as well as encourage introduction of principles of sustainable development and promote the process of sustainable development of the country and participation of society in this process.

In the period from June 2005 to December 2005, the third comparative study commissioned by the Ministry of Economics and the Latvian Investment and Development Agency about the influence of administrative procedures on business environment was conducted in Latvia. The first study was conducted in 2001 and the second one was carried out in 2003.

The study consisted of the following elements:

- profound interviews with representatives of business associations from various fields, advisors and leaders of social partner organisations (Employers’ Confederation of Latvia and Free Trade Union Confederation of Latvia), which are also founders of the National Economy Council;
- summary and analysis of the most important problem issues of business associations, the National Economy Council, and the Council of the Small and Medium-Sized Enterprises and Crafts.

The study covered such spheres as starting business activity, licensing, environmental requirements, foreign trade, observance of working regulations, inspection activities, tax administration, state support for business activity and electronic services. The study included issues of administrative costs and the time spent fulfilling demands of supervisory institutions, while entrepreneurs conducted daily business activities in start-up, selection of place, and operation phases.

To carry out independent supervision of the study and define entrepreneur priorities, a panel of private sector experts and business association representatives was established. NEC experts also worked in the panel.

In the 1st half of 2006, six NEC meetings were held. The following important issues were discussed during these meetings:

- Action strategy of the Ministry of Economics for 2007-2009;
- Draft “Public Procurement Law” and proposals of the NEC for its improvement;
- Amendments to the Law “On Taxes and Fees” and proposals of the NEC for its improvement;
- Operational programmes for absorption of the Structural Funds for the next planning period (2007-2013) – operational programme „Innovation and Business Activity”;
- Operational programme „Human Resources and Employment”;
- Operational programme „Infrastructure and Services”;
- Public private partnership pilot projects implemented at the Latvian Investment and Development Agency;
- Co-operation with social partners, developing Latvian national positions under the authority of the Ministry of Economics on EU issues.

6.15.2. Council of the Small and Medium-Sized Enterprises and Crafts

The Council of the Small and Medium-Sized Enterprises and Crafts (hereinafter CSMEC) is an advisory institution of the Ministry of Economics. CSMEC consists of representatives delegated by 28 non-governmental organisations representing small and medium-sized enterprises (SME) and businessmen (organisations of various sectors of economy and regional organisations of SMEs).

The composition and statutes of the CSMEC were approved by Regulation No. 49 of February 16, 2004 of the Ministry of Economics. The activity of the CSMEC has an aim to involve the non-governmental organisations of SMEs and the industry associations into development and implementation of favourable SME business environment policy.

The key functions of the CSMEC are: to review and follow settlement of such issues as draft normative documents, national economy development concepts, state budget and other documents, which are important for development and implementation of favourable SME business environment policy and would promote development of SMEs, as well as prepare proposals and make recommending decisions on these issues; to carry out dialogue between entrepreneurs, the Ministry of Economics, other public institutions and non-governmental organisations as well as international organisations, which influence operation and development of SME.

CSMEC meetings are held once per month on average. Work of the CSMEC is led by the Chairman elected by the Council.

In between CSMEC meetings, the recommending decisions are taken by the CSMEC Steering Committee that consists of five CSMEC members nominated by participating organisations of the Council. The Business Environment Improvement Division of the Latvian Investment and Development Agency ensures work of the Council and performs functions of its secretariat.

During its operation the Council has launched a positive and efficient dialogue with institutions representing businessmen, the Ministry of Economics, the Latvian Investment and Development Agency and public institutions responsible for improvement of business environment in Latvia. There is a positive trend that, through co-operative efforts with the Ministry of Economics, businessmen are invited on a regular basis to assess SME development issues and the draft programming documents shaping SME development policy before their adoption by the government.

On initiative of the CSMEC, an internet portal www.mazaibizness.lv has been set up for SMEs, which is made as a manual and provides practical information for people willing to launch business activity as well as information necessary for SMEs regarding legislative acts, various legal and financial issues and latest developments.

The Council has actively participated in finding solutions to the issues related to improvement of taxation policy. For more detailed acquaintance with business environment in Latvian regions, the CSMEC organises visiting sessions on a regular basis; during these sessions, meetings with local government leaders and specialists as well as businessmen of the respective region are held, problems and needs of entrepreneurs are being discovered and solutions to them are being found collectively. In the 1st half of 2006, visiting session of the Council has taken place in Ventspils.

In the visiting sessions, the main topics of discussion are business environment and development prospects in the respective region, municipal support for entrepreneurs, tax allowances, opportunities for entrepreneurs to use financing from the EU Structural Funds and hindering factors, positive experience of entrepreneurs in the use and absorption of EU financing.

In order to strengthen the role of the CSMEC in improvement of business environment and ensure that the non-governmental sector is competently represented in absorption of the EU Structural Funds and aid programmes, the CSMEC members and representatives of its participating organisations are delegated in the following councils, committees and working groups:

- EU Structural Funds Supervision Committee at the Ministry of Finance;
- Working group of the EU Structural Funds Steering Committee at the Ministry of Finance;
- Working group for national taxation policy assessment at the Ministry of Finance;
- Information Society National Council;
- Export Promotion Council at the Ministry of Economics;
- Advisory Council of the Latvian Investment and Development Agency.

One of CSMEC representatives takes part in work of the European Economic and Social Affairs Committee in Brussels. Comments and proposals on the following projects have been given to the Committee:

- Employment Guidelines for 2005-2008;
- Volume and consequences of company transfers;
- How to co-ordinate the procedure of granting rights for conclusion of state construction contracts, state supply contracts and state services contracts;
- On improvement of introduction and implementation of EU legal acts;
- Contribution of tourism to socio-economic recovery of regions on the decline;
- On annual reports and consolidated reports of companies of certain kind;
- On EU development policy “European Consensus”;
- Social dialogue and involving the employees – a way to forecasting and control of changes;
- On the role of advisory bodies and professional organisations in implementation of partnership agreements and in the European Neighbourhood Policy.

In the 1st half of 2006, five meetings of the Council of the Small and Medium-Sized Enterprises and Crafts have taken place, where the following important issues were reviewed:

- On principles of introduction of the EU single currency euro;
- On measures implemented in 2005 in the framework of the SME development programme and planned measures for promotion of SME development in 2006;
- On amendments to the Law “On Taxes and Fees”;
- On amendments to the Law “On Value-Added Tax”;
- On current events in development of the National Development Plan for 2007-2013;
- On Competitiveness and Innovation framework Programme for 2007-2013;
- On introduction of the reduced rate of value-added tax in Latvia;
- On reduction of the personal income tax rate and increase of the untaxed minimum;
- Action of the state to ensure labour force in the domestic labour market;
- On burdens for small enterprises regarding agreements on technical maintenance of cash registers, and on the procedure for use of new type of invoices with numbers given by the State Revenue Service.

The Council of the Small and Medium-Sized Enterprises and Crafts plans to solve the following issues at meetings in the nearest future:

- Participation of small enterprises in public procurement;
- Issue of the amount of the entrepreneurship risk state fee and the part of the fee to be transferred into the employee claims guarantee fund in 2007;
- Operational programmes for absorption of the Structural Funds for the next planning period (2007-2013), etc.

7. Recommendations

The aim of the economic policy of Latvia is to ensure sustainable and balanced economic and social development, implement transition from labour-intensive economy to knowledge-intensive one and reach the EU average GDP per capita level in 20-30 years.

In order to achieve this aim and ensure continued fast growth also in the following years, it is necessary to maintain stable macroeconomic environment and promote competition, continue improving the business environment and promoting establishment of efficient and competitive sectoral structure as well as encourage employment.

In order to maintain stable macroeconomic environment and promote competition, it is necessary:

- **to observe permissible volume of the total budget deficit and ensure efficiency of the budget spending** in implementation of the fiscal policy;
- **to limit inflation more actively**, by restricting increment rate of crediting and regulate accessibility of consumption credit and mortgage credit resources as well stimulating entry of new market participants in those sectors, where competition is insufficient;
- **to plan changes of public utility tariffs gradually** in order to avoid a rapid growth of inflation. Not only specific criteria and methodology for review of prices have to be in place, but also a system must be developed, which would allow to forecast the potential impact of measures for raising all administratively regulated prices, including prices of public utilities regulated at local government level, on the total inflation in certain time period;
- **to encourage functioning of the EU internal market**, ensuring control over transposition and implementation of EU directives and preventing administrative restrictions, which hinder free movement of services.
- by transposing EU requirements on further opening of the energy sector, electronic communications and postal markets, **it is important to promote real competition and ensure that the implemented changes are in consumer interests. To ensure availability and adequacy of energy**, improving the energy supply infrastructure and widely implementing energy-efficiency measures in the consumer sector as well as increasing efficient use of renewable energy resources and generation of energy in the co-generation process. The market liberalisation process has to be harmonised with application of flexible regulation principles and further improvement of commercial activity principles of energy companies;
- **to strengthen supervision of competition and encourage development of competition** to public benefit in all national economy sectors, timely identifying the risk sectors, where violations of competition law are possible, limiting administrative and other obstacles to competition. More active fight is needed against the heaviest violations of competition law, such as abuse of dominant position and cartel agreements, introducing more efficient investigation instruments and a motivating sanctions policy. Along the *ex post* application of competition protection instruments, when market distortions are identified and investigation is under way in the framework of particular cases, to focus more actively on the use of *ex ante* preventive measures in order to disallow a possibility of such distortions;
- **to assess normative acts already during their drafting**, in order to identify and prevent potential violations of competition law, technical barriers to trade, and discriminating conditions (legal and administrative barriers) in the area of free circulation of goods and services and business law;
- **to continue fight against corruption and money laundering and opportunities to operate in shadow economy**. Supervision of state support and procurement has to be improved, achieving high level of transparency for state support projects as well as following the changes in EU normative acts and implementing preconditions for electronisation of the procurement process. Opportunities to prevent money laundering, which are prescribed in normative acts, have to be used more efficiently. It is essential to ensure availability of information about implementation and legal control of public administration functions delegated to commercial companies. This should promote more efficient use of resources and lessen opportunities of corruption;

- **to strengthen protection of consumer rights** through continued improvement of legislation, among other things, including the consumer interest protection into other policies and strengthening the mechanism of its observance supervision. Special attention has to be focused on safety of goods and services, protection of economic interests of consumers, and awareness of consumers and entrepreneurs about consumer rights;

In order to create conditions favourable for the functioning of the business activity, it is necessary:

- **to ease the legislative burden on business activity**, by promoting simplification, clarity, mutual harmonisation and transparency of the legislative process. *Action Plan for Improvement of Business Environment* has to be updated and implemented on a regular basis, including in it the recommendations of the *National Economy Council of the Ministry of Economics, Council of the Small and Medium-Sized Enterprises and Crafts, Foreign Investors Council in Latvia* and *Foreign Investment Advisory Service of the World Bank* and maintaining a constant dialogue with social partners;
- **to encourage development of local governments and ensure the rise of their capacity**. The administrative territorial reform has to be completed before the local elections of 2009 in order to establish optimum administrative and organisational structure of local governments and promote their capacity. **Special attention has to be paid to incentives for development of less developed regions**. Real levers and instruments have to be created in order to stimulate entrepreneurs to invest into depressive regions;
- **in order to provide qualitative acquirement from the Structural Funds and Cohesion Funds** for the next financial perspective years (2007 till 2013), **all necessary planning documents and normative acts have to be created till 2007**.
- **to promote introduction of the public private partnership mechanism**, especially with regard to the absorption of the EU Structural Funds. For the *Concessions Law* to become really functional and for the central and local government officials and business people to understand and start using an entirely new instrument in provision of public services, allowing for considerable economy of the central or local government budget resources, the legal base must be improved, development of public private partnership (PPP) projects and evaluation of PPP resources have to be encouraged, consultations on risk analysis should be given, and recommendations have to be made for preparation and administration of the public private partnership;
- **to provide efficient management of state-owned properties** by promoting expropriation of state-owned real estates and capital shares that are not needed for public administration functions, among other things, promoting privatisation of state-owned entities, improving and centralising the state-owned real estate management system. Legal improvement and consolidation must be made to the management of state-owned corporate enterprises and the mechanism for application of national interests in the state-controlled corporate and other enterprises.

In order to promote creation of efficient and competitive sectoral structure, it is necessary:

- **to promote research and development (R&D) and innovation, especially in the private sector**. Measures have to be developed and carried out to foster co-operation between educational, research and national economy sectors, ensuring transfer of knowledge and technologies. National research programmes and principles for distribution of grants need to be improved. State aid must be provided to innovative enterprises and infrastructure for development of research and knowledge centres, technological centres, business incubators and knowledge-intensive technology enterprises. Capacity of the Latvian Investment and Development Agency has to be strengthened, by broadening functions of the agency in order to promote private sector investment in applied research, encourage transfer of technologies and ensure introduction of efficient research results in production;
- **to promote the development of the information society more actively**, by raising availability of internet and introducing e-government. It is especially important to speed up the introduction of electronic signature that is a precondition to ensure development of e-government;
- **to improve access to financing for SME**, by promoting availability of credit resources, issuing guarantees for medium-term and long-term loans, ensuring allocation of finances for

- business development in early stage and opportunities to receive preferential loans, promoting access to finances in the form of SME risk capital from 3 newly established risk capital funds as well as **ensuring informative and advisory support to SME and business beginners**;
- **to improve efficiency, capacity and quality of the educational and training system and its compliance with long-term labour market demands.** Co-operation between public administration bodies, educational establishments and employers in correction of educational system supply in accordance with labour market needs has to be strengthened, and cost efficiency in all stages and forms of education has to be raised. Implementing changes in the educational system, the principle of access to education must be observed in order to ensure it in the context of life-long learning;
 - **to raise the level of technological skills and knowledge of natural science on the whole,** by improving the system of professional orientation and ensuring availability of professional orientation services for all population in the context of life-long learning;
 - **to foster expansion into new export markets and consolidation in the existing ones.** It is essential to provide the institutional base of export promotion and rise of its capacity, development of foreign economic representative offices, access to financial instruments and support to companies in export marketing. In order to strengthen international competitiveness of Latvian companies, it is necessary to ensure that border-crossing procedures (tariff and non-tariff barriers) do not raise unjustifiably the costs of raw materials, inter-consumption goods and services for Latvian companies and to promote bigger market access for exporters in third countries, especially in rapidly growing markets (Russia, China, India);
 - **to foster introduction of quality assurance systems.** Introduction of such quality management systems as environmental management systems, work protection and safety management systems, food quality assurance systems and other quality management systems must be supported and fostered in order to promote upgrading of companies and hence the growth of competitiveness;
 - **to improve conformity assessment system,** by co-ordinating the standardisation policy at national level, ensuring international traceability of conducted measurements and encouraging use of adequate measuring instruments, as well as promoting accreditation of conformity assessment institutions in the regulated sphere. Applying these conformity assessment instruments, Latvian entrepreneurs and their products/services will have additional credibility also in other EU member states;
 - **to improve the existing state aid programmes,** by making them an effective instrument to strengthen long-term competitiveness of Latvian entrepreneurs. The state aid granting system must be improved, focusing the state aid on projects that will give the biggest value in the future. Influence of the existing state aid programmes on competitiveness of Latvia has to be assessed and state aid programme priorities for the next planning period must be defined, changes in aid granting conditions have to be done in order to channel resources to activities, where state aid will be needed the most for strengthening of the long-term competitiveness of Latvian entrepreneurs.

Promotion of employment requires:

- **to solve structural problems of employment,** by supporting efforts to get adequate and higher skills in accordance with labour market requirements and facilitating the labour mobility, especially through improvement of transport infrastructure;
- **to reduce unemployment,** as it is the main cause for poverty and social exclusion. In order to encourage faster inclusion of the unemployed into labour market and improve quality of services provided to them, it is necessary to improve the existing active employment measures and develop new ones, among them measures for promotion of self-employment and launching business activity, strengthening competitiveness of the unemployed from problem groups and job seekers, especially the long-term unemployed, persons with a low education, persons after childcare leave, the disabled with various functional disorders, and other problem groups, taking into account the specific situation of unemployment in regions;
- **to reduce undeclared employment,** by raising the minimum wages and increasing the non-taxable minimum in order to lessen the tax burden on people with low income, and raising administrative capacities of the State Labour Inspectorate, attracting additional

personnel, improving control over observance of labour law norms, raising the level of society's awareness about labour law issues, strengthening the role of trade unions and employer associations in business activity, encouraging entrepreneurs to unite in business organisations in order to create favourable environment for increased reputation of socially responsible business activity;

- **to revise the system of taxes and allowances so that the work would pay off**, increase the efficiency of social expenditures and raise the non-taxable minimum.

In order to achieve strategic goals of Latvia, it is essential to continue improving **co-ordination of economic policy** in the country and **continue the reform of public administration** by introducing, among other things, a uniform system of wages and strengthening the existing public administration bodies. Therefore it is necessary:

- **to introduce more consistently the strategic planning in ministries and the medium-term budget planning**, thereby promoting purposeful, far-sighted, co-ordinated, transparent and result-oriented use of available resources and a link of strategic plans of ministries with the budget;
- **to continue the reform of public administration** by introducing, among other things, a uniform system of wages and strengthening the existing public administration bodies so that Latvia in the EU would be able to operate as a full-fledged EU member state both performing its duties and using opportunities and rights given to Latvia.

Consistently implemented economic policy will promote the convergence process and increased 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 everyone's personal initiative everywhere in Latvia under the conditions of mutual understanding and dialogue within the society.