

**Ministry of Economics
Republic of Latvia**

**ECONOMIC
DEVELOPMENT
OF LATVIA**

REPORT

**RIGA
JUNE 2005**

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All the numerical information and data unless otherwise indicated was provided by the Central Statistical Bureau. Data of the Bank of Latvia have been used in characteristics of Balance of Payment and monetary indicators of Latvia.

The Report was prepared under the guidance of K.Gerhards – State Secretary at the Ministry of Economics.

Cover design: Ingmārs Usas

Printed:

State Land Service of the Republic of Latvia
Polygraphy Division “Latvijas karte”
O.Vācieša iela 43, Rīga, LV-1004
Phone: 371-7611186

ISSN 1407-4109

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Reference mandatory in case of reprinting and quoting.

Dear reader,

Specialists of the Ministry of Economics have prepared the 22th **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. Since 2000 Latvian GDP has increased annually by 7.6% on average and in 2004 it went up even faster by 8.5%. Such indicators of development are among the highest in the European Union.

To ensure continued growth also in the future, it is necessary to promote transition from labour-intensive economy to knowledge-based economy. Latvian business activities at present are characterised by production based on low added-value product but the proportion of high technologies is very small. Economy based on knowledge and innovation is the basis of development and competitiveness of Latvian national economy, therefore we must invest in research and education already today.

To enact development of knowledge-based national economy, the government has resolved to increase expenditures for research and development already since this year so that by 2010 they will reach 1% of GDP. To foster creation and development of innovative enterprises, the resources of the EU Structural Funds are available and the fund of venture capital funds is being formed. The Ministry of Economics is developing the potential solutions how the state could help to ensure start-up capital for the new businessmen who have excellent ideas but lack financial resources to fulfil them.

The government continues working for improvement of business conditions. At present the work proceeds for application of corporate income tax rate of 15% to all businesses, development of e-government, simplification of legislation and procedures, and strengthening the dialogue between the government and non-governmental organisations.

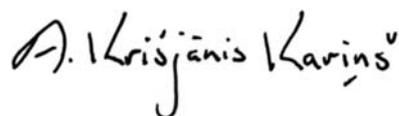
I am convinced that successful implementation of structural reforms will ensure stable growth also in the next years. We predict that Latvian GDP will grow by at least 7.5% in 2005.

In the Report you will find information on both the development of main economic and social indicators, growth of national economy sectors and the external economic environment, and the government's long-term economic policy, foreign trade policy, utilisation of the EU Structural Funds and the Cohesion Fund, innovation and business 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 the issues addressed in the Report, therefore many conclusions about development of national economy and proposals for further work reflect purely the opinion of specialists of the Ministry of Economics.

I hope that the Report will be useful to economists, entrepreneurs and all those people who are interested in problems of Latvia's economic development and will encourage exchange of opinions between public institutions, various organisations and interest groups, economists and other stakeholders.

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



June 2005

Artūrs Krišjānis Kariņš,
Minister of Economics

Contents

Abbreviations	6
1. Economic Situation: Brief Overview	8
2. Development of World Economy	12
3. Growth and Productivity	16
3.1. GDP Dynamics and Productivity	16
3.2. GDP Expenditure	19
3.2.1. Total Demand	19
3.2.2. Private and Public Consumption	20
3.2.3. Investment	21
3.2.4. Exports and Imports	26
3.3. Sector Contribution	32
3.3.1. Sectoral Composition of Economy	32
3.3.2. Manufacturing	33
3.3.3. Energy Sector	39
3.4. Development of Regions	41
3.5. Forecasts	43
4. Macroeconomic Stability	46
4.1. State Finances	46
4.1.1. Fiscal Policy and Central Government Debt	46
4.1.2. General Government Consolidated Budget Revenues	49
4.1.3. General Government Consolidated Budget Expenditures	52
4.2. Prices	55
4.2.1. Consumer Prices	55
4.2.2. Producer Prices	59
4.3. Balance of Payments	60
4.3.1. Current Account	60
4.3.2. Financial Flows	62
4.3.3. Foreign Direct Investment	64
4.4. Financial and Capital Markets	67
4.4.1. Monetary Policy and the Exchange Rate	67
4.4.2. Market Structure and Development	69
4.4.3. Deposits and Loans	71
5. Labour Market	75
5.1. Employment and Unemployment	75
5.2. Labour Costs	77
5.3. Employment Policy	78

6. Economic Policy and Priorities of Structural Policy	82
6.1. Targets and Priorities of the State Economic Policy	82
6.2. Integration of Latvia in the Economic and Structural Policy of the EU	89
6.2.1. Utilisation of the European Union Structural Funds and Cohesion Fund	89
6.2.2. Foreign Trade Policy	94
6.3. Sectors Development Policies	98
6.3.1. Industrial Policy	98
6.3.2. Energy Policy	100
6.3.3. Construction Policy	102
6.3.4. Tourism Policy	105
6.4. Business Environment	106
6.5. Innovation	109
6.6. Information Society	111
6.7. Small and Medium-Sized Enterprises	115
6.8. Competition Policy	119
6.9. Regulation of Public Utilities	122
6.10. Export Promotion	124
6.11. Protection of Consumer Interests and Market Surveillance	127
6.12. Quality Assurance	130
6.12.1. Quality Structural Policy	130
6.12.2. Standardisation, Metrology, Accreditation	132
6.13. Privatisation	134
6.14. Public Private Partnership	136
6.15. Advisory Councils of the Ministry of Economics	139
7. Recommendations	143

Abbreviations

Abbreviations

CEE	Central and Eastern Europe
CEES	Common European Economic Space
CIF price	Price of goods created by the value of goods inclusive of freight and insurance costs till the border of the importing country
CIS	Commonwealth of Independent States
CPI	Consumer price index
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
ECSC	European Coal and Steel Community
EDIS	External Decentralised Implementation System
EEA	European Economic Area
EFTA	European Free Trade Association
EIC	European Information Centre
EMU	European Monetary Union
ERM II	European currency rate mechanism
ESF	European Social Fund
ETA	European Technical Approval
EU	European Union
EU-10	New European Union Member States
EU-15	European Union before expansion of May 1, 2004
EU-25	European Union after expansion of May 1, 2004
FCMC	Financial and Capital Market Commission
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
FICIL	Foreign Investors Council in Latvia
FOB price	Price of goods created by the value of goods inclusive of freight and insurance costs till the border of the exporting country
GDP	Gross domestic product
GVA	Gross value added
HEX	Helsinki Stock Exchange
ICT	Information and communications technologies
IMF	International Monetary Fund
IRC	Innovation Relay Centre
IS	Information Systems
ISB	Information Society Bureau
ISPA	Instrument for the Structural Policies for Pre-accession
IT	Information technologies
ITU	International Telecommunication Union
JSC	Joint stock company
LCD	Latvian Central Depository

LEED	Local Economic and Employment Development
LEPP	Latvian Export Promotion Programme
LGA	Latvian Guarantee Agency
LIDA	Latvian Investment and Development Agency
LNMC	Latvian National Metrology Centre
LVS	Latvijas Standarts
MLBL	Mortgage and Land Bank of Latvia
MPI	Producer price index for imported products
NAPE	National Action Plan for Employment
NATO	North Atlantic Treaty Organisation
NEC	National Economy Council
NGO	Non-government organisation
NIB	Nordic Investment Bank
NPFT	National Programme of Foreign Trade
OECD	Organisation for Economic Co-operation and Development
OIML	International Organisation of Legal Metrology
PIP	Public Investment Programme
PPI	Producer price index
PPP	Public and private partnership
R&D	Research and Development
RAPEX	Rapid Information Exchange System
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
SIA	Limited liability company
SME	Small and medium-sized enterprises
SOLVIT	Efficient Solving of Internal Market Problems
TRIS	Technical Regulation Information System
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, official currency of the European Union
GBP	British pound
LVL	Latvian lat
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 accomplished in Latvia and integration in the European Union have left a positive impact on economic development of the country. **Latvia has shown one of the highest economic growth rates in the EU.** In the period from 2001 to 2003 the average gross domestic product growth in Latvia was 7.3% a year. In 2004 GDP increased even faster – by 8.5 per cent.

High growth rates are due to stable domestic demand dynamics and increase in exports. **The economic activity increases in all major branches of the national economy.** In the last years almost three-fourths of the increase was ensured by growth of service sectors where the biggest contribution was made by growth of trade, transport and communication sectors.

Manufacturing contributes essentially to the growth. In the period from 2001 to 2003 output in manufacturing has grown by 9.4% on average every year, considerably exceeding average growth rates of the national economy. In these years the biggest contribution to industrial growth in Latvia was made by wood industry, machine building and metalwork production.

In 2004 manufacturing output grew at a slightly slower pace by 7.9%, and the fastest growth was in chemical industry and production of construction materials. Other sectors showed a more moderate growth than in the previous years, which is partly related to adjustment to new circumstances after accession to the EU. Modernisation and reconstruction of production as well as utilisation of the EU funds will increase productivity and competitiveness of the sector, therefore it is expected that industry will continue developing dynamically.

Growth in agriculture was 3.5% in 2004. Low productivity and external competition are the main obstacles to development of this sector. Development of agriculture will depend on adjustment of agricultural production facilities and products to the EU standards and quality criteria and the external demand. Latvia's accession to the EU will ensure more equal competition opportunities for farmers in the EU internal market, while support from the EU funds will facilitate modernisation of agriculture and diversification of agricultural activities.

Rapid rise in investment has a favourable influence on development of construction, and it grew by 13% in 2004. Construction of industrial and residential buildings, hotels, streets and roads, and other objects is growing fast. The construction sector is expected to maintain high development rates also in the future in relation to development of mortgage lending, increased economic activity and investment as well as implementation of projects financed from the EU funds.

Increased domestic demand promotes development of services, especially those concerning wholesale and retail trade (in 2004 this sector grew by 10.1%). 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 which are provided to non-residents. This share increases annually.

The dynamics of domestic demand is stable 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 the market saturation. Big opportunities for growth are lying ahead for the tourism sector which has developed very rapidly in recent years.

Transit services are of great importance for the national economy of Latvia. They constitute approximately 15% of 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 in the last years the domestic use of transport sector services has been growing faster than their external use. Two-thirds of the growth in the transport and communications sector depend on the domestic demand (development of communications, warehousing, parking services, tourism etc.) and only one-third depends on the external demand (transit).

All in all, the transport and communications sector grew by 12.9% in 2004. In the 2nd half of 2004 after accession to the EU, cargo transportation increased especially fast and passenger transport services grew, including air transport services.

Statistical data indicate that the economic growth of Latvia in the 1st quarter of 2005 (increase by 7.4% against 1st quarter of 2004) was mostly ensured by robust domestic consumption and high level of investment. Trade turnover and construction continued growing rapidly and transport operation

indicators improved. Mostly due to the negative impact of January 2005 storm on the biggest export sector (production of wood and wood products) the development of industry decelerated in the 1st quarter of 2005. Increase in industry growth rates is expected in the 2nd half of 2005. The Ministry of Economics forecasts that **GDP in Latvia will grow by 7.5% in 2005.**

Economic growth in Latvia is achieved in conditions of stable macroeconomic environment.

The Bank of Latvia implements a *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 of January 1, 2005 the national currency lat (LVL) is re-pegged from the SDR currency basket to the euro (EUR) at the rate 1 EUR = Ls 0.702804. Change of 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 lat against the euro, namely, 1 EUR = 0.702804 LVL. Latvia will have to participate in ERM II at least 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. According to forecasts of the Bank of Latvia, this could happen at the beginning of 2008. Until then the LVL will remain the national currency of Latvia.

Table 1.1

Latvia: Key Indicators of Economic Development

	2001	2002	2003	2004	2005 f
	(growth against the preceding year, %)				
Gross domestic product	8.0	6.4	7.5	8.5	7.5
Private consumption	7.3	7.4	8.6	8.9	7.0
Public consumption	2.8	2.2	1.9	2.3	2.5
Total fixed capital formation	11.4	13.0	10.9	17.3	15.0
Exports	7.5	5.2	5.0	9.3	5.7
Imports	14.5	4.6	13.0	15.6	4.1
Consumer prices	2.5	1.9	2.9	6.2	5.5
	(in % of GDP, unless stated otherwise)				
Central government budget fiscal balance	-2.0	-2.3	-1.6	-1.1	-1.7
Central government debt	13.8	13.3	13.4	13.2	13.3
Current account balance	-7.6	-6.7	-8.2	-12.3	-9.8
Foreign direct investments (flows)	1.6	2.8	2.7	4.8	5.0
Share of job seekers (% of economically active population, 15-74 years old)	13.1	12.0	10.6	10.4	10.0

f – forecast

In 2000-2003 the average annual consumer price inflation in Latvia had been within the 2-3% band but in 2004 it reached 6.2%. Higher inflation growth in 2004 was due to a combination of several one-time factors, mainly the 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.

According to forecasts, inflation will return to its previous level in the coming years due to gradually diminishing impact of the mentioned one-time factors which are raising prices. In January-May 2005 inflation grew at a more moderate pace (by 3.9%) than in January-May of the preceding year (by 4.8%).

In view of growing domestic demand and to hold down credit growth rate, in March and November of 2004 the Bank of Latvia raised the refinancing rate by 0.5 percentage points to 4% and increased the reserve requirement from 3% to 4% in July. However, the impact of these 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 credits 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 under the Maastricht Treaty, and gradual improvement of the fiscal situation has been observed. 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 and gradual improvement of fiscal situation in municipal budget.

In 2004 the fiscal deficit of the consolidated total state budget was lower than the planned one, namely, it amounted to 79 million LVL or 1.1% of GDP. Revenues to the total state budget in 2004 were 20% higher than in 2003, while expenditures increased by 19.3%. The Saeima has approved the state budget for 2005 with a fiscal deficit in amount of 134.5 million LVL or 1.68% of GDP. It is planned that in 2005 revenues to the general government consolidated budget will increase by 21.2% in comparison with performance of 2004, while expenditures will grow by 22%.

Revenues to the total state budget in the first 4 months of 2005 were 25.3% higher than in the respective period of the preceding year, while expenditures rose by 27.8%. Fiscal surplus of 79 million LVL was in the budget.

The central government debt in Latvia is among the lowest in the EU. At the end of 2004 it equalled to 975 million LVL or 13.2% 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 investments in particular. Strongly negative trade balance is the main reason for the current account deficit. Slightly less than one-third of the deficit is covered by the positive balance of services because there is high share of transit services in the economy.

In 2004 the current account deficit amounted to 12.3% of GDP and was by 4.1 percentage points higher than in 2003. It was caused by worsened trade balance (by 2.2 percentage points) and decrease in positive balance of services (by 0.8 percentage points). Worsening of the revenue balance (by 1.4 percentage points) due to increase in direct investment revenues has to be noted, while increase in reinvested profit is to be evaluated positively. Worsening of the trade balance was caused by the growing domestic demand and accumulation of product reserves before accession to the EU, as well as several one-time purchases of investment goods in big volumes. After May 1, 2004 (Latvia's accession to the EU) import volumes did not increase so rapidly and the current account deficit started decreasing.

Even though the current account deficit is at relatively high level, at present it is not to be regarded as critical 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 the EU member states has been constantly expanding since restoration of Latvia's independence, and currently more than 70% of Latvian exports and imports are linked to the EU, including also the new EU member states. In 2004 most of Latvia's foreign trade turnover was made up by trade with Germany (14% of the total), Lithuania (11%), Sweden (8%), Russia (8%) and Estonia (8%).

During 2000-2002 the exports of Latvian goods in current prices grew by 11-12% annually, in 2003 the export growth was 17%, while in 2004 the exports increased by 29.1%.

In 2004 the exports of goods were favourably affected by the rapid increase in export unit value, which reached 17.5% in the last quarter of the year in comparison with the 4th quarter of 2003. Price growth was caused by favourable changes of currency exchange rate as well as increased world prices in several categories of goods, especially for metals and metalwork.

Exports significantly increased to all sales markets for Latvian goods – to EU member states, CIS countries and other countries of the world.

In exports to EU countries, the biggest contribution to export value growth was made by metal and metalwork exports (23% of the total export growth to EU-25 countries) and wood exports (18%). Growth of food product exports also should be noted. In 2004 volume of food product exports to EU countries exceeded the volume of the preceding year by one-third.

At the same time also imports considerably exceeded the level of the previous year (by 26.1% in current prices). Imports increased especially fast in March-April 2004 due to businessmen's wish to import as much interconsumption and consumer goods as possible on previous conditions in the last months before accession to the EU. Increase in imports was observed in all categories of goods, the

biggest increases were in the categories of mineral products (constituting 24% of all import value increase) and machine building products (15%).

In the first quarter of 2005 the volume of exported products in LVL exceeded the volume of the respective period in the preceding year by 37%, while imports increased at a relatively moderate pace (by 26%).

With the economic growth, income of the population is also growing. The real income of employees in the period from 2000 till 2003 has increased by 21%, and in 2004 the growth was 2.4%. In 2004 the growth rate of real wages has slightly slowed down due to comparatively high level of inflation.

It should be said that the growth of population's income is very uneven, the society is becoming increasingly polarised in terms of income and the number of poor people in the country is relatively high. 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 had been mainly reached at the expense of productivity and less due to higher number of employees. In 2004 the number of employed persons increased only by 8% as compared to 2000. The trend of growth having little effect on employment remains present in nearly all sectors of the national economy. With the 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 is 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 future growth will be mostly based on increase of productivity rather than growth of the number of employees.

Economic activity of the population (participation in the labour market) in Latvia is slightly lower than the EU average but economic activity of women has already exceeded the average indicators in the EU. In the period from 2000 till 2004 employment rate in Latvia has increased by 4.8 percentage points. In 2004 it reached 62.3%, only slightly falling behind the EU average.

According to data of the Labour Force Survey done by CSB, unemployment rate has went down from 14.4% in 2000 to 10.4% in 2004. The unemployment rate 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 – twice as low as the average in Latvia.

The economic growth potential is best characterised by growth of investments. From 2000 till 2004 the total fixed capital formation has increased 1.6 times.

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, including stable macroeconomic environment, inflow of foreign investments, reduction of interest rates on loans and strengthening of the banking sector, increase of general economic activity and formation of positive future expectations, etc.

In 2004 high investment level was retained in the national economy. Investments in fixed assets increased by 17.3% in 2004. Investment process was favourably affected by improvement of accessibility of finances, gradual reduction of long-term credit rates and high growth rates.

At the end of 2004 foreign direct investments accumulated in Latvia amounted to 2318.3 million LVL or about 31.5% of annual GDP volume.

The volume of incoming foreign direct investments in 2004 twice exceeded the volume of 2003 and equalled to 350.2 million LVL (4.8% of GDP). This covered almost one-fifth of investment in fixed assets. Investments in energy, financial mediation and communications were the most voluminous.

Interest of investors from EU countries in Latvia has increased in comparison with the previous year. 85% of incoming foreign direct investments in 2004 were related to investors from EU countries. The most significant foreign direct investments in this period were attracted from Germany, Russia and Netherlands.

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 that the growth will be sustainable also in the coming years. In absence of any external shocks, GDP can be expected to grow by 6-8% annually in the medium term.

2. Development of World Economy¹

In 2004 the growth of world economy was among the fastest during the last years. In 2004 economic activities have considerably increased in almost all regions of the world, especially in the biggest oil producing countries. Speedy growth was observed in the countries of Asia and in the Central and Eastern European countries, and big contribution to the development of world economy was made by poorer countries mostly from the African continent.

Table 2.1

GDP Growth
(percentage against the preceding year)

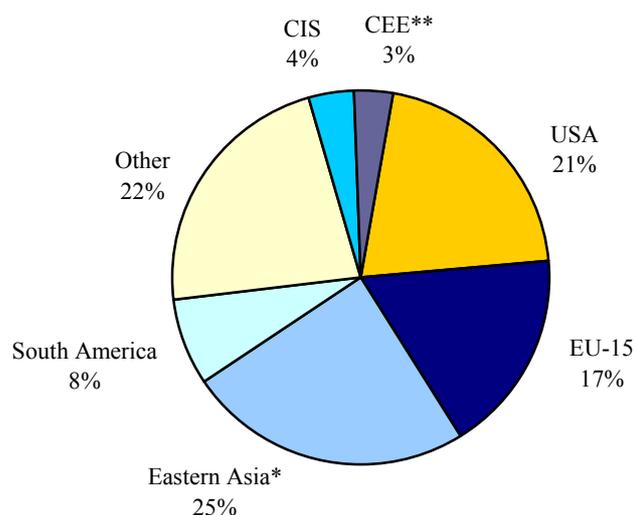
	1996-2001 (annual average)	2003	2004	2005 f	2006 f
World	3.6	4.0	5.1	4.3	4.4
USA	3.1	3.0	4.4	3.6	3.6
Japan	1.2	1.4	2.6	0.8	1.9
EU-25	2.7	1.2	2.5	2.1	2.5
CIS	2.3	7.9	8.2	6.5	6.0

Source: "The World Economic Outlook April 2005", International Monetary Fund, <http://www.imf.org>
f – forecast.

In April of this year IMF forecasted that world economy will grow by 4.3% in 2005, which was by 0.2 percentage points more than forecasted in September 2004.

Figure 2.1

The World GDP Distribution by Groups of Countries in 2004
(structure, GDP by purchasing power units)



Source: "The World Economic Outlook April 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.

¹ In this section, data from "World Economic Outlook", International Monetary Fund, April 2005 and "Economic Survey of Europe", ECE, 2005 No.1 were used, unless indicated otherwise.

At the beginning of 2004 the economy of the **United States** was characterised by good growth, however, in the 2nd quarter the growth rate went down to 2.7% due to increase in oil prices which also adversely influenced the private consumption. 2004 in the US economy ended with a small increase in growth (4.4%) mostly due to increase in private consumption.

IMF has raised US growth forecasts in 2005 to 3.6% (in comparison with autumn of 2004) due to favourable business confidence indicators and increasing private consumption.

The rapid growth of **Japan** in the 1st quarter of 2004, which was based on increase in exports, decreased and was close to zero in other quarters of 2004. This stagnation was due to the weak demand for IT products in the world, which reduced growth rates of exports and investments.

In 2004 Japanese GDP went up by 2.6% (1.8 percentage points less than forecasted in September 2004). IMF forecasts that growth rates in 2005 will decrease to 0.8%. Unfavourable oil price fluctuations and the high yen exchange rate that unfavourably affects increase in exports are considered the main risk to the growth.

Growth rate in the **European Union (EU-15)** has been rather low recently and mostly depends on the external demand. The domestic demand still depends on oil price fluctuations. Low global growth rates and high exchange rate of the euro unfavourably affects increase in exports, which was the main incentive for growth at the beginning of 2004. During the 2nd half of 2004 GDP in EU-15 countries increased by only 0.2 per cent.

Economic indicators in the 1st quarter of 2005 are ambiguous. Volumes of industrial output and retail trade have grown at the beginning of the year, while business confidence indicators are at a rather low level. This was the reason why IMF lowered growth forecasts for 2005 to 1.9% which is by 0.5 percentage points less than forecasted in September 2004.

Table 2.2

Main Macroeconomic Indicators of the Developed Countries
(percentage)

	GDP growth			Consumer price changes			Investment (% against GDP)			Current account deficit (% against GDP)			Budget deficit (% against GDP)		
	USA	EU-25	Japan	USA	EU-25	Japan	USA	EU-25	Japan	USA	EU-25	Japan	USA	EU-25	Japan
2003	3.0	1.2	1.4	2.3	2.0	-0.2	18.4	19.7	23.9	-4.8	0.0	3.2	-4.6	-2.9	-7.8
2004	4.4	2.5	2.6	2.7	2.2	0.0	19.6	20.2	23.9	-5.7	0.0	3.7	-4.3	-2.8	-7.1
2005 f	3.6	2.1	0.8	2.7	2.0	-0.2	19.8	20.4	24.2	-5.8	0.0	3.3	-4.4	-2.7	-6.9
2006 f	3.6	2.5	1.9	2.4	1.9	0.0	20.2	20.6	24.4	-5.7	0.0	3.5	-4.2	-2.8	-6.5

f – IMF forecast

Source: International Monetary Fund, World Economic Outlook Database, April 2005

After three-year-long stagnation, GDP in **Germany** went up by 1.7% in 2004. Increase in exports is mentioned as the main incentive for development in 2004 and has raised even more the current account's positive balance which doubled and made 3.9% of GDP in 2004. Domestic demand slightly fell because the private consumption and investment decreased.

German GDP growth in 2005 is forecasted by IMF in amount of 0.8% which is by 1 percentage point less than forecasted in September 2004.

Unlike Germany, in 2004 the growth of economy in **France** was at a rather high level and was based on the domestic demand. The private consumption increased on account of decrease in provisions. In the last four years investment has increased rapidly, while increases in exports have been insignificant. In 2004 French GDP increased by 2.3%, while IMF forecasts a slightly lower GDP increase for 2005 (by 2%).

The growth in the **United Kingdom** (UK) is still high in comparison with other biggest countries of the EU-15, although in the 2nd quarter of 2004 the growth slightly decreased in the UK as well as in other EU-15 countries and GDP growth in 2004 reached 3.1%. High domestic demand and positive trends in wage increase are still considered the main driving force for growth. Growth in the UK in 2005 is forecasted somewhat more moderate (by 2.6%).

In the **new EU member states and candidate countries** the growth in 2004, according to IMF calculations, reached 6.2% which is the highest level since beginning of the transition economy (0.6 percentage points higher than forecasted in September 2004). The rapid increase in domestic loans in the biggest part of the region was also stepped up by expansion of exports. Current account deficits are still at a rather high level due to increases in imports, as a result of the growing domestic demand. Inflation rates have rapidly gone up in the region (with the exception of Turkey) due to growing oil prices and increasing volumes of granted domestic loans as well as due to several one-time factors which are related to accession of the region's countries to the EU.

According to IMF calculations, the growth in 2005 will be a bit more moderate and more sustainable. Slight decrease in the current account deficit and inflation rates is forecasted in the region. Decrease in demand in the EU countries, which would negatively affect exports of the new member states, and unfavourable exchange rate fluctuations of the euro, considering that most national currencies of the region are pegged to the euro, are mentioned as the main risks to development of the region. According to IMF calculations, GDP growth in the new EU member states and candidate countries will reach 4.5% in 2005, which is 0.3 percentage points less than forecasted in September 2004.

Table 2.3

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

	GDP growth				Consumer prices				Current account deficit (% against GDP)			
	2003	2004	2005 f	2006 f	2003	2004	2005 f	2006 f	2003	2004	2005 f	2006 f
Total	4.6	6.2	4.5	4.5	9.5	6.7	5.4	4.1	-4.3	-4.9	-4.7	-4.3
Estonia	5.1	6.2	6.0	5.5	1.3	3.0	3.7	2.7	-13.2	-13.8	-11.0	-9.7
Latvia	7.5	8.5	7.3	6.2	2.9	6.2	5.7	5.3	-8.2	-12.3	-10.9	-9.8
Lithuania	9.7	6.6	7.0	6.8	-1.2	1.2	2.9	3.0	-7.0	-8.6	-9.5	-9.3
Czech Republic	3.7	4.0	4.0	3.9	0.1	2.8	2.5	2.7	-6.2	-5.2	-4.8	-4.4
Hungary	3.0	4.0	3.7	3.8	4.7	6.8	4.0	3.8	-9.0	-9.0	-8.6	-8.1
Poland	3.8	5.3	3.5	3.7	0.8	3.5	3.1	2.5	-1.9	-1.5	-2.1	-2.5
Slovakia	4.5	5.5	4.8	4.9	8.5	7.5	3.6	2.8	-0.9	-3.4	-6.0	-4.6
Slovenia	2.5	4.4	4.0	4.0	5.6	3.6	2.3	2.0	0.1	-0.6	-1.4	-2.2
Cyprus	1.9	3.7	3.8	4.0	4.1	2.3	2.5	2.5	-3.4	-4.1	-3.4	-2.7
Malta	-1.8	1.5	1.5	1.8	1.9	2.7	2.4	1.9	-5.8	-10.3	-4.0	-3.0
Turkey	5.9	8.0	5.0	5.0	25.3	10.6	9.0	6.1	-3.4	-5.2	-4.5	-3.7
Bulgaria	4.3	5.7	5.5	5.5	2.3	6.1	4.0	3.5	-9.3	-7.4	-7.6	-6.9
Romania	5.2	8.3	5.5	5.0	15.3	11.9	8.2	5.7	-6.8	-7.5	-6.9	-6.3

Source: IMF
f – IMF forecast

Baltic countries still are leaders among the new EU member states in economic growth, mostly due to increases in entertainment and productivity. These factors can play a determinant role in growth also in the future, considering strengthening of competitiveness. The growth will also be determined by the domestic demand. Rapidly growing private consumption and exports have stimulated increase in imports as well. Current account deficits are at a rather high level but are not risky in the short term

because they are mostly covered by foreign direct investment. The total economic growth in 2004 equalled to 6.2% in **Lithuania** and 6.6% in **Estonia**, while in 2005 the forecasted GDP growth is by 7% in Lithuania and 6% in Estonia.

Decrease in external demand and rise of oil prices, which can adversely affect not only production costs and prices but also industrial output and productivity, are mentioned as potential risks to regional growth just like in other regions.

Growth in the group of **Commonwealth of Independent States (CIS)** in 2004 remained at high level mainly due to high prices of energy and metals and to high domestic demand. Total GDP growth in the region reached 8.2% which was 0.2 percentage points more than forecasted in September 2004. Successful monetary and fiscal policies in the region encouraged progress in curbing of inflation.

Also in 2005 the total growth is forecasted at good level, although the growth rate may slightly decrease to 6.5%. Fluctuating oil prices and investment rate decrease in Russia (in 2005 the growth in Russia is forecasted in amount of 6% which is 0.6 percentage points less than forecasted in September 2004) which may adversely influence the total regional growth are mentioned as potential risks to the growth.

Table 2.4

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

	2003	2004	2005 f	2006 f
GDP growth	7.9	8.2	6.5	6.0
of which in Russia	7.3	7.1	6.0	5.5
Consumer prices	12.0	10.3	11.4	8.8
of which in Russia	13.7	10.9	11.8	9.7
Current account balance (against GDP)	6.4	8.5	9.4	6.9
of which in Russia	8.2	10.2	11.4	8.7

f – IMF forecast

Despite the increasing interest rates in the world and high oil prices, the global growth in 2005 and 2006 is projected rather positively (4.3% and 4.4% respectively) even though at a slightly lower rate than in 2004. Positive trends for growth may be provided by recovery of Western European countries' and Japanese economies as well as by increases in growth of Asian region countries, China in particular, which is stimulated by improvement of conditions of financial markets.

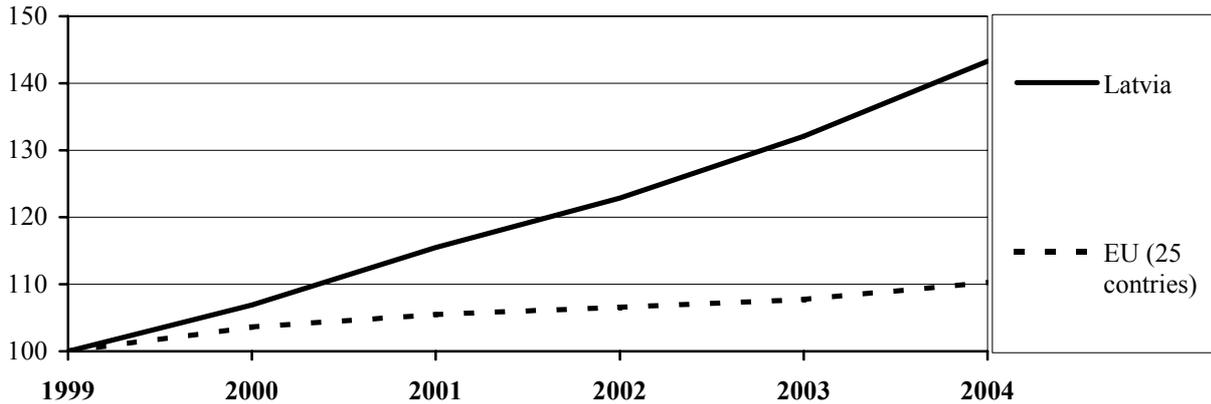
3. Growth and Productivity

3.1. GDP Dynamics and Productivity

Rapid economic growth is observed in Latvia for several years. In the last five years (2000-2004) GDP went up annually by 7.5 per cent on average.

Figure 3.1

GDP Growth in Latvia and EU-25
(in per cent, 1999 = 100%)



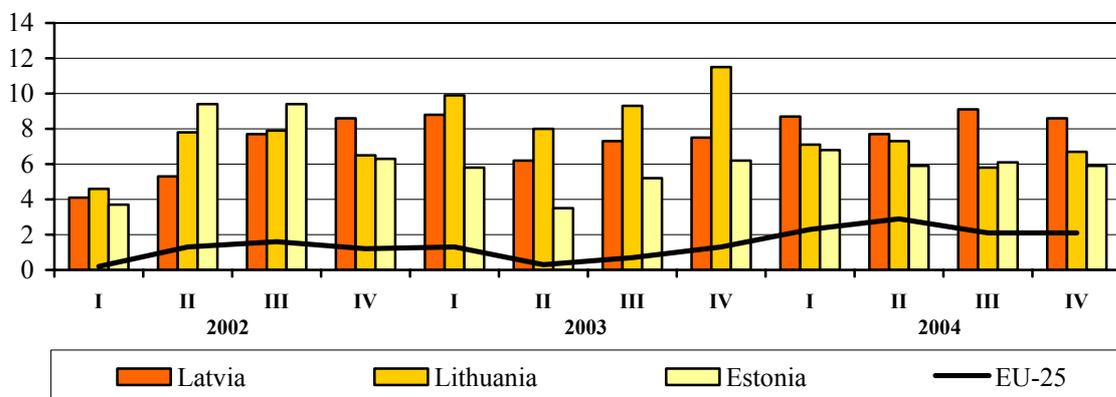
Source: Eurostat

Growth was especially fast in 2004 – by 8.5%. The steady growth is ensured by stable dynamics of domestic demand and ability to expand export markets.

Although the average growth of EU countries 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 Latvia is the most balanced without pronounced slowdowns or declines.

Figure 3.2

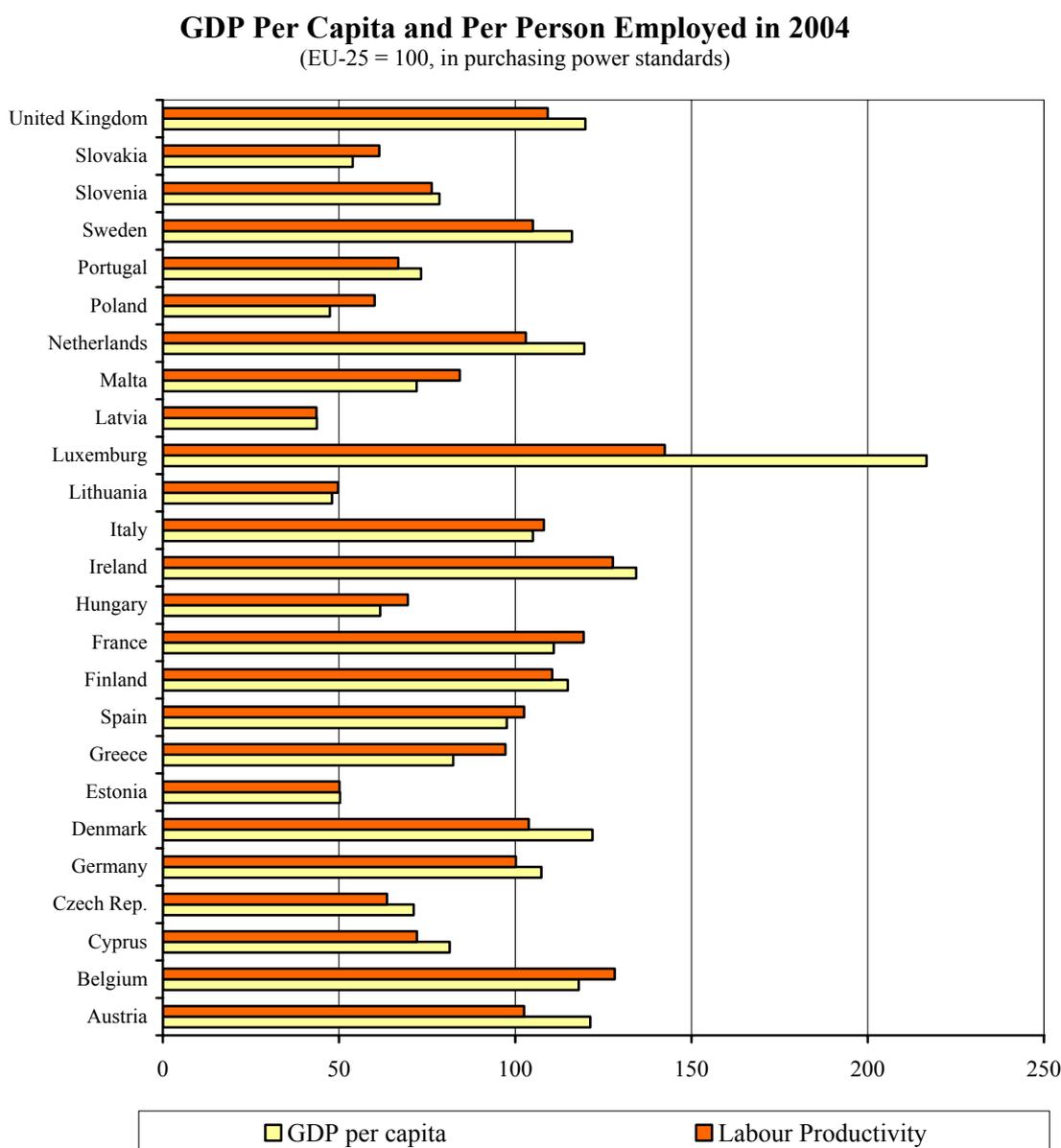
GDP Growth in Latvia, Lithuania, Estonia and EU-25, Quarterly Profile
(percentage change against the corresponding quarter of the preceding year)



Source: Eurostat

In 2004, Latvian GDP per capita in purchasing power standards was 43.7% of the EU-25 average (according to assessment by Eurostat). In comparison with 1999, the lag behind the average EU level was reduced by 9.5 percentage points.

Figure 3.3



Source: assessment by Eurostat

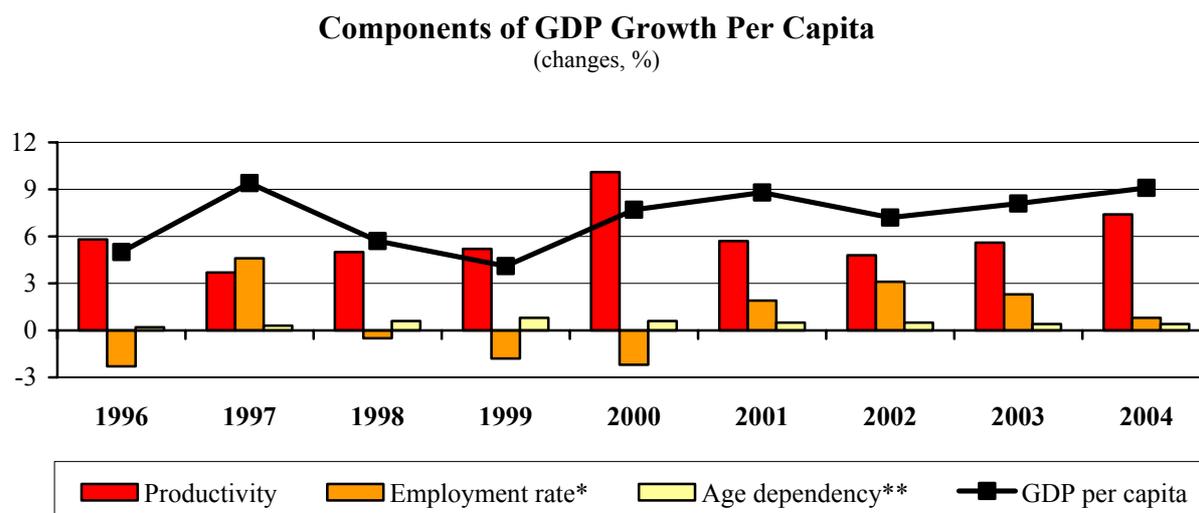
In this period, real volume of GDP per capita has increased 1.4 times in Latvia and 1.2 times on average in EU-25.

Growth of GDP per capita is affected by changes of several its components¹.

Increase in Latvian GDP per capita was mainly fostered by productivity rise and, to a smaller extent, by employment growth and demographic changes (see Figure 3.4). In 2004, volume of GDP per person employed in Latvia compared to the EU-25 average was almost at the same level as GDP per capita.

$$\underbrace{\frac{\text{GDP}}{\text{population}}}_{\text{GDP per capita}} = \underbrace{\frac{\text{GDP}}{\text{employed}}}_{\text{productivity}} * \underbrace{\frac{\text{employed}}{\text{population in working age}}}_{\text{employment level}} * \underbrace{\frac{\text{population in working age}}{\text{population}}}_{\text{age dependency (inverse)}}$$

Figure 3.4



* for persons aged 15-64 years

** age dependency – indicator characterising changes of proportion of non-workable age population (under 14 years, 65 and more years) in the total population

After 2000 along with productivity growth also the employment rate increases, and this reflects in faster GDP growth per capita. The positive impact of age dependency decrease on GDP per capita is also to be noted. Age dependency decreased due to the rapid decline of population aged under 14 years, which exceeded growth of population aged over 64 years.

Rate of productivity changes has been increasing in the last two years. One-tenth of productivity increase was caused by structural changes in the national economy to benefit of higher-added-value sectors but the rest of increase is related to productivity growth in every particular sector.

Table 3.1

Productivity by Sectors of National Economy – Added Value per Person Employed

	Average changes in per cent during the period, 2001-2004 (%)	Level in current prices (LVL per person employed) 2004
Primary sectors	6.3	2299
Manufacturing	10.2	5668
Electricity, gas and water supply	4.8	11373
Construction	-0.6	4440
Trade, hotels and restaurants	9.3	7261
Transport and communications	4.2	11121
Other services	2.3	10447
Public services*	2.6	4844
Total national economy	5.9	6509

* Public administration with health care and education

Productivity is increasing faster in manufacturing industry and agriculture but its level in these sectors still lags behind indicators of several services sectors. For example, the productivity level in financial services is 4 times higher than in manufacturing and 3.3 times higher than in the national economy on average.

3.2. GDP Expenditure

3.2.1. Total Demand

Stable growth in the last years was greatly ensured by the growing domestic demand. Private consumption has increased. Private consumption is favourably influenced not only by the annual increase of wages but also by the opportunity for individuals to get consumption credits and loans to purchase and repair housing that are offered at affordable interest rates. Also the rate of investment growth was high.

Table 3.2

Latvian GDP by Expenditure Items
(percentage)

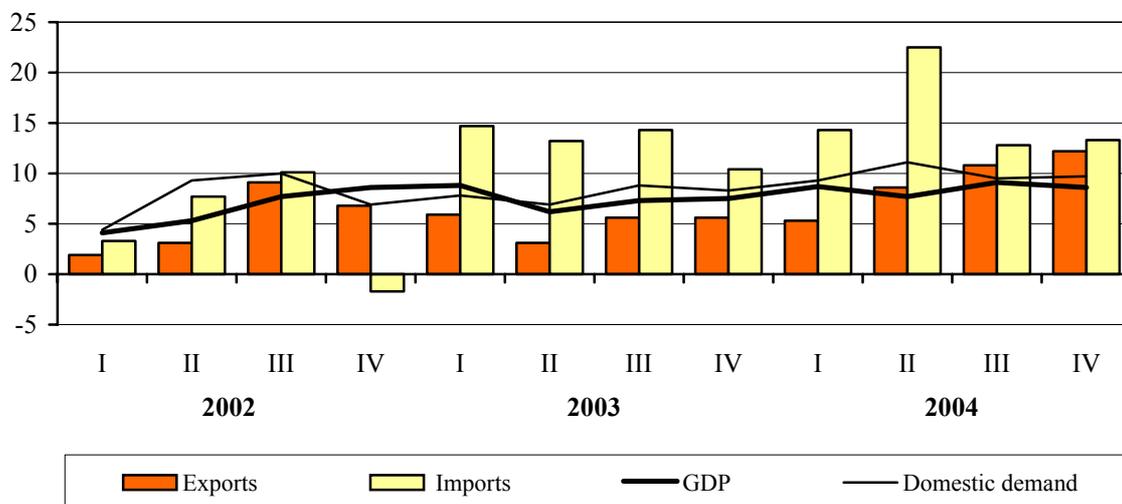
	2002			2003			2004		
	structure	growth rates	contribution to growth	structure	growth rates	contribution to growth	structure	growth rates	contribution to growth
Gross domestic product	100	6.4	6.4	100	7.5	7.5	100	8.5	8.5
Private consumption	62.7	7.4	4.6	63.0	8.6	5.4	62.5	8.9	5.7
Public consumption	21.1	2.2	0.4	21.8	1.9	0.4	20.9	2.3	0.4
Gross fixed capital formation	24.1	13.0	3.3	24.4	10.9	2.9	25.9	17.3	4.8
Changes in inventories	2.2	-	-1.7	3.7	-	3.4	6.4	-	2.4
Exports	41.1	5.2	2.2	42.3	5.0	2.1	43.8	9.3	3.7
Imports	-51.2	4.6	-2.4	-55.1	13.0	-6.7	-59.5	15.6	-8.5

a – assessment by the Ministry of Economics

Excellent growth indicators were reached in 2004 – by 8.5%. The same as in the previous year, the main growth determinant was the stable domestic demand, but the contribution of export growth has increased in comparison with the two previous years.

Figure 3.5

Quarterly changes in Real GDP and Major Expenditure Items
(% over the corresponding quarter of the previous year)



3.2.2. Private and Public Consumption

In the recent years the disposable income of households¹ in Latvia amounts to 58-60% of GDP but final consumption expenditures are close to 63%, therefore net savings are negative and make more than 3% of GDP.

Table 3.3

Disposable Income and Final Consumption Expenditures of Households, Net savings

	2001	2002	2003 e	2004 e
Disposable income of households (changes in % against the preceding year)	10.8	7.6	11.6	14.6
Final consumption expenditures of households (changes in % against the preceding year)	10.1	9.7	11.7	15.4
Net savings in % of disposable income	-3.2	-5.2	-5.3	-6.1
Net savings in % of GDP	-2.0	-3.1	-3.2	-3.6

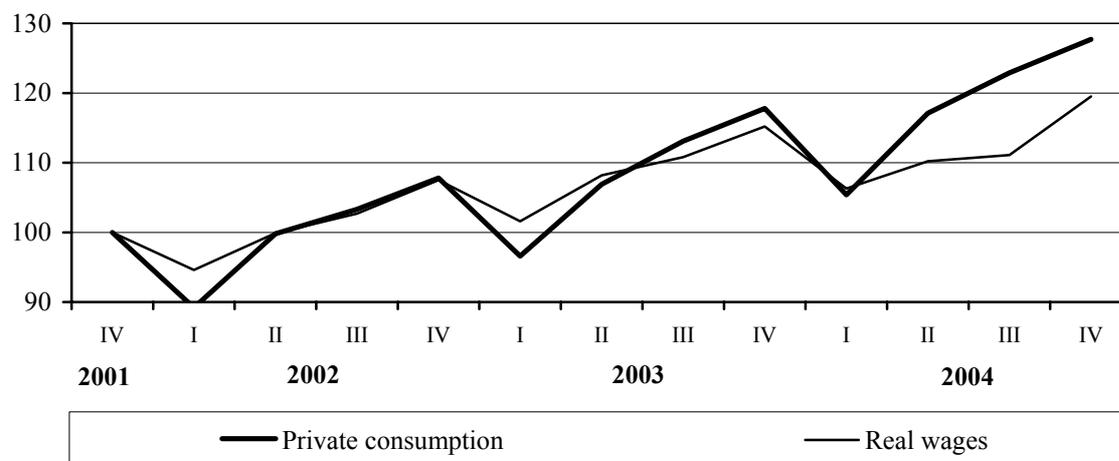
e – estimate by the Ministry of Economics

Dynamics of disposable income and final consumption (private consumption) expenditures of households are different, and the difference was especially pronounced in 2004 when expenditures increased considerably faster than income, increasing even more the deficit of income-expenditure balance. The growing opportunities to make use of consumption credits and housing repair loans determine the fastest growth of consumption.

Figure 3.6

Growth of Real wages and Private Consumption, Quarterly Profile

(4th quarter of 2001 = 100)



During the last three years the structure of disposable incomes of households has little changed – the pay part has somewhat decreased but incomes from business and property incomes have increased.

In 2003, disposable income of average per household member per month increased by 8.6% in comparison with 2002 and reached 87 LVL². Growth of consumer price index in this period was lower and amounted to 2.9%, therefore the purchasing power of population rose by 5.8% on average. The highest nominal growth of disposable income was in cities (12%), while the disposable income in the countryside diminished by 2.1%.

Average household consumption expenditures per household member in Latvia were 100 LVL per month in 2003, exceeding the disposable income by 13 LVL. The consumption expenditures in households of cities were higher (114 LVL) but in rural households the consumption expenditures were considerably lower (73 LVL) mainly due to decrease of income from agricultural production caused by draught.

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.

² According to data of household budget survey

Although the assessed real volume of public consumption grows at considerably slower pace, its nominal value increases at a rate equal to nominal GDP and therefore its share in GDP expenditure does not diminish actually.

On the whole, growth of final consumption expenditures in 2004 was a bit slower than GDP growth rates both in current and fixed prices.

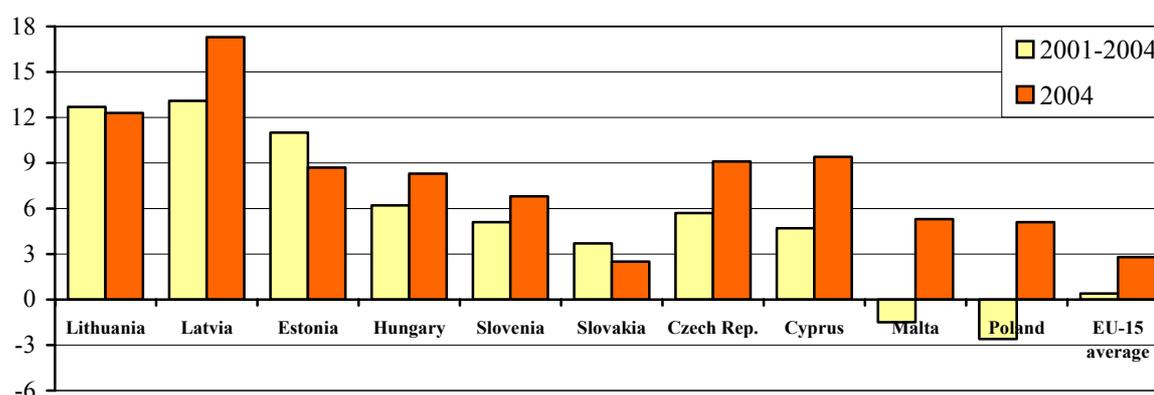
3.2.3. Investment

Latvia is experiencing fast investment growth for several years. In 2004 the volume of investment in fixed assets was 1.8 times bigger than in 2000, i.e., the investment in this period has increased by 13.1% annually on average. Investment is favourably affected by stable macroeconomic and financial environment, positive evaluation of Latvian investment environment by independent international organisations, and investment-supportive governmental policy.

As indicated by Eurostat data, investment growth in the new EU member countries has somewhat slowed down in the last four years in comparison with the previous five years but still several times exceed the EU-15 average growth rate which equalled only to 0.4 per cent from 2001 to 2004.

Figure 3.7

Average Annual Growth of Investment in the New EU Member States
(percentage)

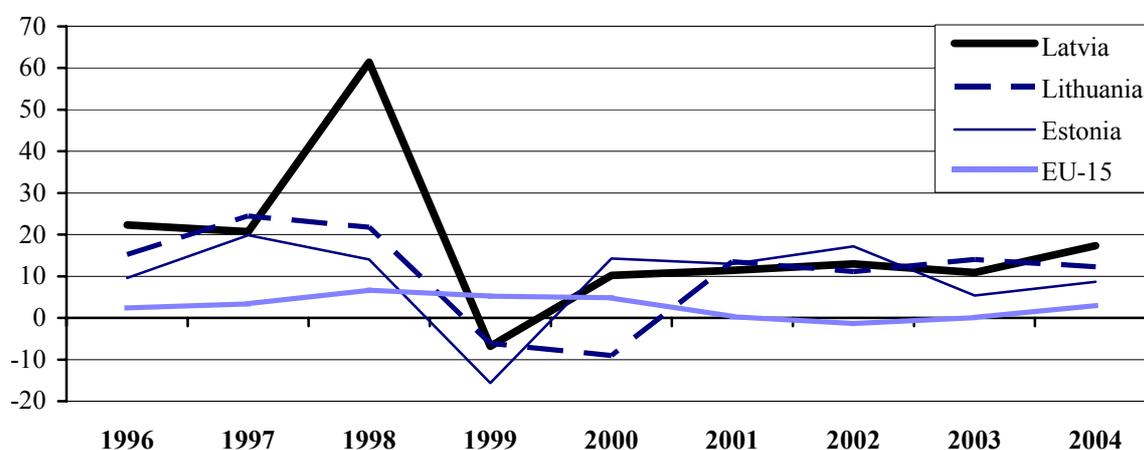


Source: Statistical Annex of European Economy, Spring 2005

Baltic States have taken leading positions in investment dynamics since 2001. Besides, the investment dynamics has become stable in comparison with fluctuating volumes in 1998 and 1999.

Figure 3.8

Investment Growth in Baltic States
(percentage against the preceding year)



Source: Statistical Annex of European Economy, Spring 2005

With fast investment growth rate which several times exceeded GDP growth, share of investment in GDP increased every year. In the period from 1991 till 2000 share of investment in Latvian GDP equalled to 16.2% on average and was the lowest indicator between the present EU member states but in the last four years nearly a quarter of national income has been used for the gross fixed capital formation – by almost 5 percentage points more than in EU-15 on average.

In 2004 investment in Latvian national economy grew by 17.3% in comparison with 2003 and expenditures for gross fixed capital formation made up 25.9% of GDP, exceeding the level of the previous year by more than 1 percentage point.

Table 3.4

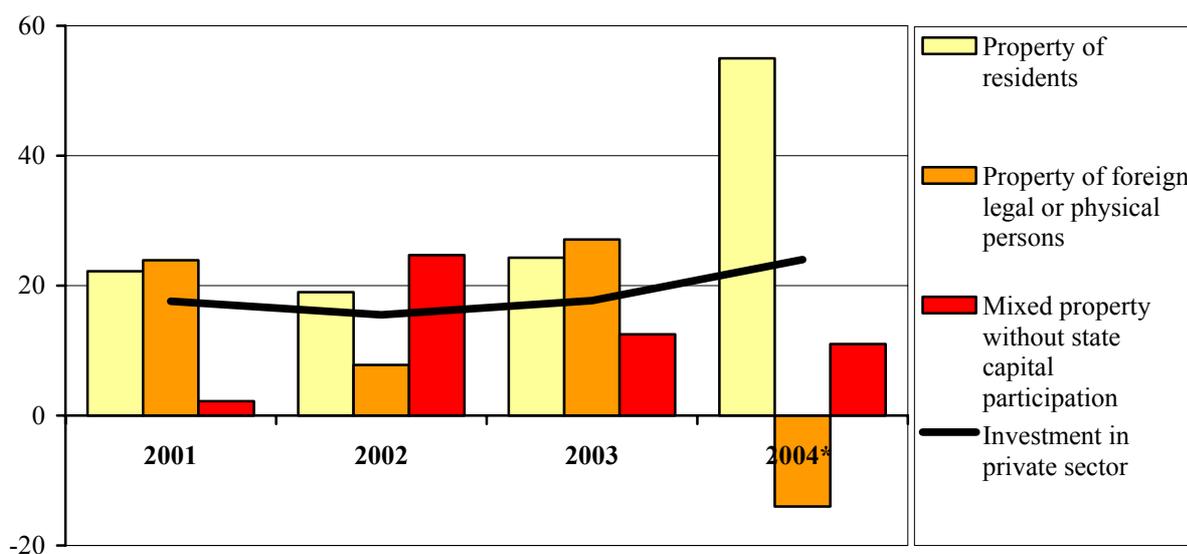
Gross Fixed Capital Formation			
	2001-2004 (average per year)	2003	2004
Real growth			
GDP	7.6	7.5	8.5
Gross capital formation	19.8	22.7	22.6
– gross fixed capital formation	13.1	10.9	17.3
Percentage against GDP			
Gross capital formation	28.6	28.0	32.3
– gross fixed capital formation	24.9	24.4	25.9
– changes in inventories	3.7	3.7	6.4

The investment growth is mainly ensured by the investment in the private sector. In the period from 2001 to 2004 the investment in the private sector has doubled (increased on average by 19.2% annually) while the investment in the public sector¹ has increased by 34% in 4 years (on average by 7.6% annually).

In 2004 investment in the public sector went up faster (by 29%) than in the private sector (by 24%), and 36.1% of all investment in Latvian national economy were made in the public sector.

Figure 3.9

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



* assessed by quarterly data

¹ Public sector includes enterprises and organisations of the central government 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.

Investments in companies owned by residents and in companies owned by non-residents increased at different paces (see Figure 3.9). Since 2001 the investment in companies owned by residents increased on average by 24.4% per annum and made up 41% of investment in the private sector or 26.8% of total investment. Investment in companies owned by non-residents reached 17.1% of investment in the private sector, growing on average by 19.3 annually.

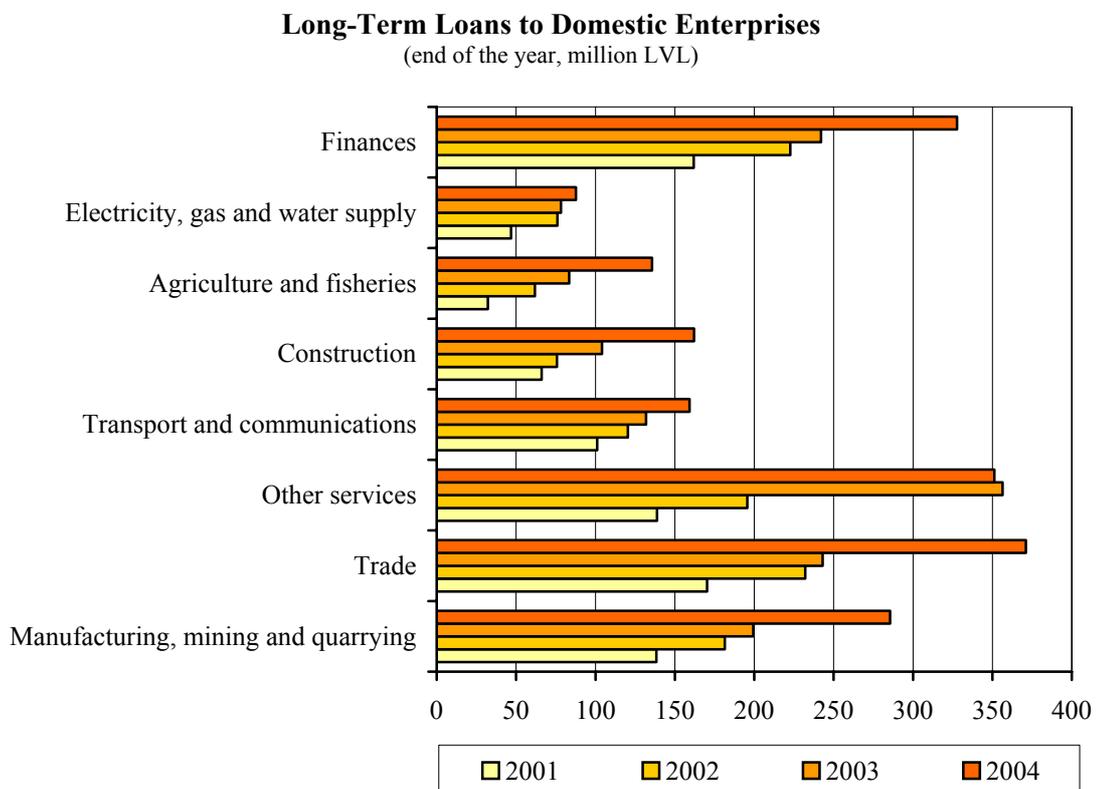
The speedy dynamics of investment is based on increased rate of capacity utilisation, increased availability of financial resources, and so-called technical factors which are related to necessity to renew the existing capacities in order to maintain and increase competitiveness.

Results of business surveys indicate that load rate of capacity utilisation in Latvian enterprises is increasing gradually. In 2004 the rate of capacity utilisation (as percentage of full capacity) in industry equalled to 71% on average, exceeding the average level of 2000 by 11 percentage points. In July 2004 the rate of capacity utilisation reached 73% and was the highest since 1993. The growing domestic and external demand in conditions of high rate of capacity utilisation can create additional stimuli for investment also in the future.

High growth rate of investment is largely linked to availability of finances. Reduction of tax burden and increased sales of products due to growing demand positively affected financial position of enterprises, thereby increasing opportunities to invest own means. Surely, the most essential financial incentive to investment in the last years is reduction of interest rates on loans. In the period from 2000 to 2003 the average weighted annual rates on long-term loans issued in LVL to domestic companies decreased from 10.3% to 7.5% whereas the long-term loans to domestic private companies at the end of 2003 were 2.9 times higher than at the end of 2000, having grown by 25.6% in 2003 alone. Although in 2004 the average weighted annual rates for long-term loans equalled to 9.2%, i.e., exceeded the level of 2003 by almost 2 percentage points, in view of higher inflation the real interest rates on loans were lower than in 2003, and at the end of 2004 the long-term loans to domestic companies increased by 36 per cent.

During 2000-2003 the long-term loans to the services sector have grown 2.9 times (2.3 times in the production sector). At the end of 2004, compared with the end of 2003, the long-term loans have gone up by 33.3% in the services sector and 43.2% in the production sector, including by 43.1% in manufacturing.

Figure 3.10



In breakdown by sectors, crediting volumes increased most rapidly for commercial activity, construction, hostels and restaurants. It was determined by infrastructure development, increased activity in construction of dwelling-houses, and growth of the number of tourists. Share of long-terms loans to the manufacturing industry in the total crediting portfolio also went up.

Results of business survey also indicate that the demand for products is the determinant factor with the biggest positive influence in all survey years among the factors affecting investment. In 2005 its importance increases. 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 financial resources availability.

Sectoral structure of investment¹. In 2001-2003 investment in Latvian national economy sectors went up by 37.7% in total or by 11.3% annually. Investment dynamics is faster in production sectors, which can be explained by general increase of economic activities, improvement of crediting terms, and economic policy favourable to investment. In this period, investment in production sectors grew by 60.5% (annually by 17.1% on average), while in the services sectors investment increased by 28.9% (annually by 8.8% on average). Similar trends remained also in 2004. In 2004 investment in production sectors was by 60.5% higher than in the previous year, while investment in services sectors grew by 28.9%. Positive investment dynamics was observed in all sectors of national economy.

Table 3.5

Investment by Sectors (Excluding Investment in Individual Construction)
(percentage)

	Growth			Structure	
	Average 2001-2003	2003	2004	average 2001-2003	2004
Primary sectors	36.2	5.1	36.4	3.0	3.8
Manufacturing	14.7	7.1	17.5	16.2	17.0
Electricity, gas and water supply	15.2	25.4	113.0	8.1	13.1
Construction	14.6	33.7	42.0	2.9	3.7
Trade	7.9	12.2	19.6	17.6	15.2
Transport and communications	1.4	-18.0	4.0	21.5	17.8
Other commercial services	20.6	43.6	23.6	17.3	16.5
Public services	6.5	11.6	22.5	13.4	12.8
Total	11.3	13.3	26.0	100.0	100.0

The share of production sectors in the investment structure increases year by year from 29.8% in 2001 to 37.6% in 2004.

In 2004 the investment into manufacturing went up by 17.5% and constituted 17% of the total investment in the national economy. These investments were mostly made in food industry and wood processing. Investment structure in manufacturing industry is changing gradually. In the period from 2001 to 2003 the share of these two sectors in investment made into manufacturing amounted to 57.4% but decreased to 45% in 2004. This was mostly influenced by decreased investment in wood processing. In 2004 investment into wood processing was by 30% lower than in 2003, and the share of this sector in the total investment into manufacturing decreased by 12% in comparison with 2003 and constituted 18.2%.

In 2004 as in the preceding periods the majority investment was made in labour-intensive and low technology sectors, although in the last years considerable growth of investment has occurred also in high technology sectors. During the last three years investment in high technology sectors went up on average by 28.4% per annum; in 2004 it grew by 46.2%, including growth of investment by 124% in chemical industry, by 8% in machinery, and by 22% in production of electric machines and appliances. Due to faster growth of investment, the share of these sectors in the total investment amount in 2004

¹ Investment in distribution by sectors is presented according to non-financial investment statistics which does not include all investment in fixed assets.

increased by 2.3 percentage points in comparison with 2003 and reached almost 20%. Share of medium technology sectors in the total investment made into manufacturing is also growing. Investment in these sectors in 2004 increased by 37.8% in comparison with 2003, and the share of medium-technology sectors in the total investment into manufacturing reached 20%. These trends would be evaluated positively although the share of low technology sectors is still convincingly big.

Table 3.6

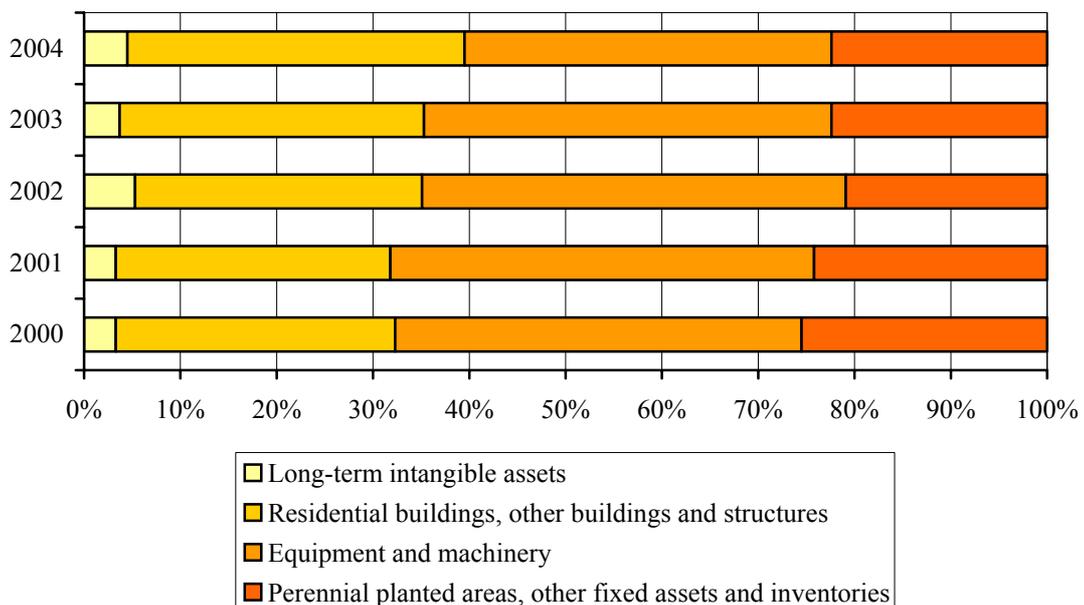
Investment in Manufacturing
(%)

	Growth rates			Structure		
	average in 2001-2003	2003	2004	average in 2001-2003	2003	2004
Food industry	13.9	5.4	5.6	29.3	30.5	27.4
Light industry	13.4	21.4	23.0	8.2	7.2	7.5
Wood processing	10.0	-2.8	-30.0	29.2	30.6	18.2
Paper industry and publishing	-3.3	-12.0	148.2	6.2	5.3	11.2
Chemical industry and related industries	19.2	19.4	98.4	5.6	5.1	8.6
Production of other non-metallic mineral products	11.1	38.6	17.0	3.6	3.5	3.4
Production of metals and metal articles	32.4	-9.2	55.0	7.2	6.5	8.6
Production of machines and equipment	27.0	11.6	18.6	6.8	7.1	7.2
Other industries	26.0	21.0	114.2	3.9	4.3	7.8

Evaluating technological structure of investment, it must be noted that in the last two years the share of residential buildings, other buildings and structures in the total investment increased especially fast, which was greatly influenced by development of mortgage crediting in Latvia. The share of investment in the long-term intangible assets is still small.

Figure 3.11

Technological Structure of Investment
(percentage)

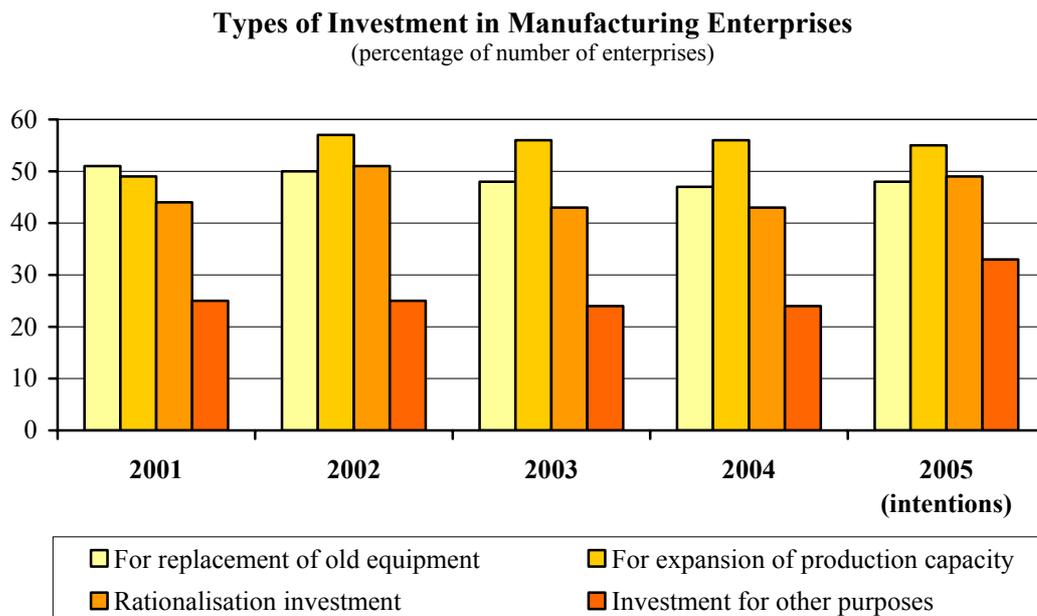


The share of technological machinery and equipment (including transport vehicles) in the total investment structure has gradually diminished from 42.2% in 2000 to 38.1% in 2004.

Issue of qualitative directions of investment in connection with their influence on production processes is no less important than the evaluation of investment dynamics and the technological structure of investment. Such information is being aggregated and published in the CSB bulletin „Business and consumer survey results”¹.

Results of business survey indicate that majority of companies every year make investments for replacement of old equipment. Such tendency is also expected in 2005. Investments for replacement of old equipment are planned by 50% of surveyed industrial companies.

Figure 3.12



Investments in manufacturing industry since 2002 are mostly made for expansion of production capacities. Also in 2005 such investments are planned by 55% of surveyed companies. In 2003 and 2004 investments in production were made more for expansion of its capacities and not for mechanisation and automatisisation. In 2005, rationalisation investment is planned in bigger amount than in the previous years. The number of companies which plan to make investments for rise of labour safety and environmental protection is growing, and this fact would be evaluated positively. In 2004 such investments were made by 24% of companies but in 2005 such investments are planned by 33% of companies.

3.2.4. Exports and Imports

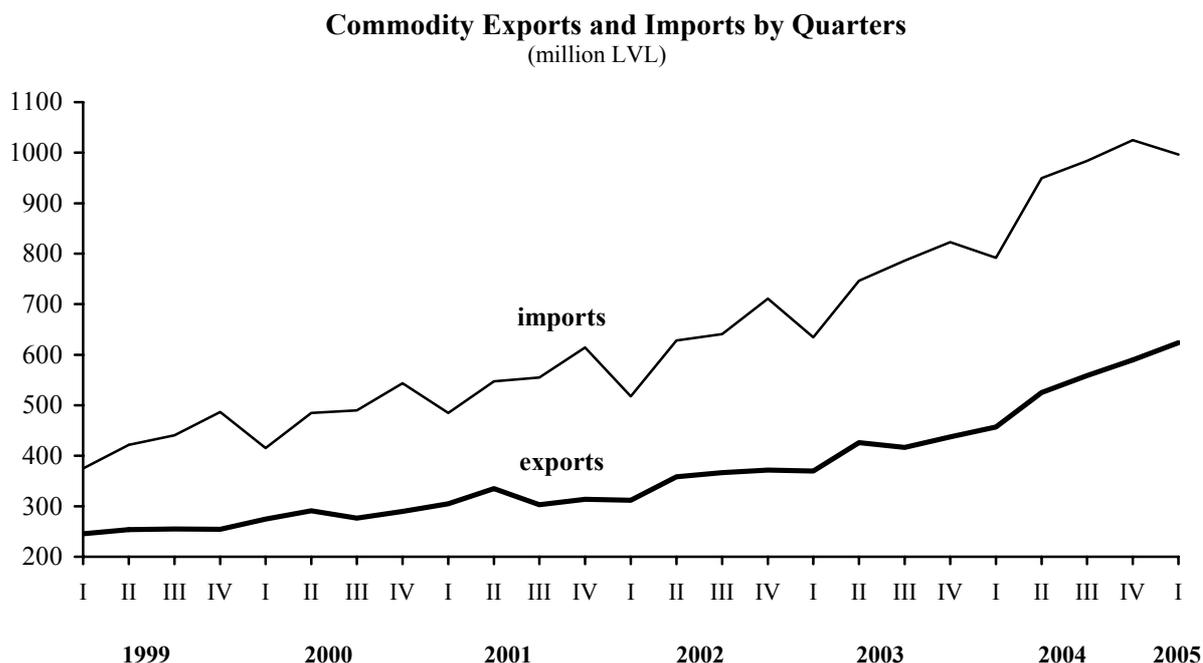
Exports and imports of commodities

Exports of Latvian commodities in 2004 grew considerably by 29% in current prices. Also 2005 has begun with a very rapid increase in exports by 37% in the 1st quarter of 2005 in comparison with the respective period of the preceding year.

Also imports in 2004 went up but at a slightly slower pace by 25%. Imports grew particularly fast in March-April 2004, which was determined by wish of entrepreneurs to import as many intermediate and consumption goods as possible by the old terms in the last months before Latvia’s accession to the EU. In the 1st quarter of 2005 imports were by 26% bigger than in the 1st quarter of the previous year.

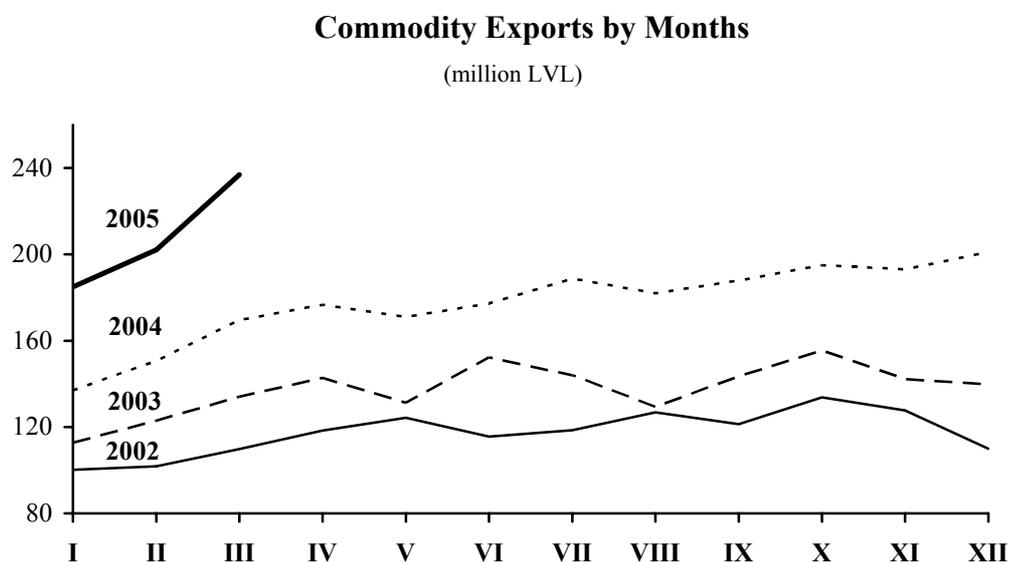
¹ According to EU methodology of investment conjuncture survey, all investments are divided into:
 – investment for production capacity expansion (means used for retaining the previous production and for expansion of production);
 – rationalisation investment (means channelled to mechanisation and automatisisation of production and to introduction of new technology);
 – investment for other purposes (means channelled to pollution control, work safety increase, etc.).

Figure 3.13



In 2004 the **commodity exports** were favourably influenced by the fast rise of the export unit value which grew by 13% in comparison with 2003, and this was the highest growth rate after 1995. The main reason of the rise was the favourable changes of currency exchange rates.

Figure 3.14



Commodity exports in 2004 went up in all groups of goods, especially metals and metal products, mineral products, wood and wood products, which accounted for respective 20%, 18% and 14% of the total growth of exports (see Table 3.7).

Table 3.7

Exports by Main Groups of Commodities

(FOB prices)

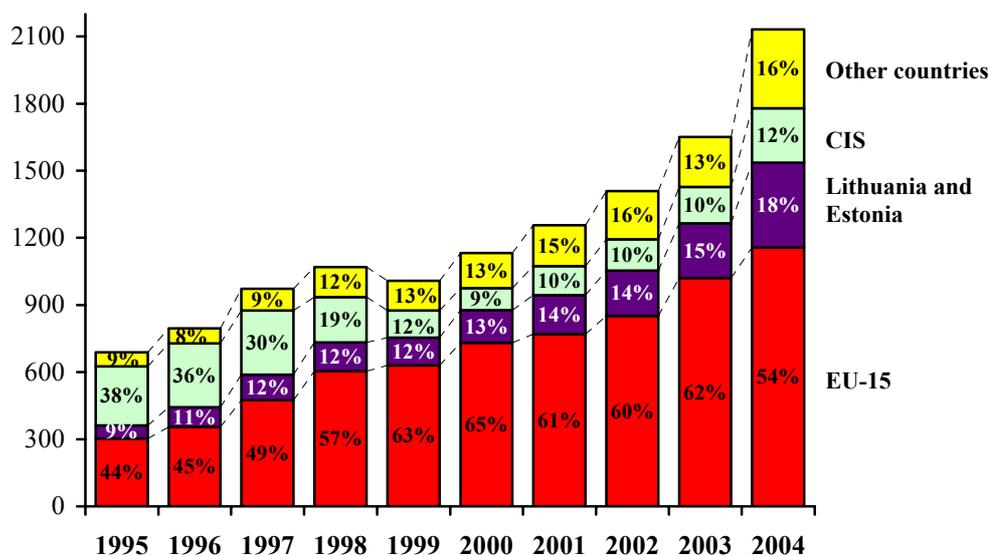
	2003			2004		
	million LVL	structure (%)	increase against 2002 (current prices, %)	million LVL	structure (%)	increase against 2003 (current prices, %)
Total	1650.6	100	17.2	2130.7	100	29.1
including:						
wood and wood products (IX)	581.8	35.2	23.0	649.4	30.5	11.6
metals and metal products (XV)	207.4	12.6	18.3	301.8	14.2	45.5
light industry products (VIII; XI-XII)	225.4	13.7	17.5	243.1	11.4	7.9
agricultural and food products (I-IV)	148.5	9.0	3.2	206.7	9.7	39.2
products of chemical industry and allied industries, plastics (VI-VII)	127.0	7.7	22.6	167.9	7.9	32.2
machinery (XVI)	116.8	7.1	18.3	167.4	7.9	43.3
mineral products (V)	26.4	1.6	29.5	113.5	5.3	329.5
transport vehicles (XVII)	34.2	2.1	18.3	53.6	2.5	56.6
other commodities (X; XIII-XIV; XVIII-XXII)	183.1	11.1	8.2	227.5	10.7	2.7

Exports to the **EU-25 countries** in 2004 were by 25% higher than in the previous year. Exports increased in all groups of commodities, and the biggest contributions to the growth were made by exports of metals and metal products (22% of the total growth of exports to the EU-25 countries), wood and wood products (18%), and mineral products (16%). Fast increase in exports to the EU-25 countries continued also in the 1st quarter of 2005, when these exports went up by 32% in comparison with the respective period of the preceding year.

Figure 3.15

Exports by Groups of Countries

(percentage)



Exports to the **CIS countries** in 2004 increased at especially rapid pace by 50%. The biggest contributions to this growth were made by increased exports of machinery (30% of the total growth of exports to the CIS countries), chemical industry products (13%) and light industry products (12%). Exports to the CIS countries continued rapidly increasing also in the 1st quarter of 2005 (by 63% in comparison with the 1st quarter of 2004).

Latvia's commodity exports to **Estonia** grow faster than to **Lithuania**. The exports to Estonia increased by 64% in 2004 (by 50% to Lithuania) and by 66% in the 1st quarter of 2005 (by 50% to Lithuania).

Commodity imports in 2004 increased by 26% (see Figure 3.16 and Table 3.8). Imports increased in all groups of commodities; the biggest growth was observed in the group of mineral products, which accounted for 24% of the total increase of imports, and in the group of machinery (15%).

Figure 3.16

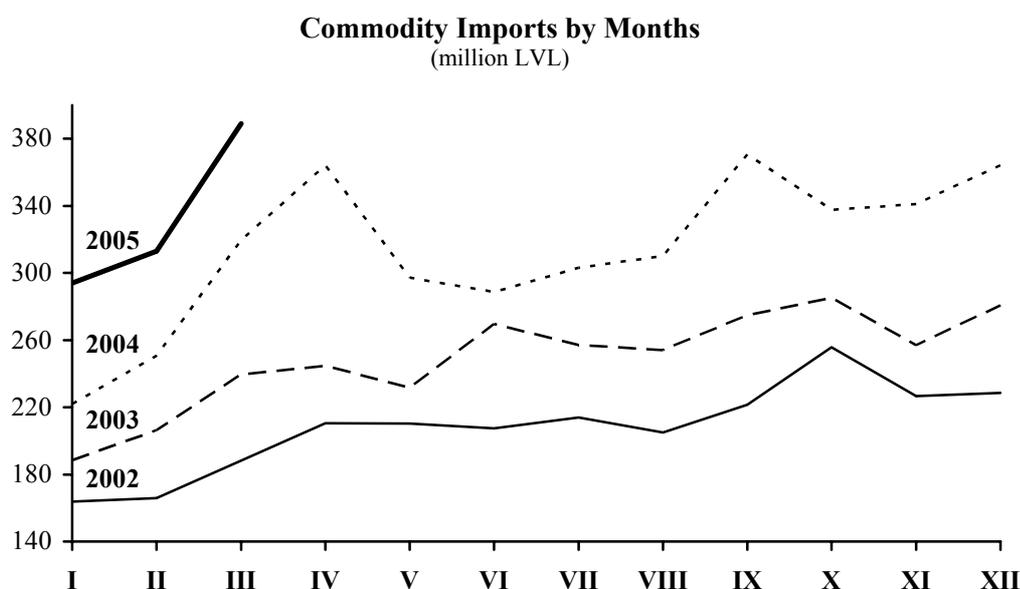


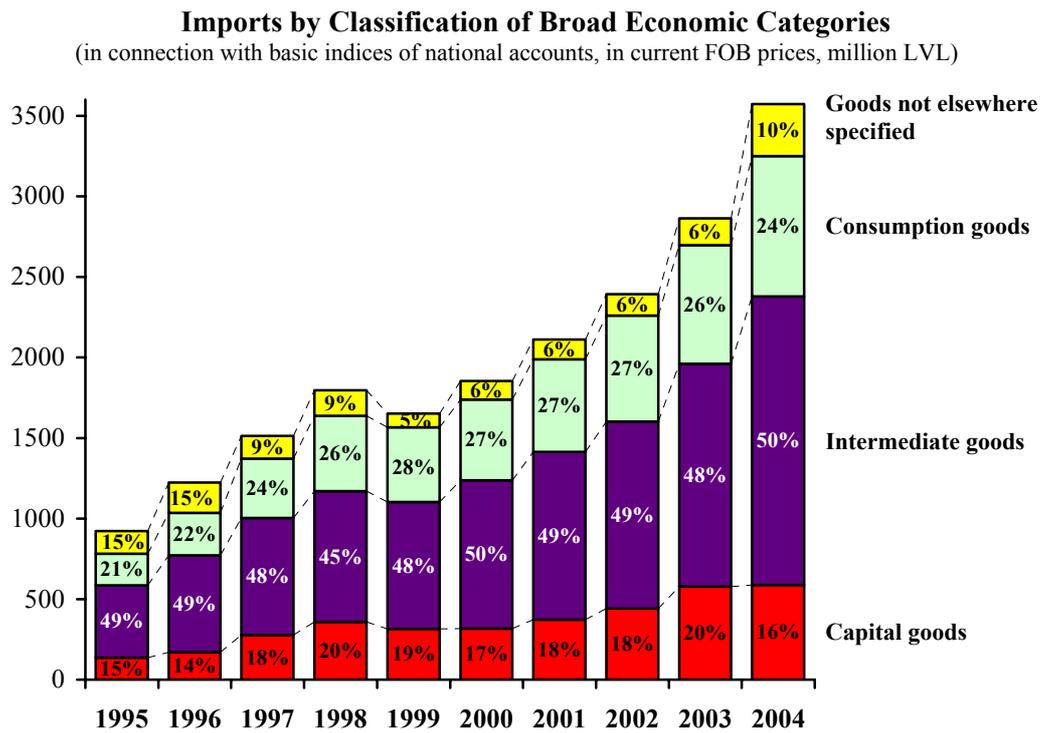
Table 3.8

Imports by Main Groups of Commodities
(CIF prices)

	2003			2004		
	million LVL	structure (%)	increase against 2002 (current prices, %)	million LVL	structure (%)	increase against 2003 (current prices, %)
Total	2989.2	100	19.7	3768.2	100	26.1
including:						
wood and wood products (IX)	70.2	2.3	68.2	114.3	3.0	62.8
metals and metal products (XV)	277.3	9.3	39.1	385.8	10.2	39.1
light industry products (VIII; XI-XII)	232.2	7.8	16.2	259.8	6.9	11.9
agricultural and food products (I-IV)	361.1	12.1	7.8	442.8	11.8	22.6
products of chemical industry and allied industries, plastics (VI-VII)	454.0	15.2	17.9	535.2	14.2	17.9
machinery (XVI)	629.6	21.1	18.2	743.9	19.7	18.2
mineral products (V)	296.9	9.9	22.1	482.5	12.8	62.5
transport vehicles (XVII)	313.6	10.5	28.3	404.5	10.7	29.0
other commodities (X; XIII-XIV; XVIII-XXII)	354.2	11.8	15.5	399.3	10.6	12.7

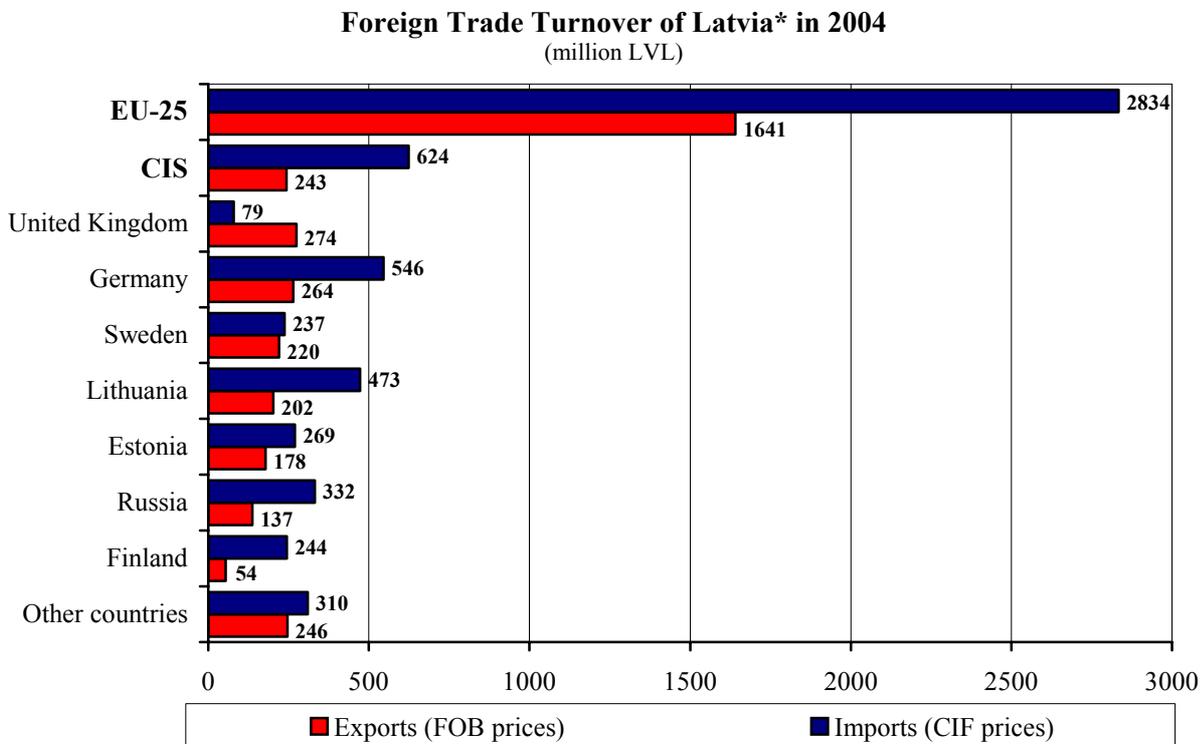
As viewed by classification of broad economic categories, the imports have not changed substantially during the last four years, but it should be noted that the share of intermediate goods has slightly increased.

Figure 3.17



The biggest **trading partners** of Latvia in 2004 were Germany (14% of the total foreign trade turnover), Lithuania (11%), Russia (8%), Sweden (8%) and Estonia (8%).

Figure 3.18

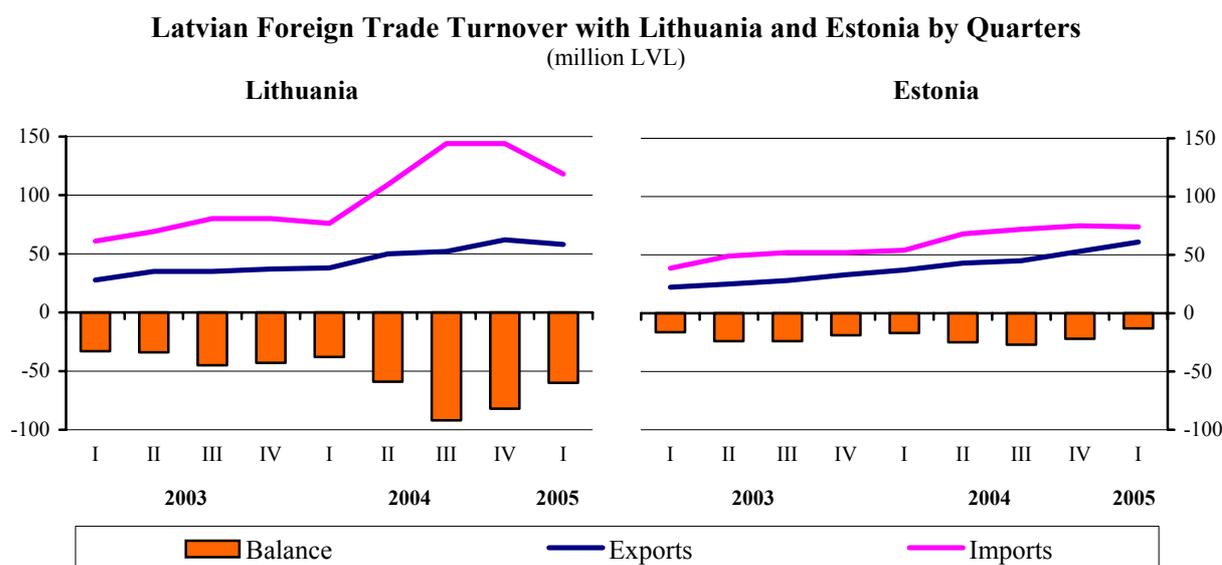


* with countries where foreign trade turnover with Latvia is no less than 5%.

Latvia's imports from Lithuania more than twice exceeds Latvia's exports to Lithuania. Latvian exports to Estonia equals to approximately 65% of Estonia's exports to Latvia (see Figure 3.19). Total Latvia's exports to Lithuania and Estonia increased by 53% in 2004, while the imports from these

countries to Latvia increased by 52%. Very rapid growth of imports from Lithuania took place in the 2nd half of 2004.

Figure 3.19



Exports and imports of services

The clearly negative foreign trade balance 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 2004, compared with the preceding year, has decreased, as exports of services went up by 11% but imports increased more rapidly by 19%.

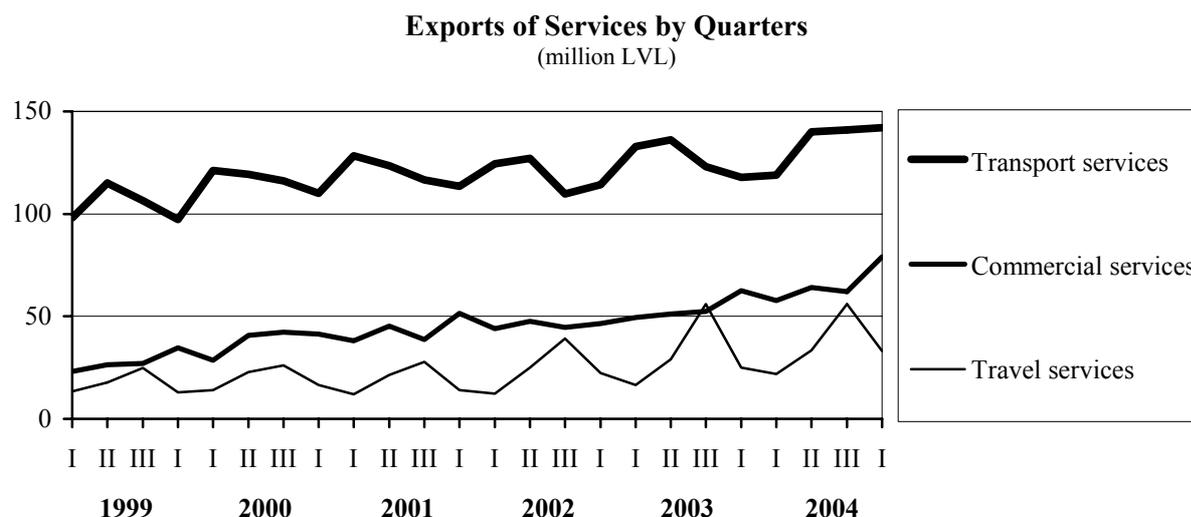
Table 3.9

Exports and Imports of Services in 2004

	Million LVL			Structure (%)		Changes against the previous year (%)	
	exports	imports	balance	exports	imports	exports	imports
Services – total	963.2	636.5	326.7	100	100	11.4	19.1
including:							
Transport services	541.9	224.2	317.7	56.3	35.2	6.3	30.7
– sea transport	237.3	58.5	178.8	24.6	9.2	-2.2	9.3
– air transport	55.5	67.2	-11.7	5.8	10.6	46.8	60.4
– other transport	249.1	98.5	150.6	25.9	15.5	8.5	29.4
Travel	144.3	203.8	-59.5	15.0	32.0	13.9	8.9
Commercial services	263	193.2	69.8	27.3	30.4	22.0	17.1
Other services	14	15.3	-1.3	1.5	2.4	12.0	40.4

More than half of the exports of services are revenues from transit haulage. 2004 was slightly better for the transit business than the preceding year. Increase of revenues from commercial services and incoming tourists is significant. Still, travellers from Latvia, as usual, have spent more money abroad than incoming tourists in Latvia.

Figure 3.20



3.3. Sectoral Contribution

3.3.1. Sectoral Composition of Economy

The structure of Latvian economy in sectoral profile has little changed in the last years. The share of service sectors has slightly increased from 72.2% (by added value) in 2000 to 72.7% in 2004 because trade developed faster than other sectors of economy.

Table 3.10

Structure of Economy
(%)

	By added value		By number of employees	
	2000	2004	2000	2003
Primary sectors	4.6	4.5	14.5	12.9
Manufacturing	13.5	14.0	17.9	15.9
Electricity, gas and water supply	3.5	3.0	1.9	2.0
Construction	6.1	5.8	5.9	8.2
Trade, hotels and restaurants	17.6	19.8	17.7	17.3
Transport and communications	14.2	15.7	8.3	9.2
Other commercial services	23.2	22.2	12.3	13.4
Public services	17.2	15.0	21.5	21.1
Total	100.0	100.0	100.0	100.0

The structure of economy in terms of employment is very much different from the structure by added value due to great difference between productivity levels in various sectors of economy.

Rapid economic growth in recent years has been ensured by both increased domestic demand and greater export opportunities. Increase of domestic demand had a direct effect on growth of services but industrial growth was mainly based on rising exports.

Increasing trade (wholesale and retail) contributed nearly one-third to growth in the last three years (2002-2004). The contribution by manufacturing is 3 percentage points smaller. The most stable growth has been observed in three sectors – trade, manufacturing and construction.

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

Table 3.11

GDP Growth
(%)

	Growth rate				Contribution to growth			
	2002	2003	2004	2002-2004 average	2002	2003	2004	2002-2004 total
Primary sectors	5.1	1.3	4.3	3.6	0.2	0.1	0.2	0.5
Manufacturing	8.9	9.1	7.9	8.6	1.2	1.3	1.1	3.8
Electricity, gas and water supply	4.2	2.8	4.9	4.0	0.1	0.1	0.2	0.4
Construction	10.8	13.7	13.0	12.5	0.7	0.9	0.9	2.5
Trade, hotels and restaurants	11.9	11.6	10.3	11.2	2.1	2.2	2.0	6.8
Transport and communications	3.4	8.9	12.9	8.3	0.5	1.2	1.8	3.9
Other commercial services	5.4	4.4	7.7	5.8	1.3	1.0	1.7	4.4
Public services	2.4	2.9	4.0	3.1	0.4	0.4	0.6	1.5
Total	6.4	7.5	8.5	7.4	6.4	7.5	8.5	24.1

Total demand of the transport and communications at least by two-thirds is determined by domestic demand which has been stable and growing 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, travel agencies. The external demand for transit services is unstable. Due to the discriminatory attitude of Russia as regards transit of oil products through Ventspils port, total amount of cargo sent to ports declined, particularly in the 2nd half of 2002. The situation improved in 2004 mostly due to growth of cargo turnover in other Latvian ports but it should be said that Ventspils port is also recovering as more and more cargo is transported to the port by rail.

Rapid growth in transport and communications in 2004 was 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 while contributions by railway transport and port services were smaller.

Passenger transport services increased substantially, especially in air transport.

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

3.3.2. Manufacturing

The manufacturing has demonstrated stable growth in the last three years (2002-2004), and average annual growth rate has reached 8.6% which is well above the average growth in the economy.

Table 3.12

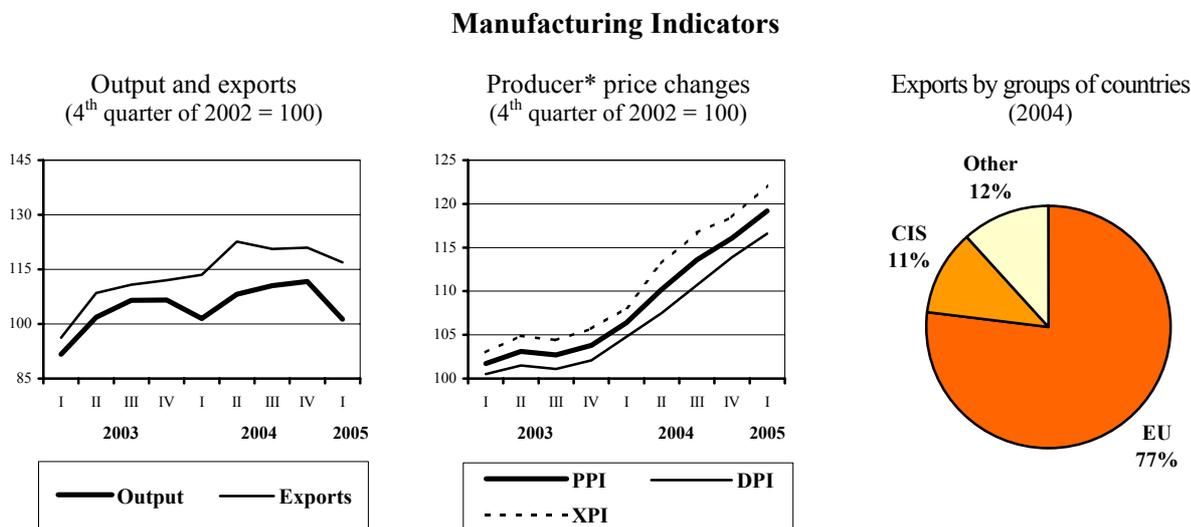
Key Indicators of Manufacturing by Sectors in 2004*
(per cent)

	Structure (by added value)	Growth	Share of exports in sector's sales
Manufacturing – total	100	6.2	52.2
Food industry	24.7	6.5	21.8
Light industry	8.5	-0.4	79.1
Wood processing	20.1	5.9	68.2
Paper production and publishing	8.3	2.2	20.0
Production of chemical, rubber and plastic products	6.4	19.8	51.9
Production of other non-metallic mineral products	3.5	12.5	35.0
Production of metals and metalwork	11.3	6.9	76.4
Production of machinery and equipment	11.3	5.9	69.3
Other industries	5.8	10.4	68.1

* according to operational data

In majority of sectors most of the output is being exported therefore their growth largely depends on expansion of export opportunities. After 2002, producer prices have increased every year, especially for the products meant for export. After Latvia's accession to the EU the growth rate of manufacturing industry has decreased, mostly due to narrowed exports of products of two manufacturing industry sectors – wood processing and textile industry.

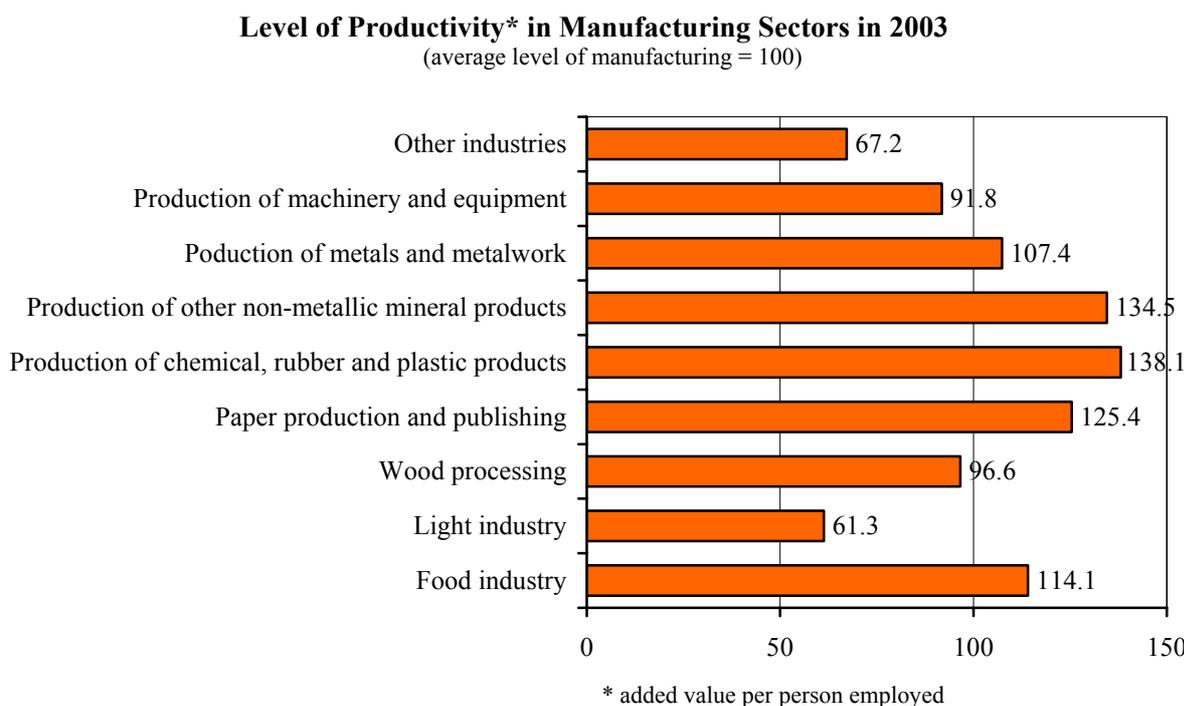
Figure 3.21



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

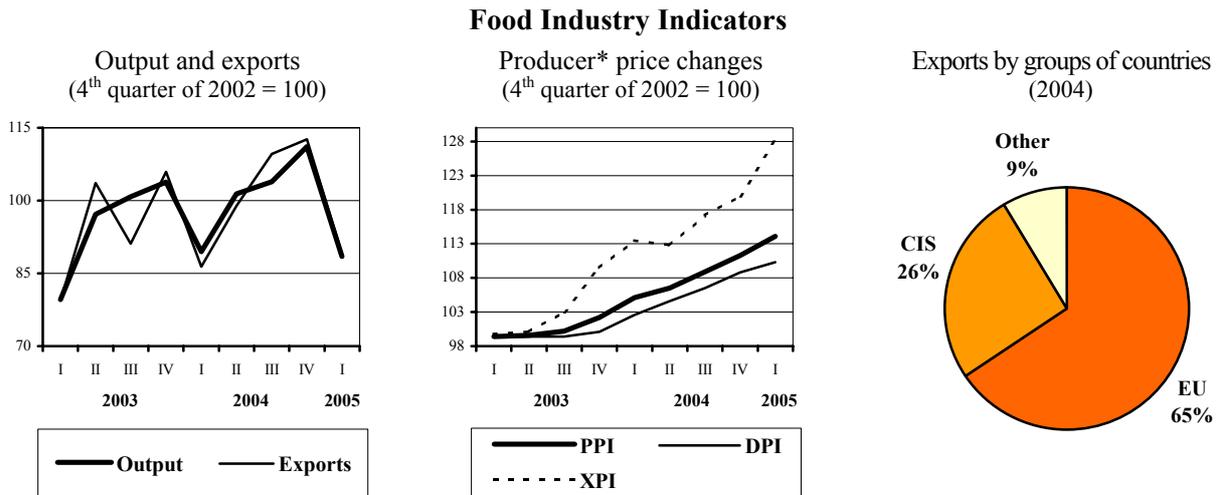
Growth in 2004 was faster in sectors with relatively higher added value per one person employed, i.e., in chemical industry and production of construction materials. Low level of productivity is in machinery and in wood processing which is one of the biggest manufacturing sectors in Latvia.

Figure 3.22



Food industry is the biggest sector in Latvian manufacturing (accounting for nearly one-fourth of the total added value of manufacturing).

Figure 3.23



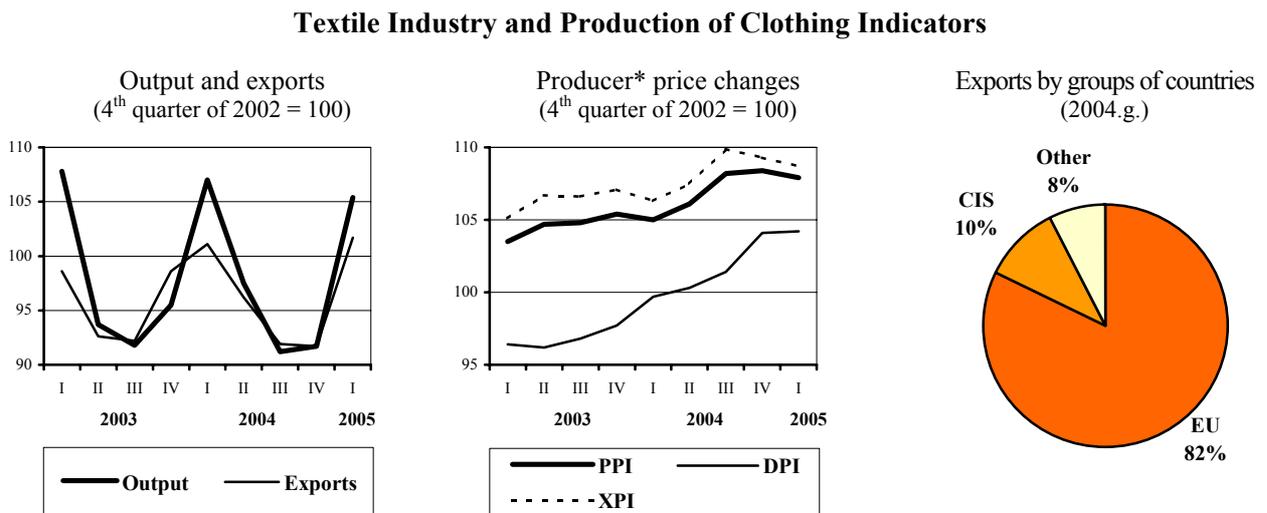
* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Approximately 80% of the total food industry output is consumed in the domestic market, the rest is exported mostly to Russia, Lithuania and Estonia. Exports of food products to Lithuania and Estonia makes up slightly more than a half of exports of Latvian foodstuffs to the European Union (EU). In 2004 demand for Latvian foodstuffs increased in all trade directions – both to Russia and other CIS countries and to the European Union (EU), and exports to the EU countries increased more than 1.5 times.

In 2004 export prices grew very rapidly, while prices for products sold in the domestic market increased more moderately. This trend will continue also in 2005. Export prices in the 1st quarter of 2005 were 15% higher than in the 1st quarter of the preceding year, while producer prices for products sold in the domestic market exceeded the level of the previous year by 8%.

Light industry (textile industry and production of clothing) makes up less than 9% of the total added value of manufacturing. Only about one-fifth of the light industry output remains in Latvia. Most of the output (82% of exports) is exported to the EU member states.

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

Textile industry outputs and exports have decreased in recent years, especially in the clothing. The main sales markets for Latvian textile industry are in EU countries. Due to the weak demand in EU countries and the high competition in the sector Latvian producers have not been able to expand

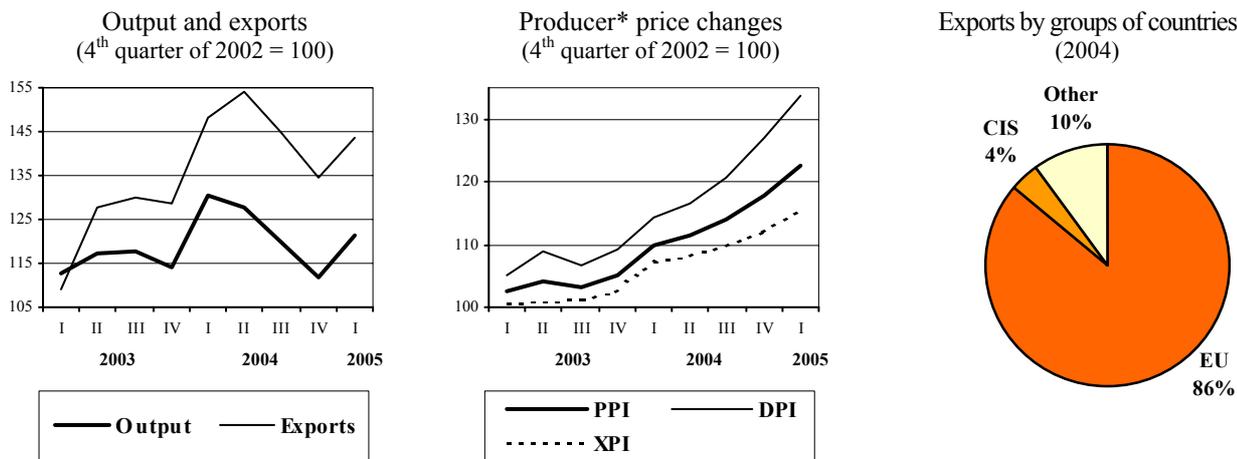
production outputs despite the rise of prices in the recent years. Narrowing of exports to the EU was partly compensated by growth of exports to the CIS countries.

Wood processing is the second biggest sector in the Latvian industry (approximately one-fifth of the total added value). This sector can boast the fastest growth since restoration of Latvia's independence, almost tripling its output during this period. The sector has shown rapid growth also in the last three years (2002-2004), growing by 9.1% on average annually. High proportion of exported products (almost 70% of the production output) is characteristic to wood processing.

Production output in 2003 went up very rapidly by 16.5%. Producer prices grew significantly during the year due to the high euro exchange rate as the EU member states are the most important sales markets for Latvian wood processing products. In the 2nd half of 2004 the growth slowed down due to weak external demand.

Figure 3.25

Wood Processing Indicators



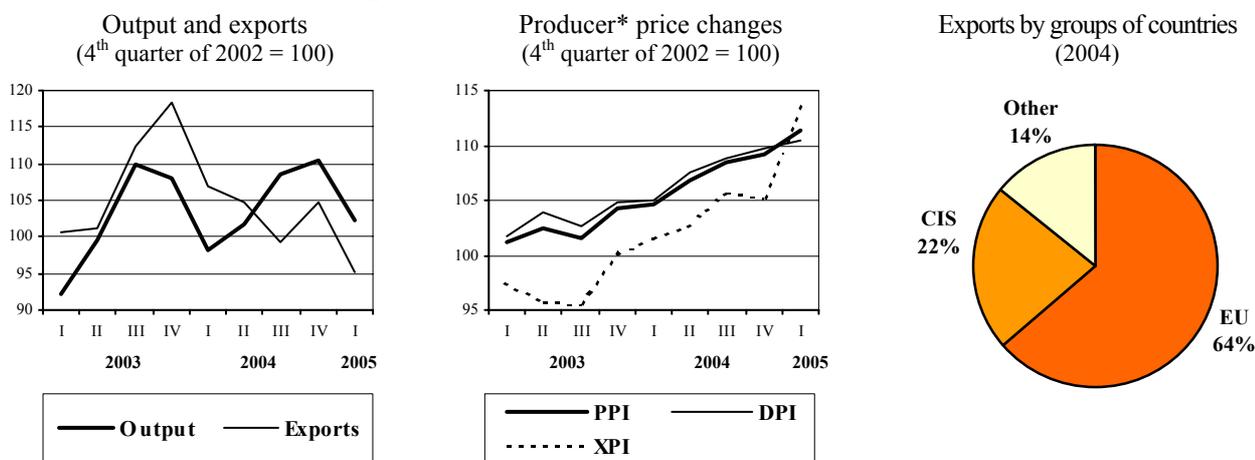
* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Producer prices in wood processing grow faster for products sold in the domestic market due to rise of domestic demand.

Paper industry, publishing and printing has grown slowly in the last years – on average by 2% annually during the last three years. The sector has a relatively small share of exports. Its competitiveness in the domestic market is decreasing.

Figure 3.26

Paper Industry, Publishing and Printing Indicators



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

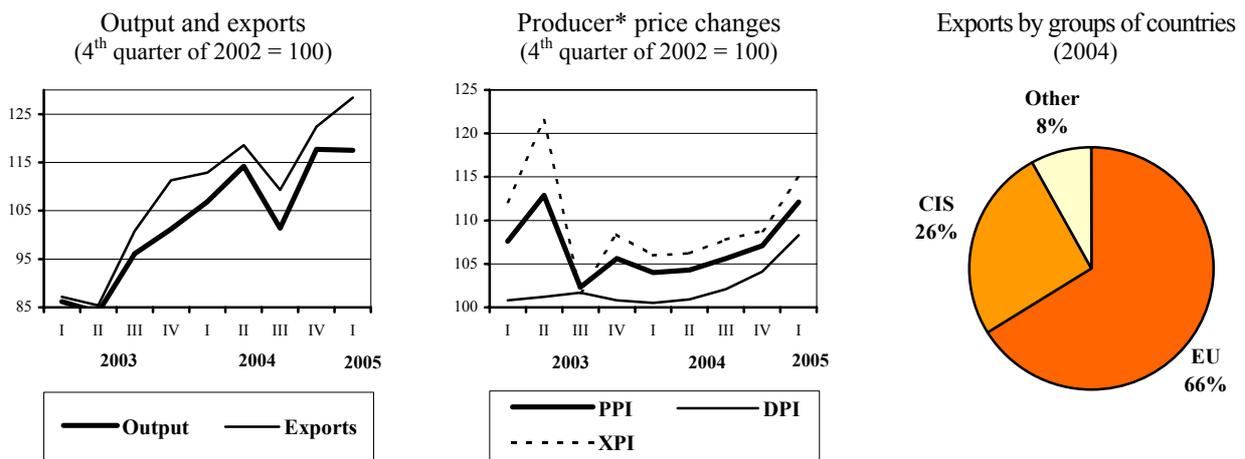
The sector's main export markets are Lithuania and Estonia, whereas chances to expand into markets of other EU countries are weak. Growth of export prices is much slower than the average price

growth, as a relatively big share of exports is connected with the CIS countries and trade conditions with these countries worsen due to the low exchange rate of the US dollar which is one of the main currencies of account in this direction of trade.

Chemical industry in Latvia has stable traditions, highly qualified 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 6% of the total added value of manufacturing. Exports of chemical products go in almost equal shares to all major trading partners of Latvia but this mostly bears evidence to the sector's weak competitiveness in markets of developed countries. Exports to Lithuania and Estonia make up approximately two-thirds of exports to the EU countries.

Figure 3.27

Chemical, Rubber and Plastic Industry Indicators



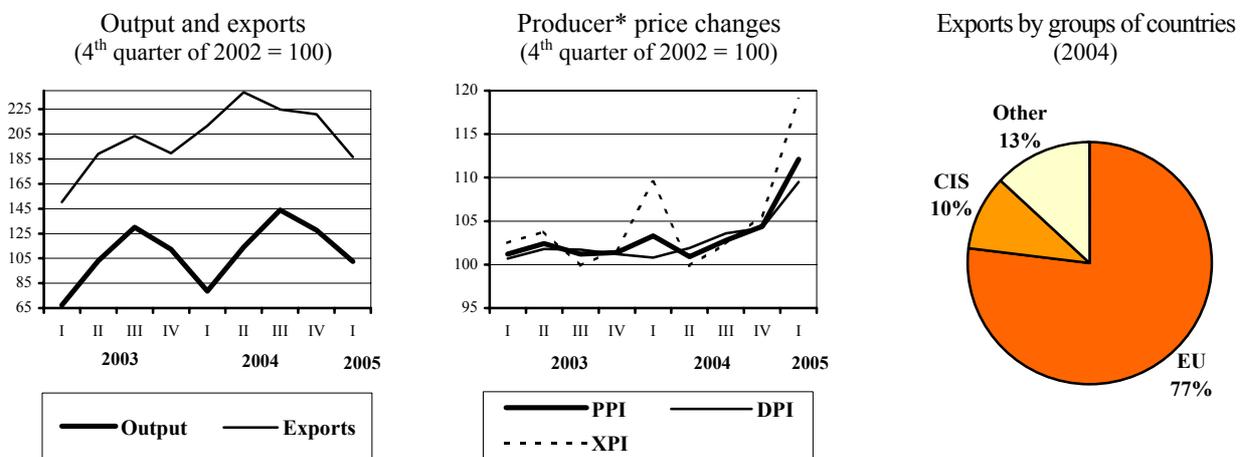
* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

The sector's growth has not been stable in recent years. There have been periods of decline, for example, in 2003 after considerable growth of output in 2002. Rapid growth by almost 20% took place in 2004, mostly due to increased demand in the CIS countries. Incomes from chemical product trade with the CIS countries in 2004 were 1.5 times higher than in the preceding year.

Manufacturing of other non-metallic mineral products (mostly construction materials) have very unstable growth rates; after steep growth by 15.3% in 2002 the growth rate in 2003 was more moderate (by 5.4%) but in 2004 the growth again was rather fast (by 12.5%).

Figure 3.28

Other Non-Metallic Mineral Products Industry Indicators



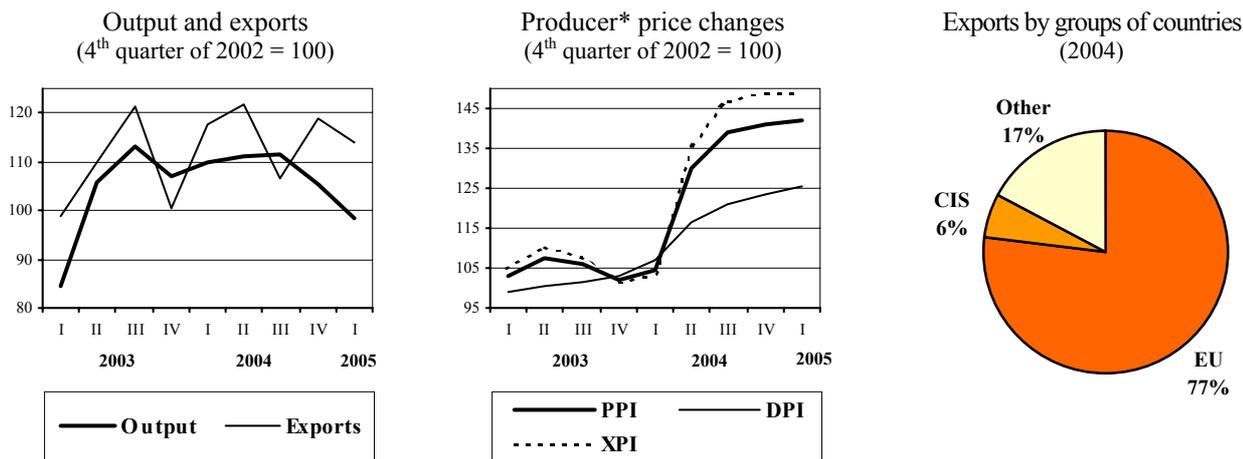
* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Increase of domestic demand is the main incentive for growth of the sector. Growth of exports is also significant, and it is especially fostered by rising export prices.

Metal and metalwork sectors constitute more than one-tenth of the total added value 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 3.29

Metal and Metalwork Industry Indicators



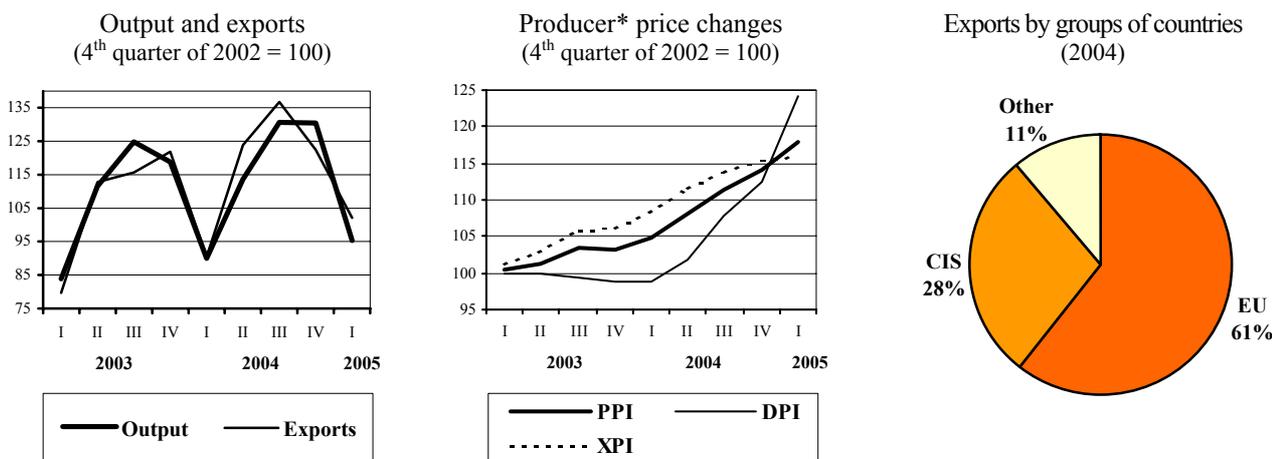
* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Average growth in the sector in 2002-2003 reached almost 7.7%. Producer prices in the sector practically did not change in 2002 and 2003 but started increasing rapidly in 2004 both for domestically sold and exported products, and the increase was considerably faster for exported products.

Machinery sectors constitute nearly one-tenth of total added value of manufacturing, and the share is growing with every year. Exports make up 70% of the total output in this sector.

Figure 3.30

Machinery Indicators



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

Seasonality is clearly present in output and exports by the sector with these indicators falling in the 1st quarter of each year, yet the sector shows significant growth in general. In 2002-2004 the average growth rate exceeded 12.9%, and in 2003 the growth was especially fast.

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 national economy, commercial consumers and population. Part of electricity is generated by Latvian HPPs and CHPs, whereas another part is imported. Mainly the imported fuels (natural gas and heavy oil) are used in heat generation. Smaller boiler houses burn local fuel and coal as well.

Table 3.13

Consumption of Energy Resources in Latvia¹

(thousand tons of conditional fuel – ktce²)

Consumption of energy resources	1999	2000	2001	2002	2003
Energy resources consumption – total	5730	5259	5740	6466	6583
of which:					
Natural gas	1495	1560	1980	1847	2138
Light fuel products and other oil products	1335	1366	1313	1610	1727
Heavy oil, oil shale	900	406	269	233	166
Firewood, peat, coke and other types of fuel	1300	1267	1475	2084	1854
Coal	120	94	123	99	90
Electricity (HPPs, wind generators and imported from abroad)	580	566	580	593	608

¹ Source: CSB and Ministry of Economics.

² 1 ktce = 0.02931 PJ.

Use of natural gas as a primary energy resource is growing increasingly. The Ministry of Economics forecasts essential decrease of heavy oil share in energy balance in the next few years due to implementation of the EU Directive 1999/32/EC which prescribes that sulphur content of heavy oil must not exceed 1% (mass percentage).

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

In 2004 Latvenergo generated 63% of the required electricity, 31% was supplied by other countries and 6% purchased from small power plants. In comparison with the respective period of the preceding year, the electricity consumption has increased by approximately 2.6%. Electricity consumption by industrial, residential and commercial sectors has increased, while consumption by agricultural enterprises and farms has decreased. Losses of electricity at transformer stations, transmission and distribution networks had been reduced.

Table 3.14

Electricity Supply in Latvia¹

(billion kWh)

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

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

Forecasts show that sales of electricity in 2005 will grow by 3-4% in comparison with 2004.

Some essential conclusions from the report *On Security of the Electricity Supply from the Energy System* worked out by the state JSC Latvenergo are presented below:

- now and till 2005 the security of electricity supply from the power system of Latvia will be kept at the present level if there are no unpredictable extraordinary events;
- in the period till 2010 the supply capacities of energy sources will be sufficient only if the investment projects into generation planned by Russian, Latvian, Lithuanian and Estonian power utilities are implemented. Otherwise, Latvia will face shortage of basic capacities and a necessity for construction of a new power plant may arise;
- in the period after 2010 the excess capacity generated by energy systems of the neighbouring countries will become smaller and the opportunities to ensure import of electricity will decrease;
- the transmission grid will be able to ensure the necessary electricity flows in normal (standard) modes if renewal of the network keeps its present pace (annual investment of 10-13 million LVL);
- at present the common work of Baltic power systems with centralised dispatcher control system is sufficiently secure due to co-ordinating functions of DC “Baltija” and existence of accident prevention automatics;
- separation of the Baltic states from the common electricity grid may be caused by unscheduled switch-off of several electricity transfer lines or stoppage of some power plant;
- partial cut-off of Latvian consumers (up to 45%) is possible only due to inaccessibility of generation reserves or malfunction of dispatcher service. Dying out of all system is possible only in the case of several unfavourable events happening simultaneously;
- implementation of the market and chosen model of the market must not diminish the security of energy system.

The consumption structure of *centralised heat supply* has not essentially changed over the recent years, with central heating comprising 65 to 70%, and hot water supply making 30 to 35%. From the total amount of sold heat energy 2.2% were sold to industry, 74% to households and 23.8% to other consumers.

The biggest consumers of *natural gas* are CHP and heat generation enterprises of Latvenergo (60%), industry (25%) and other consumers (15%). Riga region accounts for 80% of the total natural gas consumption in Latvia. Natural gas is not used in Latgale region at all, with the exception of Daugavpils city and Preiļi district. In Kurzeme region, gas consumption is the biggest in Liepāja – 11% (by JSC “Liepājas siltums” and JSC “Liepājas metalurģis”); 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, with certain reservations, also function in the area of oil product deliveries in Latvia.

Oil products have an important place in the Latvian energy resources market; their market share is about 30%, including heavy fuel with about 6%. The biggest consumers of heavy oil are heat supply (53%) and industry (35%). Its consumption is basically concentrated in the biggest cities where natural gas is not available – Ventspils and Rēzekne. Complying with requirements of the mentioned EU Directive 1999/32/EC, on March 2, 2004 the Cabinet of Ministers adopted Regulations No. 125 “On Limitation of the Sulphur Content of Certain Liquid Fuels”. It is expected that heat supply companies which used heavy oil for heat generation will replace this type of fuel with other energy resources.

Latvia has started to create its oil product stock. Creation of such stock, its storage and recording is a difficult process both financially and technically. According to the Treaty of Accession to the European Union, Latvia should create oil product reserves for 30 days and this should be done by July 1, 2004. Formation of the oil product stock should be completed by December 31, 2009. The total amount of the stock should cover 90 days in accordance with the EU Council Directive 98/93/EC adopted on December 14, 1998, amending Directive 68/414/EEC under which the member states of the European Community must keep minimum stock of crude oil and/or oil products.

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 the rational use. In the total fuel consumption the share of firewood is quite substantial already and has reached 25 to 30%. The biggest consumers of firewood are households

(39%), heat supply companies (25%), industry (mainly wood processing companies) and other consumers (36%). Firewood and coal are evenly used across all regions of Latvia. Use of peat in the energy sector is decreasing.

3.4. Development of Regions

In 2004 Latvia was divided into six statistical regions (see Table 3.15).

Table 3.15

Area, Population and Population Density of Latvian Statistical Regions in Early 2005

	Area (% of the total)	Population (% of the total)	Number of inhabitants per km ²
Riga	0.5	31.7	2382.0
Pierīga	15.7	15.9	36.1
Vidzeme	23.6	10.6	16.1
Kurzeme	21.1	13.5	22.8
Latgale	22.5	15.8	25.0
Zemgale	16.6	12.5	26.8

Marked social and economic differences between regions exist in Latvia.

More than a half of the total **gross domestic product** (GDP) of Latvia is produced in Rīga (see Table 3.16)¹. In 2002 Riga and Riga district together produced 63% of Latvian GDP. Cities of Daugavpils, Liepāja and Ventspils are in equal positions, each producing slightly more than 3% of Latvian GDP. Valmiera district has produced 1.9% of Latvian GDP (as many as Jelgava city) distinguishing itself among districts.

Table 3.16

GDP of Statistical Regions in 2002

Name of territory	GDP in real prices		GDP per capita	
	total in thousand LVL	% of total	LVL	% against the state average
Latvia	5 689 376	100	2 433	100
including:				
Riga	3 283 356	58	4 418	182
Pierīga	572 612	10	1 596	66
Vidzeme	354 951	6	1 407	58
Kurzeme	637 296	11	2 015	83
Zemgale	394 993	7	1 354	56
Latgale	442 871	8	1 176	48
Produced outside Latvia	3 296	0.1	x	x

Riga is the only region which exceeds the average level of the 10 new EU member states, reaching 138% against this level. Average indicator for Latvia makes 76% of this level, Kurzeme makes 63% and the poorest region Latgale makes only 37%. Unfortunately, the average level of all EU member states is still unattainable for Latvia (see Figure 3.31).

¹ Regional GDP in 2002 was calculated in line with the improved methodology of Latvian GDP calculations in compliance with EU requirements. International practice indicates that such way of doing calculations is very labour-consuming and complicated process, for that reason the results are published with a deviation of approximately two years.

Figure 3.31

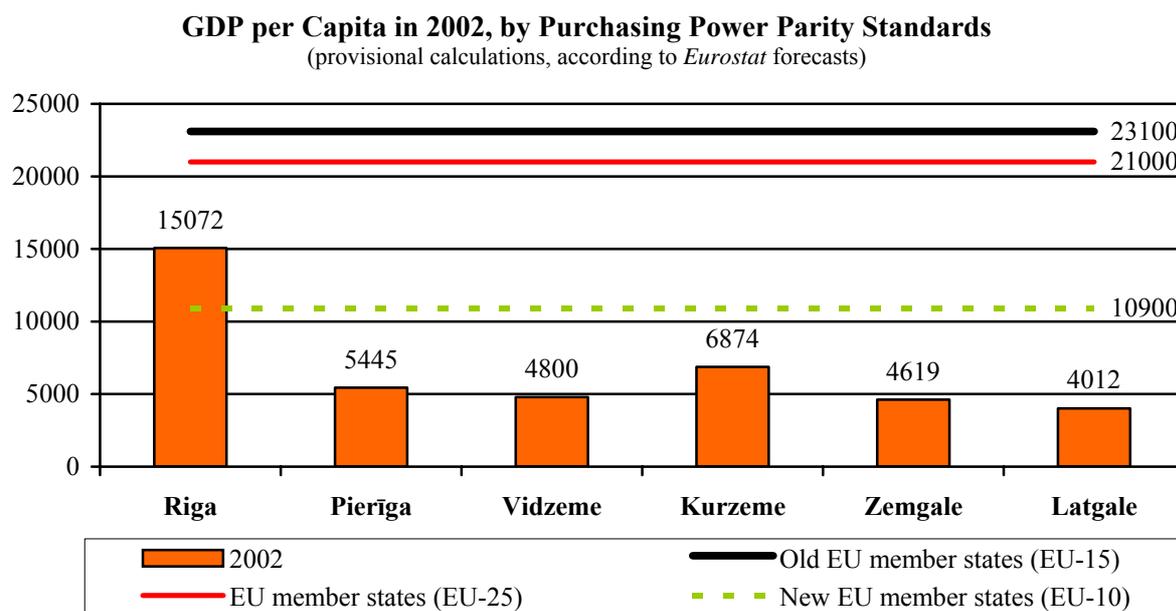
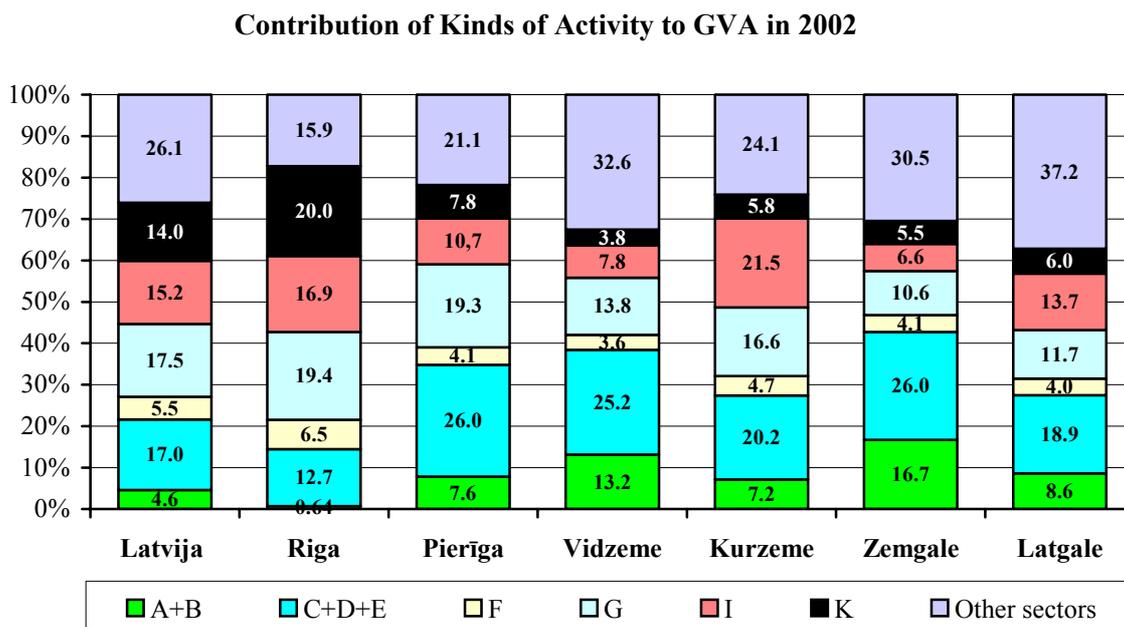


Figure 3.32



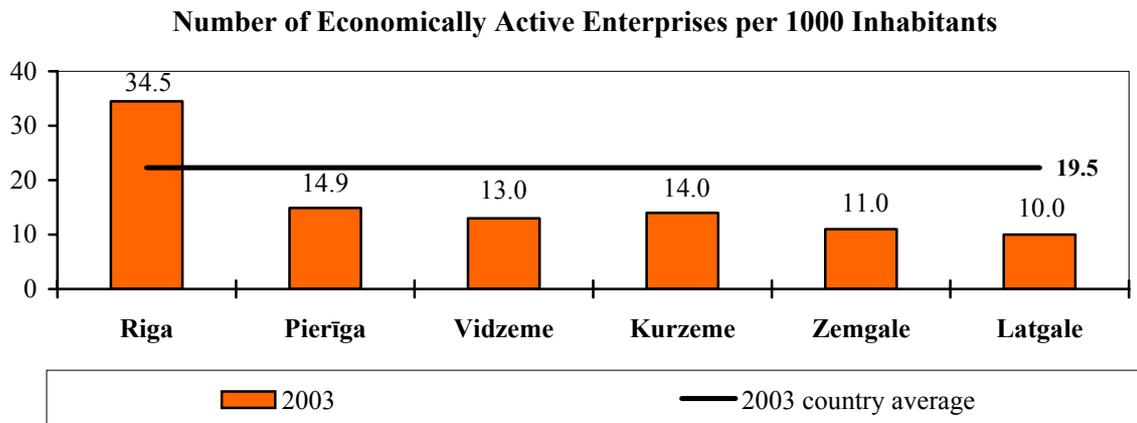
* A+B – agriculture, forestry and fishery; C+D+E – manufacturing; F – construction; G – trade; H – hotels; I – transport and communications; K – commercial services.

Manufacturing and trade sectors have the biggest proportions in Latvian regions, and trade is one of the most rapidly growing sectors. Big proportion of “other sectors” is characteristic to regions with the lowest GDP per capita. This is mainly related to the fact that in other sectors the biggest share is made by the so-called public services (services provided by local government administration, education and health care institutions) which are provided to population irrespective of economic activity level.

Most of entrepreneurs prefer Riga region as the most suitable place for developing their business. In 2003 the number of **economically active enterprises** in Riga region was 25 385 while their total number in Latvia was 45 300. Number of enterprises in Pierīga, Vidzeme, Kurzeme, Zemgale and Latgale regions was 5418, 3229, 4389, 3193 and 3686 respectively. In Latgale there were only 10 economically active enterprises per 1000 inhabitants, which was three times less than in Riga (see

Figure 3.33). In 2003 the number of economically active enterprises in Latvia increased by 2766 enterprises, and the most significant increase was characteristic to Riga region (by 2008 enterprises).

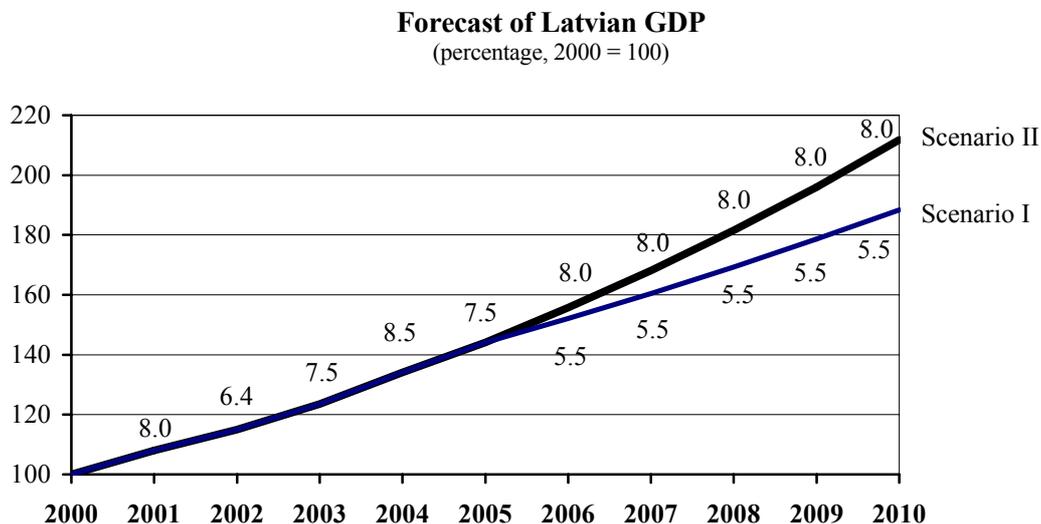
Figure 3.33



3.5. Forecasts

The Ministry of Economics has developed two scenarios of national economy development for medium-term period (until 2010): the slow growth scenario (Scenario I) and the dynamic scenario (Scenario II). The development scenario forecasts are based on possible fluctuations of external and domestic demand, depending on several factors.

Figure 3.34



Development prospects in 2005 and 2006

It is anticipated that the previous trends of development will be in progress also in 2005 and 2006, namely, the stable domestic demand and expansion of export possibilities.

According to forecasts the private consumption and GDP will increase at the same rate. This will be ensured by growing incomes of population but the household demand may be reduced by the fast rise of prices.

Investment will increase faster than the private consumption, which will be affected by the growth of previous years and positive future predictions by entrepreneurs as well as the good crediting conditions. Yet, one must take into account that interest rates on loans might stay at the level of previous

years and not diminish due to the high inflation of 2004. Investment growth will be stimulated also by 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* (manufacturing) is closely linked with possibilities to increase export of goods, which should be basically 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 the EU markets is to be associated not only with the growth of demand for imports from these countries (as forecasted by most economists for 2005) but to a great extent also with the ability of Latvian businesses 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 both these countries despite the fact that exports of Latvian goods to these countries go up rather fast every year. It is possible to accelerate Latvian exports to these two neighbouring countries, and particular attention should be given to this task, not forgetting about the competition pressure created by 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 EU and Russia on mutual trade conditions as well as good growth prospects of Russia in the nearest years in connection with high prices of oil products. There are rather good prospects to increase exports also to other CIS countries, such as Belarus, Ukraine, and countries of Central Asia.

Gradual rise of wages, which is a manifestation of the convergence process, has started having a negative impact on development of industry. Rise of wages reduces competitiveness in some sectors of industry, especially those sectors where the present maintenance of competitiveness is mostly linked with use of cheap labour force, such as textile industry, mechanical engineering, etc.

Development of industry is also limited by the so-called extreme factors, such as storms, floods, etc., which are almost impossible to forecast beforehand; as practice shows, they have a rather big impact on sectors of industry. So, at the beginning of 2005 the destruction caused by storm negatively influenced wood markets (demand and prices fell) resulting also in reduction of outputs of wood processing sector.

The rapid development of Russia might also promote Latvian revenues from *transit services*. Hopefully, the situation will improve in Ventspils port, and also Liepāja and Riga ports keep their good growth potential.

Table 3.17

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

	2005	2006*	2007-2010 * (annual average)
Gross domestic product	7.5	5.5 / 8.0	5.5 / 8.0
Primary sectors	0	2.5 / 3.5	2.5 / 3.5
Manufacturing	5.0	7.0 / 10.0	6.7 / 10.0
Electricity, gas and water supply	2.0	2.0 / 2.2	2.0 / 2.2
Construction	15.0	10.0 / 15.0	9.0 / 15.0
Trade, hotels and restaurants	12.0	6.0 / 8.0	6.0 / 7.5
Transport and communications	10.0	6.0 / 9.0	6.0 / 8.0
Other commercial services	6.0	5.5 / 8.5	5.5 / 8.5
Public services	3.0	2.0 / 3.0	2.0 / 3.0

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

Development prospects in 2007-2010

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

At the beginning of the post-accession period, drastic changes in the structure of economy and external markets are not anticipated. First of all, investments will go up, which in this period might generate additional demand for imports and therefore not allow to substantially improve the balance of the current account. Results of structural reforms and investments will become more evident starting with 2007 when growth of industrial production outputs and exports should be quite significant already. In this later period, export-oriented sectors should provide bigger contribution to the growth compared to the sectors which are stimulated by the domestic demand and made bigger contribution to growth in the preceding periods. Otherwise, the disproportion (high current account deficit, heightened inflation) might subject Latvian economy to strong influence of various external and internal shocks.

The main problems of this period should be associated with potential rise of wages and thereby with decrease of competitiveness of Latvian so-called *cheap sectors* in the world markets. In this regard, textile and food industries and partly metal-working and some sectors of machinery are to be noted. Share of these sectors in Latvian economy is very high, therefore their replacement with manufacturing of other sectors' products is not doable within a short time. Productivity increase in all sectors of economy (both high and low technology sectors) is the only way to retain the high Latvian growth rate.

Table 3.18

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

	2005		2006*		2007-2010 * (annual average)	
	structure	growth rate	structure	growth rate	structure (in 2010)	growth rate
Gross domestic product	100	7.5	100	5.5 / 8.0	100	5.5 / 8.0
Private consumption	61.7	7.0	61.4 / 62.0	4.5 / 7.0	59.9 / 61.7	4.2 / 7.0
Public consumption	20.2	2.5	20.1 / 19.6	2.5 / 2.7	17.9 / 15.8	2.5 / 2.7
Gross fixed capital formation	27.8	15.0	27.8 / 29.2	7.0 / 10.0	28.2 / 29.4	7.0 / 10.0
Changes in inventories	3.3	–	2.8 / 1.7	–	4.2 / 2.5	–
Exports	43.0	5.7	42.3 / 42.4	5.8 / 9.5	40.9 / 43.0	5.7 / 9.5
Imports	-55.9	4.1	-54.4 / -54.9	6.1 / 8.9	-51.2 / -52.5	6.0 / 8.9
Export-import balance	-12.9	–	-12.1 / -12.5	–	-10.3 / -9.5	–

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

On the other hand, growth rates of economic activities in Latvia will also be 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.

In the medium-term development context the main task to ensure stable growth is to make Latvian economy attractive for both foreign and local investors, encouraging them to implement their economic activities.

4. Macroeconomic Stability

4.1. State Finances

4.1.1. Fiscal Policy and Central Government Debt

The government of Latvia enforces a fiscal policy aimed at balanced economic growth and stability of state finances. The government has resolved to consistently ensure that the Maastricht fiscal criterion will be met in Latvia, setting non-deficit budget as a medium-term goal.

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). Decrease of the fiscal deficit in the recent years was basically determined by social security budget surplus and gradual improvement of fiscal situation in local governments' budget.

Table 4.1

General Government Consolidated Budget

	2001	2002	2003	2004	2005 f
Revenues (million LVL)	1696.9	1874.0	2107.4	2530.1	3066.2
(% of GDP)	32.8	32.9	33.3	34.4	38.4
Expenditures (million LVL)	1801.1	2022.0	2212.5	2639.5	3220.9
(% of GDP)	34.8	35.5	35.0	35.9	40.3
Net loans (million LVL)	-2.7	-17.5	-2.7	-30.3	-20.2
Fiscal balance (million LVL)	-101.5	-130.5	-102.4	-79.0	-134.5
(% of GDP)	-2.0	-2.3	-1.6	-1.1	-1.68

f – forecast of the Ministry of Finance

In 2004 the fiscal deficit of the general government consolidated budget was lower than projected and equalled to 79 million LVL or 1.1% of GDP. Revenues of this budget in 2004 were by 20% higher than in 2003, while expenditures grew by 19.3%.

As seen in Figure 4.1, in 2004 the EU average budget deficit level was 2.6% of GDP¹. On the whole, public balances improved in 14 EU member states and deteriorated in 10 member states in 2004. The biggest general government deficit as a percentage of GDP in 2004 was fixed in Greece (-6.1%), Malta (-5.2%), Poland (-4.8%), Hungary (-4.5%), Cyprus (-4.2%), France (-3.7%), Germany (-3.7%), Slovakia (-3.3%), and the United Kingdom (-3.2%). Six EU member states in 2004 showed general government surplus: Denmark (+2.8%), Finland (+2.1%), Estonia (+1.8%), Sweden (+1.4%), Ireland (+1.3%), and Belgium (+0.1%). According to the ESA95 National Accounts System, the budget deficit in Latvia equalled to 0.5% of GDP in 2004.

The Saeima approved the state budget for 2005 with a fiscal deficit of 134.5 million LVL or 1.68% of GDP. It is forecasted that in 2005 the general government consolidated budget revenues will increase by 21.2% in comparison with 2004 performance while the expenditures will increase by 22%.

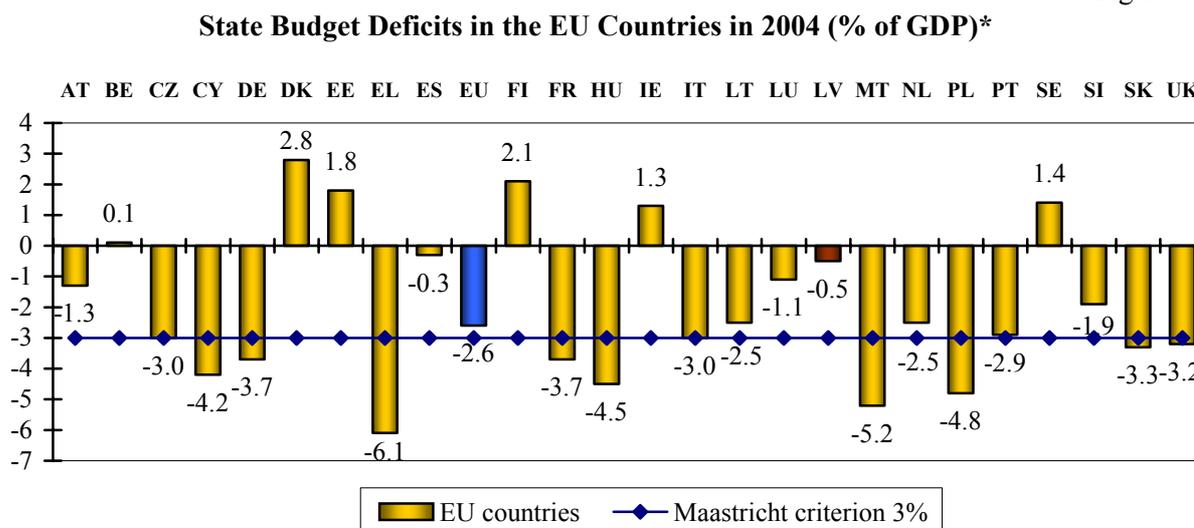
The general government consolidated budget revenues in the first 4 months of 2005 were 25.3% higher than in the respective period of 2004 while the expenditures were 27.8% higher. The fiscal surplus of the budget amounted to 79 million LVL.

The following main priorities are defined in the state budget of 2005:

- alignment of health care system, by improving quality of medical services and their availability to population, resulting in creation of functioning health care system;
- integration in the EU and NATO, fully using opportunities provided by them and successfully protecting national interests;
- full absorption of funds of EU policy instruments granted to Latvia, effectively ensuring state development and growth;
- development of scientific potential.

¹ According to the ESA95 National Accounts System.

Figure 4.1



* According to the ESA95 National Accounts System.

AT – Austria, BE – Belgium, CZ – Czech Republic, CY – Cyprus, DE – Germany, DK – Denmark, EE – Estonia, EL – Greece, ES – Spain, EU – EU-25 countries, 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.

Implementing a socially responsible policy, as from January 1, 2005 the monthly minimum not subject to personal income tax was increased from 21 to 26 LVL and the monthly allowance for dependent person was raised from 10.5 to 18 LVL. Proportion of personal income tax (PIT) revenues received by local governments was redistributed to their benefit and the local governments will receive 73% of PIT instead of the previous 71.6%, which will give additional 6.5 million LVL to local government budgets.

The budget envisages finances for ensuring funding and co-funding from EU Structural Funds and other EU policy instruments in amount of 296.5 million LVL and for programme “State defence, security and integration in NATO” in amount of 153 million LVL (29.4 million LVL more than in 2004, ensuring funding for this programme in amount of 2% of GDP).

Latvia as an EU member state has to participate in formation of EU budget revenues, paying regular membership fees or European Community own resources contributions¹. Latvia’s contribution to the EU budget was 63.9 million LVL in 2004 (from May 1), while in 2005 it is planned in the amount of 73.3 million LVL.

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

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

Due to the reduction of tax rates the tax revenues against GDP have dropped from 33% in 1998 to 27.5% in 2004. Meanwhile the tax base has been broadened, excluding taxable exemptions and improving administration of revenues.

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 63.8% of GDP². In 2004 the highest central government debt in percentage of GDP was fixed in Greece (110.5%), Italy (105.8%), Belgium (95.6%), Malta (75%), Cyprus (71.9%), Germany (66%), France (65.6%), Austria (65.2%) and Portugal (61.9%), while the lowest general government debt in percentage of GDP was registered in Estonia (4.9%), Luxembourg (7.5%), Latvia (14.4%) and Lithuania (19.7%).

During the last years the central government debt in Latvia has increased from 571 million LVL at the end of 2000 to 975 million LVL at the end of 2004, or from 12.2% to 13.2% of GDP (see Table

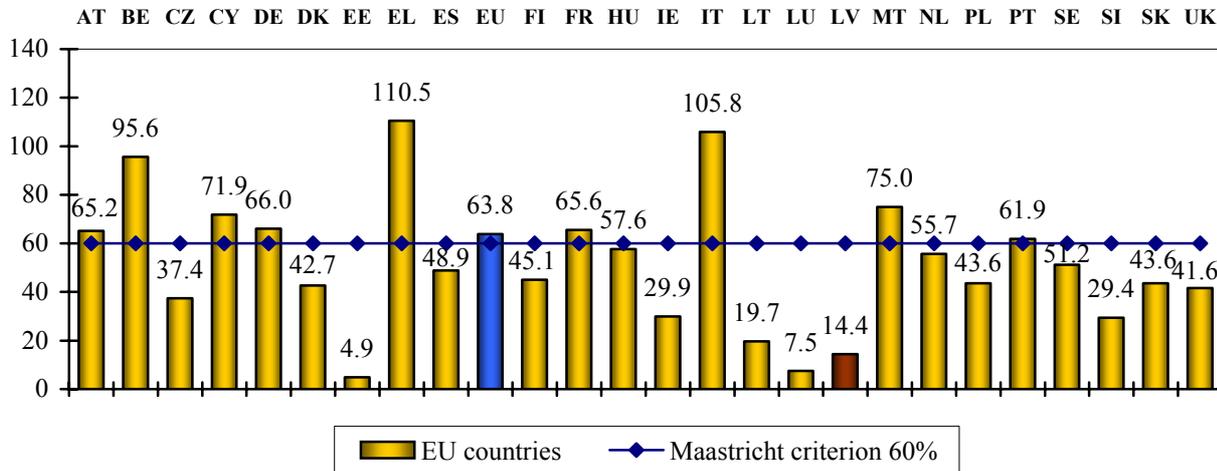
¹ In the system of European Community own resources, contributions of a member state are calculated in respect of the member state’s gross national income, VAT base, and revenues from customs duties and agricultural and sugar levies.

² According to the ESA95 National Accounts System.

4.2). At the end of April 2005 the debt amounted to 951.5 million LVL. The law “On the State Budget for 2005” sets down the maximum central government debt in the amount of 1179.6 million LVL at the end of 2005.

Figure 4.2

Central Government Debt in EU Countries in 2004 (% of GDP)*



* According to the ESA95 National Accounts System.

AT – Austria, BE – Belgium, CZ – Czech Republic, CY – Cyprus, DE – Germany, DK – Denmark, EE – Estonia, EL – Greece, ES – Spain, EU – EU-25 countries, 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.

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 (400 million EUR) and longest maturity (10 years). The opportunities to use instrument of Eurobonds in 2006 and 2007 are being evaluated at present. Volumes of borrowings and their maturity terms will depend on state budget performance indicators, situation in the financial market, central government debt portfolio indices and other influencing factors.

Table 4.2

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

	2001	2002	2003	2004
Central government debt	712.9	756.1	846.3	975.0
including:				
internal debt	256.0	291.6	426.7	423.0
of which:				
short-term debt	28.4	37.9	52.7	73.0
medium-term debt	227.6	253.6	224.1	224.1
long-term debt	–	–	97.0	125.8
currency debt	–	–	52.7	–
external debt	456.9	464.5	419.6	552.0
of which:				
loans	222.2	209.2	137.6	133.1
Eurobonds	234.7	255.3	282.1	418.8
	(% of GDP)			
Central government debt	13.8	13.3	13.4	13.2
of which:				
internal debt	5.0	5.1	6.7	5.7
external debt	8.8	8.2	6.6	7.5

Table 4.3 reflects costs related to the central government debt. These costs are rising with the increase of the debt. According to forecasts, the costs of servicing the central government debt in 2005 will go up by 2.5 million LVL in comparison with the costs projected in 2004.

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	49.0	51.5
% of general government consolidated budget expenditures	2.2	2.2	2.1	1.8	1.7
% of GDP	0.8	0.8	0.7	0.7	0.6

f – forecast of the Ministry of Finance

It is anticipated that in the coming years the costs related to servicing the central government debt will continue to grow, reaching 77 million LVL per year in 2009.

4.1.2. General Government Consolidated Budget Revenues

34% of all revenues in Latvian economy are redistributed through budget, including 28% of GDP through taxes. Total tax burden in Latvian economy should not be seen as high, since it is 9 percentage points lower than in the EU-15 countries and 1 percentage points lower than in the new EU member states¹ on average.

Table 4.4

General Government Consolidated Budget Revenues (% of GDP)

	2000	2001	2002	2003	2004
Revenues	34.6	32.8	32.9	33.3	34.4
I Tax revenues	29.3	28.1	28.1	28.2	27.5
1. Indirect taxes	11.0	10.2	10.1	10.9	10.1
– value added tax	7.2	6.8	6.7	7.3	6.6
– excise tax	3.5	3.1	3.1	3.4	3.2
– customs tax	0.3	0.3	0.3	0.3	0.2
2. Income taxes and property taxes	8.1	8.3	8.4	8.1	8.4
– corporate income tax	1.6	1.9	1.9	1.5	1.7
– personal income tax	5.6	5.5	5.6	5.8	5.9
– property taxes	0.9	0.9	0.8	0.8	0.8
3. Social security contributions	10.0	9.3	9.3	8.9	8.7
4. Other taxes	0.2	0.3	0.3	0.3	0.3
II Non-tax revenues	5.3	4.7	4.8	5.2	6.9

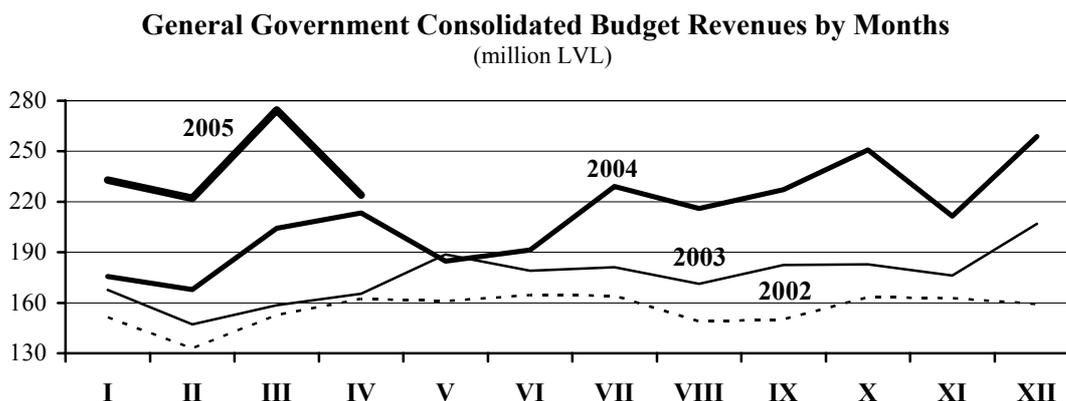
In 2004 the **general government consolidated budget revenues** were 2530.1 million LVL, exceeding the level reached in the preceding year by 20.1%. Growth of tax revenues (by 13.5%) was somewhat faster than the increase of the nominal GDP.

2004 was a successful year for both the central and local government budgets in terms of tax collection. Increase of the budget revenues was mostly influenced by higher collection of corporate income tax (increase by 36.1%) and personal income tax (increase by 18.6%).

In the 1st quarter of 2005 the tax revenues increased by 20.5% in comparison with the respective period of 2003. The revenue increase was mostly influenced by higher collection of corporate income tax (increase by 47%) and excise tax (increase by 39.9%).

¹ In Section 4.1.2 the data regarding the EU tax structure and rates are taken from the UN survey “Economic Survey of Europe”, 2004 No.1.

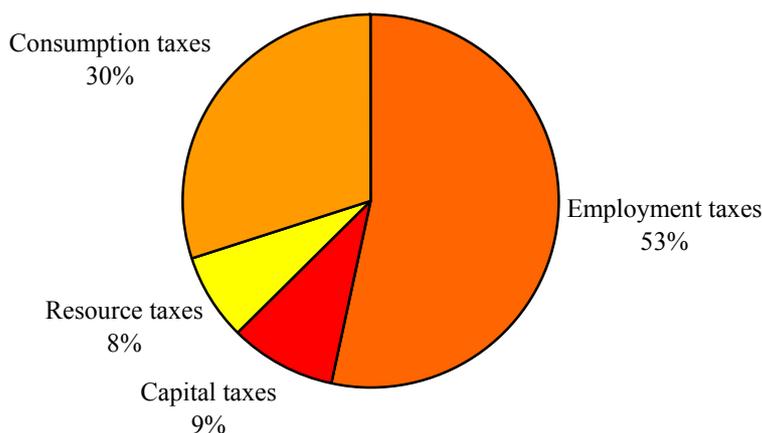
Figure 4.3



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 the share of consumption and resource taxes has grown in 2004.

Figure 4.4

General Government Consolidated Budget Tax Revenues by Tax Groups in 2004
(%)



Slightly more than a half of all tax revenues or 14.6% of GDP is collection of **employment taxes** (social security contributions and personal income tax). The share of taxes in total labour costs in Latvia equalled to 44% in 2004. 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 two times higher than collection of personal income taxes, while in the group of EU-15 states they are approximately on the same level. However it should be noted that these proportions differ considerably from state to state.

Among the new EU countries, flat personal income rate is being applied only in the Baltic states. The rest of the bloc's new members apply progressive personal income tax rate.

Starting with January 1, 2003 the new social security contribution rate, which is 2 percentage points lower than in the preceding year, took effect. This rate, which constitutes 33.09% of the gross wage, is one of the lowest in the group of the new EU member states (it was 42.6% in average 2003).

Despite lowering of the compulsory social security contribution rate in 2003, the collection of contributions in the last two years was higher than in the previous years (by 6.3% in 2003 and 14.1% in 2004) due to considerable rise of the average wage. In the 1st quarter of 2005 the collection of social security contributions was by 15.2% higher than in the respective period of the previous year.

Personal income tax revenues also increased by 18.6% in 2004 and 16.1% in the 1st quarter of 2005. Growth rate of personal income tax revenues in the 1st quarter of 2005 went down in comparison with the respective period of 2004 due to increased non-taxable minimum and raised tax allowance for dependent persons as of January 1, 2005.

Volume of state social security contributions and personal income tax payments is mostly affected by fluctuations of employment and wages. According to State Employment Agency data, the number of unemployed persons registered in the country at the end of March 2005 has decreased by 0.6 percentage points in comparison with the end of March 2004 and constitutes 8.6% of economically active population of the country.

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).

85% 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%. Starting with 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 the EU-15 states (19.6%).

In 2004 the collection of value added tax slightly increased and was by 6% higher than in the preceding year. In the 1st quarter of 2005 the budget revenues from this tax increased very sharply (by 19.2%) in comparison with the respective period of the preceding year. Growth of value added tax in the 1st quarter was basically determined by increased total turnover and consumer price index and changed procedure of tax payment.

Due to Latvia's accession to the EU, customs tax revenues have dropped considerably by 8.7% in 2004 in comparison with the previous year and by 9.7% in the 1st quarter of 2005 in comparison with the respective period of 2004. Starting with May 1, 2004, customs tax is not applied to transportation of goods inside the EU but the customs tariffs set up by the EU are applied to goods imported from countries outside the EU.

In 2004 the collection of excise tax on alcohol, tobacco, soft drinks, coffee and passenger cars slightly increased and was by 5.5% higher than in the previous year. Volume of excise tax revenues in the 1st half of 2005 in comparison with the respective period of 2004 was affected by the change of excise tax rates on particular excise goods in 2004 and from January 1, 2005 as well as the fact that as from May 1, 2004 excise tax on passenger cars and motorcycles is not collected but the passenger car and motorcycle tax is collected; in the 1st quarter of 2005 the collection of passenger car and motorcycle tax amounted to 1.64 million LVL.

Excise tax revenues on tobacco products in the 1st quarter of 2005 were two times higher than in the respective period of 2004. This can be explained by increased combined rate of excise tax on tobacco products as from January 1, 2005; as a result, a big volume of tobacco products was put into circulation in December 2004, creating considerable reserves in the domestic market for future months.

In the 1st quarter of 2005, excise tax revenues on alcoholic beverages increased by 11.9%, excise tax revenues on beer increased by 1.2%, but excise tax revenues on other excise goods decreased by 57.5%.

Capital taxes (corporate income tax and property related taxes) in 2004 amounted to 9% of all taxes, while in 2001 they made 10%. 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. In 2002 the rate was 22% but in 2003 it amounted to 19%.

In 2004 the corporate income tax rate in the new EU member states was substantially lower than in the EU-15 countries (respectively 23.2% and 29.3% on average). Moreover, in the majority of the new member states these rates were reduced in 2004.

Due to lowered corporate income tax rate, the collection of this tax in 2003 dropped by almost 15% in comparison with the preceding year. In 2004 the corporate income tax revenues considerably increased (by 36.1%), compared with 2003. In the 1st quarter of 2005 the corporate income tax revenues have went up by 47% in comparison with the respective period of 2004, and this is related to increased profit of taxpayers.

Resource tax group comprises two taxes, namely, excise tax on oil products and natural resource tax. The excise tax makes the biggest share in the group (95% in 2004). Proportion of these two taxes in the total tax revenues has slightly increased in the last years.

After accession to the EU, a time deviation arose also for the revenues which are made up by excise tax on oil products and for the value added tax, while the total collection in 2004 grew considerably faster (by 15.7%) in comparison with 2003. In the 1st quarter of 2005 the increase of excise tax revenues on oil products was 48.1% in comparison with the respective period of 2004.

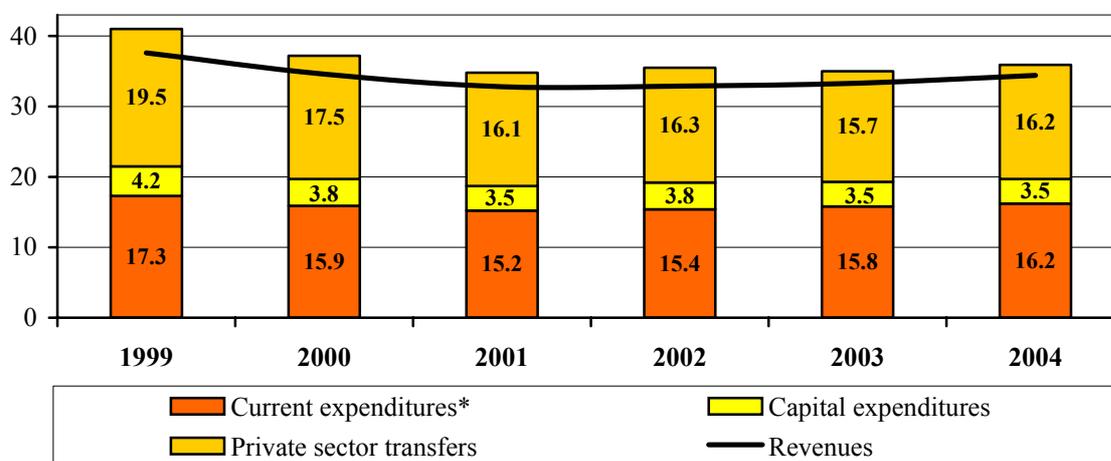
Payments of natural resource taxes are directly linked with economic activities of Latvian companies and environmental loads caused by them. Therefore, tax revenues are growing, as the total economic activity increases, and are decreasing, as companies and local governments implement environmental protection measures. Collection of this tax in 2004 was by 16% lower than in 2003, while in the 1st quarter of 2005 it went up and was higher (by 6.6%) than in the respective period of the previous year.

4.1.3. General Government Consolidated Budget Expenditures

General government consolidated budget expenditures in 2004 went up faster than revenues. The expenditures in 2004 were 19.3% higher than in the preceding year, exceeding GDP growth rate (in current prices). Thereby the general government consolidated budget expenditures went up against GDP and constituted 35.9% of GDP. There was an essential increase in current expenditures and transfers (social security and welfare payments, subsidies, grants, etc.), while capital expenditures grew fractionally.

Figure 4.5

Revenues and Expenditures of the General Government Consolidated Budget
(% of GDP)



* With payments for borrowings and credits

The biggest role in the growth of the total budget expenditures was played by the increase of expenditures for general governmental services, agriculture, social security and welfare.

Table 4.5

Expenditures of the General Government Consolidated Budget
(percentage)

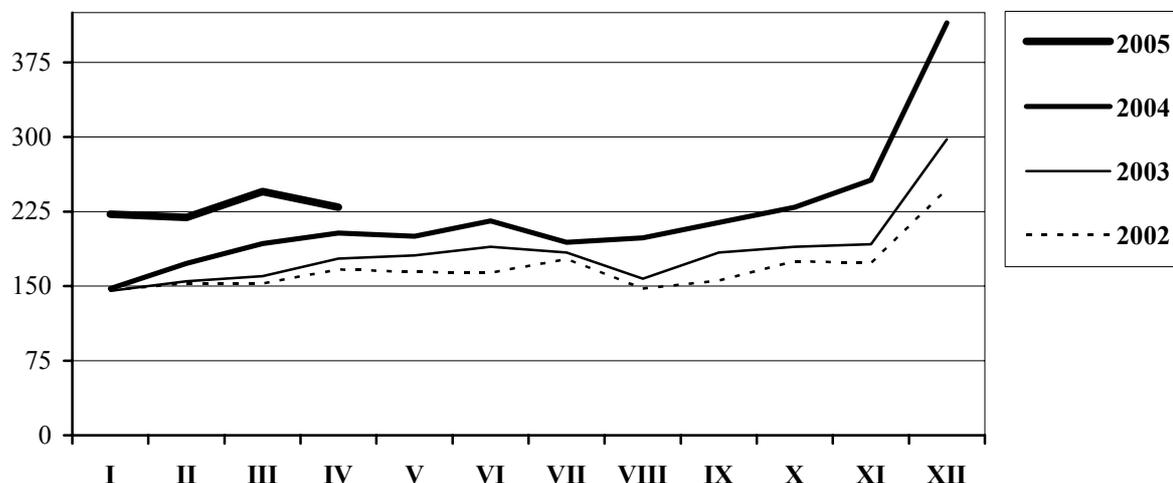
	2002		2003		2004*	
	struc- ture	of GDP	struc- ture	of GDP	struc- ture	of GDP
Expenditures – total	100	35.2	100	35.0	100.0	35.5
General governmental services	7.7	2.7	8.4	2.9	7.5	3.0
Defence	3.4	1.2	3.6	1.3	3.1	1.2
Public order and safety, law enforcement	6.5	2.3	7.0	2.4	5.5	2.2
Education	18.4	6.5	17.5	6.1	15.0	6.0
Health care	9.3	3.3	9.4	3.3	8.3	3.3
Social security and welfare	32.3	11.4	30.5	10.7	26.1	10.5
Housing and community amenity, environmental protection	5.4	1.9	5.1	1.8	4.6	1.9
Recreation, sports, culture and religion	3.9	1.4	4.0	1.4	3.2	1.3
Agriculture, forestry and fishery	4.0	1.4	4.9	1.7	5.6	2.2
Transport and communications	4.4	1.6	4.9	1.7	6.0	2.4
Other economic activity	2.5	0.9	1.7	0.5	1.5	0.6
Other expenditures not classified in major groups	2.1	0.8	3.1	1.1	13.4	5.4

* current data of general government consolidated budget expenditures

In 2004 the expenditures of the general government consolidated budget increased faster than revenues (by 19.3%) in comparison with the previous year. The fastest growth of expenditures was recorded in transport, defence, environmental protection, social security and welfare.

Figure 4.6

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



Public investment is the share of the general government consolidated budget expenditures that ensures aligned, developed and efficient socio-economic infrastructure complying with certain requirements. There are several reasons why public investment is made:

- with assistance of public investment, the fixed assets used for production of public goods and services are increased and improved;
- the government makes investment which is intended for prevention of market mechanism shortcomings and negative side-effects (e.g., environmental pollution or harm to population health). Prevention of such side-effects requires additional resources which not always can be foreseen and included in the product price by the private sector. One more type of market shortcomings is related to insufficiently functioning financial markets. Private sector does not undertake to carry out big risk projects with voluminous investment because there is no adequate insurance and venture capital.

Public investment in Latvia in the last years (2000-2004) amounted to 3.6% of GDP and 10.08% of general government consolidated budget expenditures. Taking into account that public investment as a budget expenditure item is limited by fiscal discipline, it is clear that efficiency of public investment is determined not so much by its volume as by investment direction and type. It is important to note that public investment promote attraction of private investment, improving environment for investment in private sector.

Level of public investment in the developed countries is within the limits of 2.5-3% of GDP. For example, in 2000 the public investment share in GDP equalled to 2.3% in the EU countries and 3.3% in the USA. In the new EU member states on average, public investment constitutes 4.5% of GDP (source of data: *Eurostat*).

Level of public investment in developed countries is shrinking in the last decade due to several reasons:

- trends of structural development are changing. Marginal product¹ of public investment is decreasing in highly developed countries. The highest level of public investment is in medium-development countries;
- public investment is being replaced by private investment because capital markets consolidate and provision of many public functions is handed over to the private sector (privatisation). One of the reasons is public private partnership (hereinafter PPP) when investment into public infrastructure is made as a result of co-operation between central or local government institutions and private sector companies.

¹ Additionally created product /GDP growth/ resulting from increase of one production factor /fixed assets of state/.

Table 4.6

Expenditures of the General Government Consolidated Budget

	2000	2001	2002	2003	2004
Million LVL					
Total expenditures	1743.8	1801.1	2022.0	2212.5	2639.5
maintenance expenditures	1567.7	1619.3	1805.5	1989.4	2391.1
capital expenditures	176.1	181.8	216.5	223.1	248.3
Percentage against GDP					
Total expenditures	37.2	34.8	35.5	35.0	35.9
maintenance expenditures	33.5	31.3	31.7	31.5	32.5
capital expenditures	3.8	3.5	3.8	3.5	3.4
Capital investment against all expenditures (%)	10.1	10.1	10.7	10.1	9.4
Capital investment structure					
by budget levels (%)	100	100	100	100	100
– from general government consolidated budget	48.1	43.8	45.5	52.3	57.4
– from local government consolidated budget	51.9	56.2	54.5	47.7	42.6

Source of data: State Treasury data

To consolidate the use of budget resources for capital investment and increase their efficiency, since 1995 the **Public Investment Programme (PIP)** is being implemented in Latvia but this programme comprises only the part of public investment which is planned as investment from the state budget. Local government investment projects which do not have co-funding of basic budget or state loan guarantees are left out of the PIP.

Total amount of the PIP, which consists of central government basic budget, special budget, state loans and guarantees, and other sources (gifts, own resources of project implementers), has not exceeded 2.2% of GDP since 2001 and constituted 2.0% of GDP in 2002. In 2003 and 2004 the share of the PIP total amount in GDP decreased to 1.7% and 1.2% respectively. In 2005 the PIP share from basic budget and special budget alone will increase to approximately 2.4% of GDP.

The increase may be explained by the fact that with Latvia's accession to the EU an even bigger amount of funds from foreign financial assistance programmes is available to Latvia, which essentially affects the total public investment volumes in Latvia. Financial resources from the European Regional Development Fund, Cohesion Fund, and Schengen Programme foreseeing to ensure conformity of EU external border control are envisaged as foreign financial assistance for implementation of PIP projects.

Total utilisation of PIP funds in 2003 was less than 8% of the total investment in fixed assets in the national economy, and the share of central government basic budget funding constituted only 33% of total public investment (Table 4.7).

Table 4.7

Dynamics of the Total Amount of PIP

	2000	2001	2002	2003	2004
Total funding of PIP, million LVL	141.1	115.2	112.0	108.1	91.9
% of total investment in fixed assets	12.3	8.9	8.1	7.6	4.7
% of public investment*	52.5	45.4	37.2	33.0	36.7

* share of central government basic budget in total funding of PIP

Contribution of PIP to total public investment decreases year by year from 12.3% in 2000 to 4.7% in 2004. Analysis of expenditure from central government budget investment in regard to total public investment shows that the central government budget funding planned within the PIP framework increases year by year.

91.295 million LVL were invested in PIP projects in 2004, which was 16% less than in the previous year. The priority sectors of PIP in 2004 included transport (30.2 million LVL), environmental protection (17.48 million LVL) and internal affairs (9.52 million LVL).

Growth of central government basic budget investment volume considerably lags behind volumes of its demand increase. The limited availability of central government budget resources for implementation of investment projects means insufficient maintenance and development of infrastructure, which causes negative consequences in the national economy, reducing efficiency of the public sector, value of state fixed assets and economic returns of these assets to.

Main shortcomings in public investment planning. At present Latvia lacks a single public investment policy document which would provide an overview of current situation in all sectors and spheres, long-term development goals and priorities, defining state investment priorities. In view of the limited budget resources, lack of such document essentially hinders evaluation of investment efficiency in public infrastructure. As a result, investment priorities within the PIP framework are frequently changed and political decisions affect the choice of projects included into PIP. Public investment in the country is not being co-ordinated purposefully. Therefore the National Development Plan, which is being worked out by the Ministry of Regional Development and Local Governments, should reflect characteristics of all sectors and their state policy spheres, long-term development goals and priorities, including public investment priorities.

In the process of PIP preparation the link with state budget preparation process is also insufficient. While planning current expenditures of state budget, quite often the expenditures for further maintenance of projects implemented in the PIP framework are not envisaged in due time. Besides at present there is a big number of local government investment projects whose implementation was started within the PIP framework but in 2005 no state budget funds were allocated for continuation/implementation of them. Similar situation is also in the area of sectoral ministries.

Action priorities and planned activities. To determine medium-term public investment policy in the country, the Ministry of Economics, in accordance with Latvian strategic goals and priorities, has developed and will update annually the guidelines *Notification of Public Investment Programme for Medium Term*. This political document is aimed at aligned, developed and efficient socio-economic infrastructure compliant with certain requirements. Aligned infrastructure allows dynamic development of the social sphere, providing high-quality services to all population, reduces private company operation costs and public infrastructure maintenance costs, and ensures influx of foreign investment in the country, as a result promoting balanced, stable and sustainable growth of the country.

The preparation of PIP notification is one of stages in the PIP planning cycle. Its task in the PIP planning cycle is to include basic principles for preparation of sectoral investment programmes in medium term, defining provisional sectoral investment volumes (including the envisaged funding for projects co-financed from EU Structural Funds) as well as institutional responsibility for preparation of sectoral investment programmes and planning of further activity for development of PIP in medium term by sectors. On the basis of the PIP notification, sectoral ministries will prepare investment programmes of respective sectors in accordance with policy directions.

To ensure a rational and efficient cycle of public investment planning and implementation, it is necessary to retain PIP, at the same time improving the procedure of PIP preparation, implementation and supervision.

4.2. Prices

4.2.1. Consumer Prices

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

In 2004 the inflation rate has rocketed in Latvia. In 2004 the inflation rate reached 7.3% (12-month inflation, December over December) and was among the highest in the European Union member countries.

Figure 4.7

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

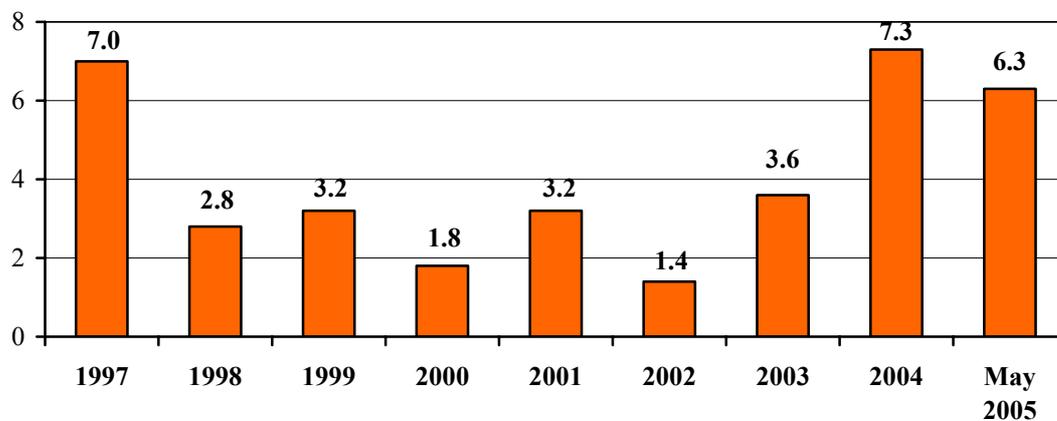
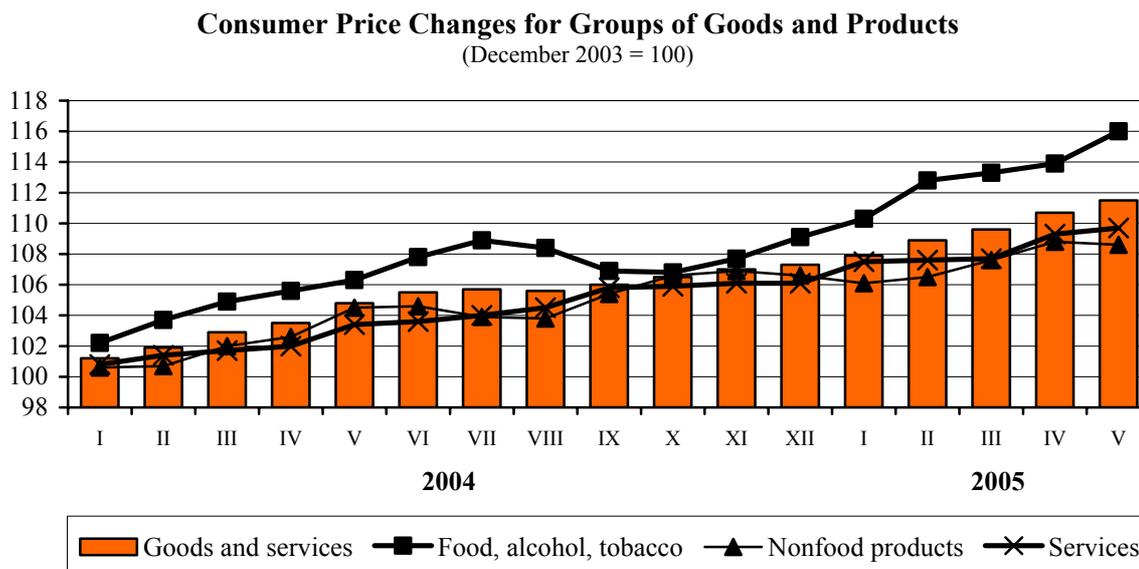


Table 4.8

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
2003	January	0.9	1.4	1.8
	February	0.3	2.1	1.7
	March	0.5	2.2	1.6
	April	0.3	2.5	1.6
	May	0.2	2.5	1.6
	June	0.7	3.7	1.8
	July	-0.3	3.8	2.1
	August	-1.1	3.5	2.3
	September	0.5	3.1	2.5
	October	0.9	3.3	2.6
	November	0.5	3.6	2.8
	December	0.2	3.6	2.9
2004	January	1.2	3.9	3.2
	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	5.2
	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

Figure 4.8



In May 2005 the inflation rate was 6.3% (12-month inflation, May over May) (see Figures 4.7 and 4.8) including 6.4% for goods and 6.1% for services. In the first 5 months of 2005 the inflation showed a trend towards a decrease. Rise in fuel price essentially affected the average level of prices in the first 5 months. Increase in food product prices had the biggest impact on the rise of prices.

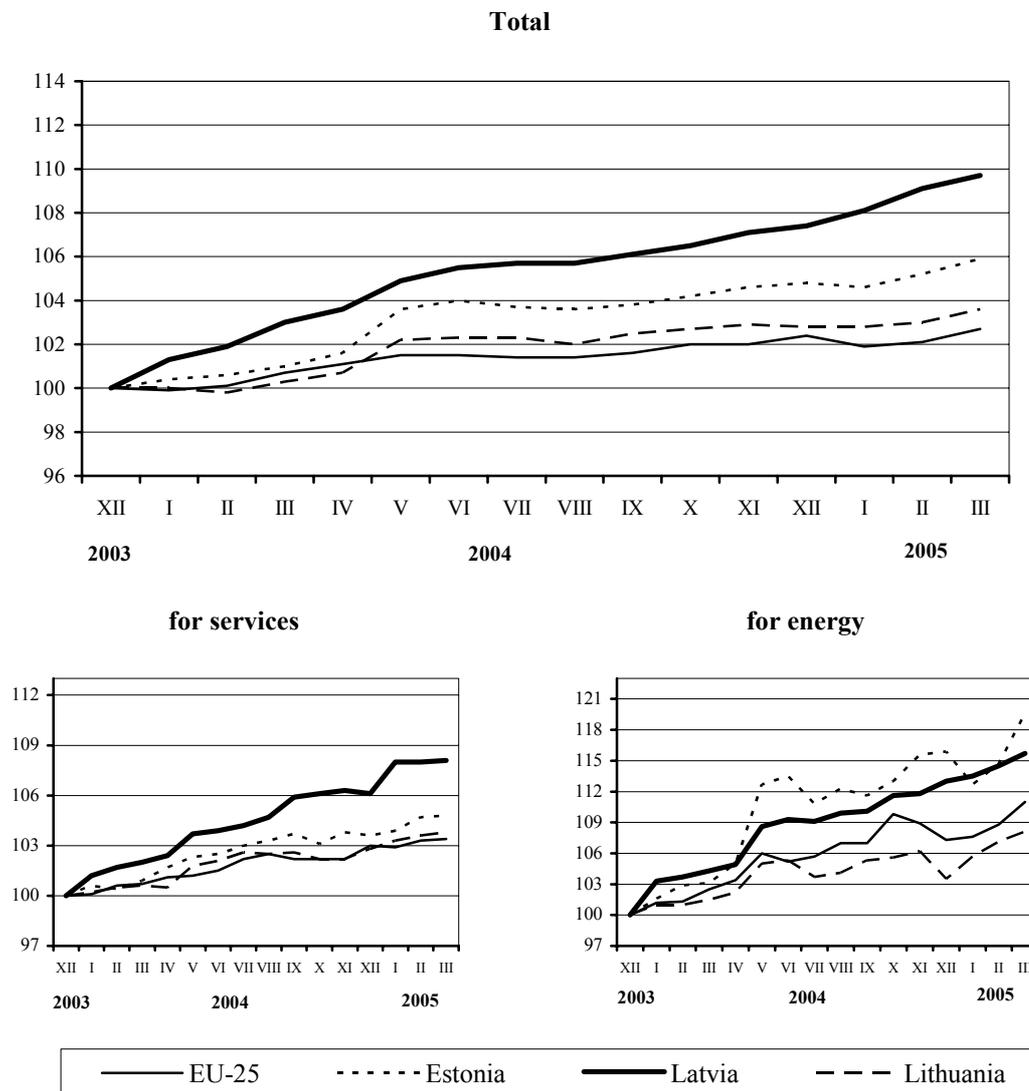
In the first 5 months of 2005, prices increased by 3.8% (in the respective period of the previous year they increased by 4.8 per cent).

The inflation rate dynamics in the first 5 months of 2005 was influenced by the following conditions:

- *the 2nd round effect of the sufficiently high inflation rate of 2004.* The basic inflation level decreased at the beginning of 2005, which indicates that the influence of the supply party factors on prices is diminishing but the influence of demand factors is becoming stronger. Essential decrease in inflation rate may be expected as from June of this year. It is anticipated that influence of several one-time factors which maintained high inflation rate in the 2nd half of 2004 will cease then; such factors are: administratively regulated prices, rise in food product prices with Latvia's accession to the EU, and the uproar of prices linked to this accession. The one-time factors made 3.8 percentage points, which was more than a half of the average inflation in 2004 (6.2 per cent).
- *changed peg of the lat to the euro* (on January 1, 2005), which ruled out fluctuations in the currency exchange rate against the euro and thereby did not create additional influence on prices of imported goods. At the end of 2004 the euro exchange rate increased at a more rapid pace that also ensured faster rise in import prices by 10.9% in the 4th quarter of 2004 in comparison with the 4th quarter of 2003 and determined rise in prices of tradable goods (some food products, clothing, footwear, medicines);
- *the rise of world oil prices*, which essentially affected the growth of domestic fuel prices in the first 5 months of 2005 (by 10.7%) and the corresponding consumer price increase by at least 0.7 percentage point annually. Also the subordinate influence of fuel prices on prices of other goods and services, which doubles the effect on the level of consumer prices, is to be taken into account.
- *administratively regulated prices* have not grown essentially in the first 5 months of 2005, except prices for living accommodation rent which have grown by 13.1%. The average increase in regulated prices reached 5% in 2004, based on substantial growth of tariffs for gas supply (by 22.4%), electricity (by 15.4%) and heat supply, as well as increase in tariffs for other public utilities (water supply, waste disposal, sewage services), while the average price level in communications group went down (by 2.2%).

Figure 4.9

Harmonised Consumer Price Index of Latvia in Comparison with the EU Average, Lithuania and Estonia



Source: Eurostat

In 2004 the consumer price inflation in Latvia was the highest among the Baltic countries. It was lower in the neighbouring countries Lithuania and Estonia; annual inflation in Lithuania was 2.9%, while in Estonia it amounted to 5% (see Figure 4.9).

At the beginning of 2005 the situation in Latvia has changed, the price changes are mostly influenced by supply party factors, and the inflation growth apparently tends to decrease. Inflation growth was lower also in Estonia (4.7%), while inflation growth in Lithuania tends to increase and reached 3.2% (12-month inflation, March over March). In the first 3 months of 2005, energy prices increased more rapidly in Lithuania (by 4.5%), in the EU in total and in Estonia they increased by 3.5% on average, while in Latvia the growth was the lowest (by 2.4 per cent).

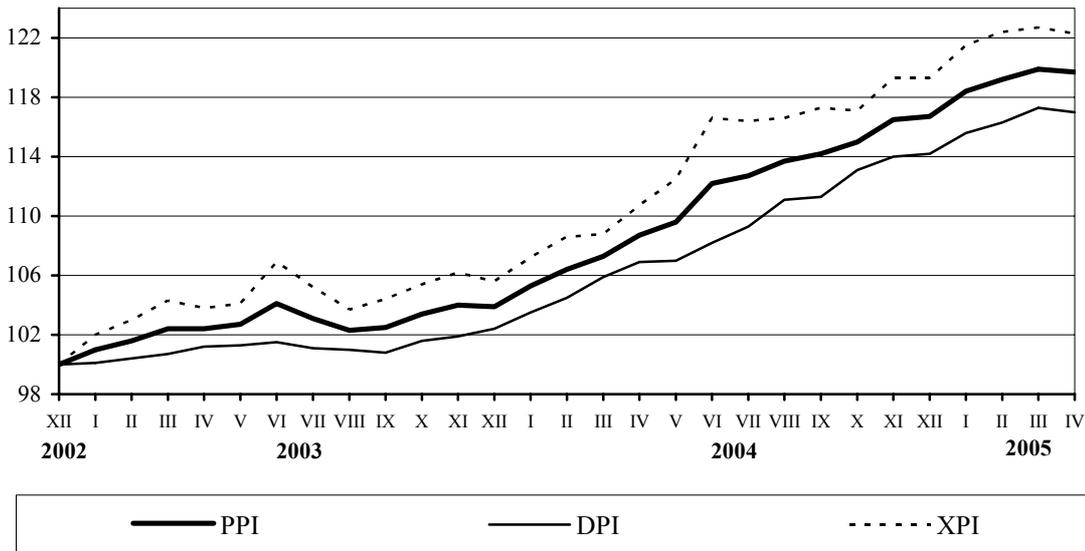
It is forecasted that in the next years the inflation will gradually return to the previous level, as the influence of one-time supply party factors which are increasing prices will lessen gradually.

4.2.2. Producer Prices

Producer prices in 2000-2003 grew slowly, which to some extent baffled the development of industry sectors. Producer price fluctuations were mostly related to changes of currency rates, as changes in export prices greatly determine the overall dynamics of the producer price changes.

Figure 4.10

Producer Price Dynamics in Manufacturing
(December 2002 = 100)



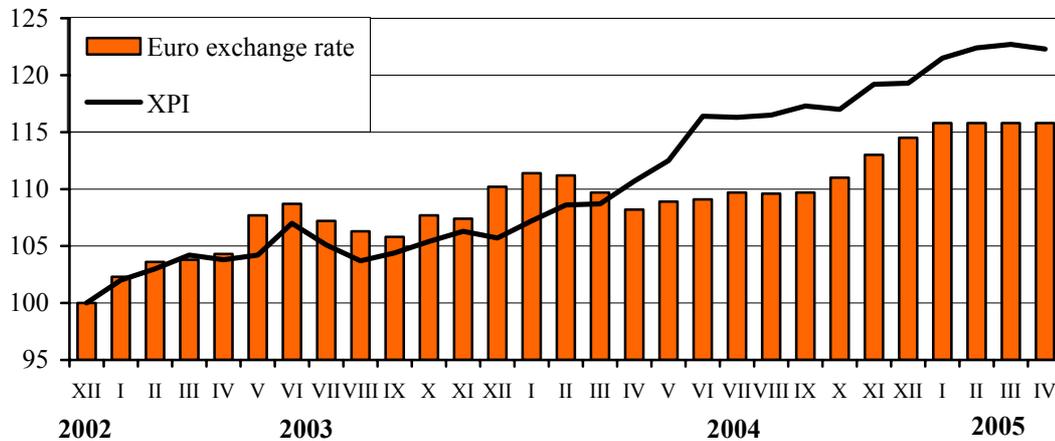
PPI – producer price indices, DPI – producer price indices for products sold on the domestic market, XPI – producer price indices for exported products

In 2004 the producer prices went up much more briskly (by 11.4%) than in 2003. In the April of 2005 the producer prices grew by 8.6% in comparison with the respective period of the previous year.

Latvia being a country with a small and open economy, producer prices largely depend on changes of foreign trade prices, which are defined 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.

Figure 4.11

Export Price Dynamics in Comparison With Dynamics of Euro Exchange Rate
(December 2002 = 100)



XPI – producer price indices for exported products in manufacturing

During the past year (April 2005 over April 2004) prices of manufacturing industry products sold on the domestic market went up at a slower rate (by 7.3%) than prices of exported manufacturing industry products (by 10.4%).

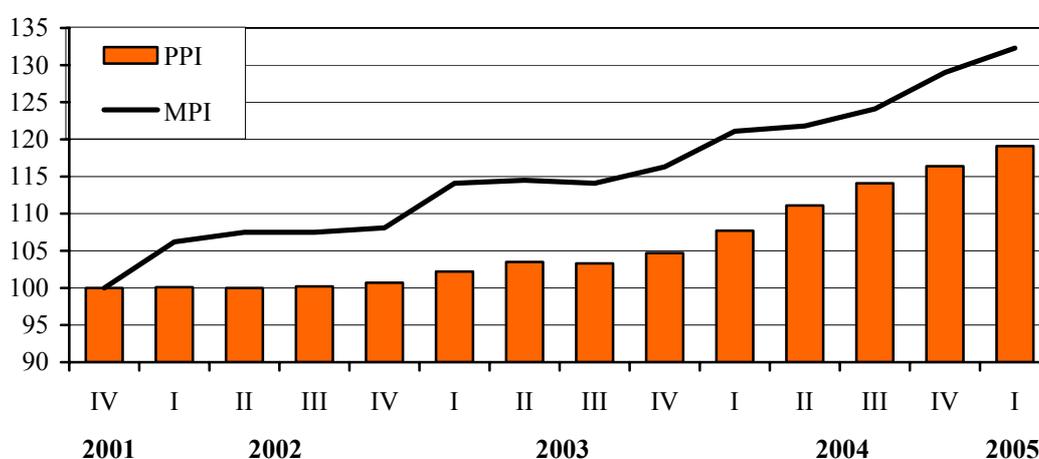
The growth of prices for products sold domestically was triggered not only by the rising domestic demand but also by the growth of export prices because supply of some products on the domestic market decreased.

In the first 4 months of 2005 the price growth of exported products was virtually unaffected by currency rate changes and was mostly influenced by rise of world prices.

Dynamics of import prices in comparison with producer price dynamics is similar (see Figure 4.12). Surge of import prices is directly related to the rise of the euro exchange rate and the growing domestic demand.

Figure 4.12

Import Price Dynamics in Comparison with Producer Price Dynamics
(IV quarter of 2001 = 100)



PPI – producer price indices, MPI – producer price indices for imported products

Import unit value went up at a slower rate than export unit value in the 1st quarter of 2005 compared with the respective period of the preceding year (by 10.1% and 14.2% respectively) thereby trade conditions improved.

4.3. Balance of Payments

4.3.1. Current Account

Latvia, typically, has a relatively big deficit of the **current account**. The main cause of the deficit is pronouncedly 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 keep growing.

Trade balance deteriorated in 2004 (see Table 4.9), as the imports of goods increased more rapidly than the exports due to the growing domestic demand and stockpiling of goods before accession to the EU, as well as several one-time bulky purchases of investment goods. Rise in goods exports was greatly determined by growth of demand for Latvian goods in external markets and steady competitiveness of these goods as well as improvement of trade conditions with the rise of export prices affected by high exchange rate of the euro.

The positive balance of services compensates one-fifth of the voluminous trade deficit. Balance of services decreased slightly in comparison with the previous years, as the balance of transportation decreased, which was partly compensated by faster growth of exports of other services.

Negative balance of revenues from factorial services also increased due to substantial rise of the reinvested profit of non-residents in Latvian companies, which deteriorates the current account of the balance of payments, yet has a positive role in terms of economic growth as these funds remain in Latvian economy and a source for new investment.

Table 4.9

Latvian Balance of Payments
(percentage of GDP)

	2000	2001	2002	2003	2004
A. Current account	-4.6	-7.6	-6.7	-8.2	-12.3
Trade balance	-13.6	-16.2	-16.0	-18.0	-20.2
<i>Exports</i>	26.9	27.3	27.6	28.6	30.7
<i>Imports</i>	-40.5	-43.5	-43.6	-46.6	-50.9
Balance of services	6.2	6.2	5.8	5.2	4.4
Net income	0.2	0.7	0.6	-0.2	-1.6
Current transfers, net	2.5	1.7	2.9	4.8	5.0
B. Capital account	0.5	0.5	0.2	0.7	1.1
C. Financial account	5.3	7.1	7.3	7.3	11.5
Direct investment	5.2	1.4	2.7	2.4	4.0
<i>abroad</i>	-0.2	-0.2	0.0	-0.3	-0.8
<i>in Latvia</i>	5.3	1.6	2.8	2.7	4.8
Portfolio investment	-4.2	1.6	-2.2	-2.0	1.6
<i>assets</i>	-4.6	-0.7	-2.4	-2.6	-0.3
<i>liabilities</i>	0.3	2.3	0.2	0.6	1.9
Other investment	4.3	7.9	6.6	7.5	8.8
<i>assets</i>	-5.1	-1.0	-5.1	-6.1	-12.4
<i>liabilities</i>	9.3	8.9	11.7	13.6	21.2
D. Net errors and omissions	-1.2	0.0	-0.8	0.2	-0.2
E. Reserves	0.1	-3.7	0.0	-0.6	-2.9

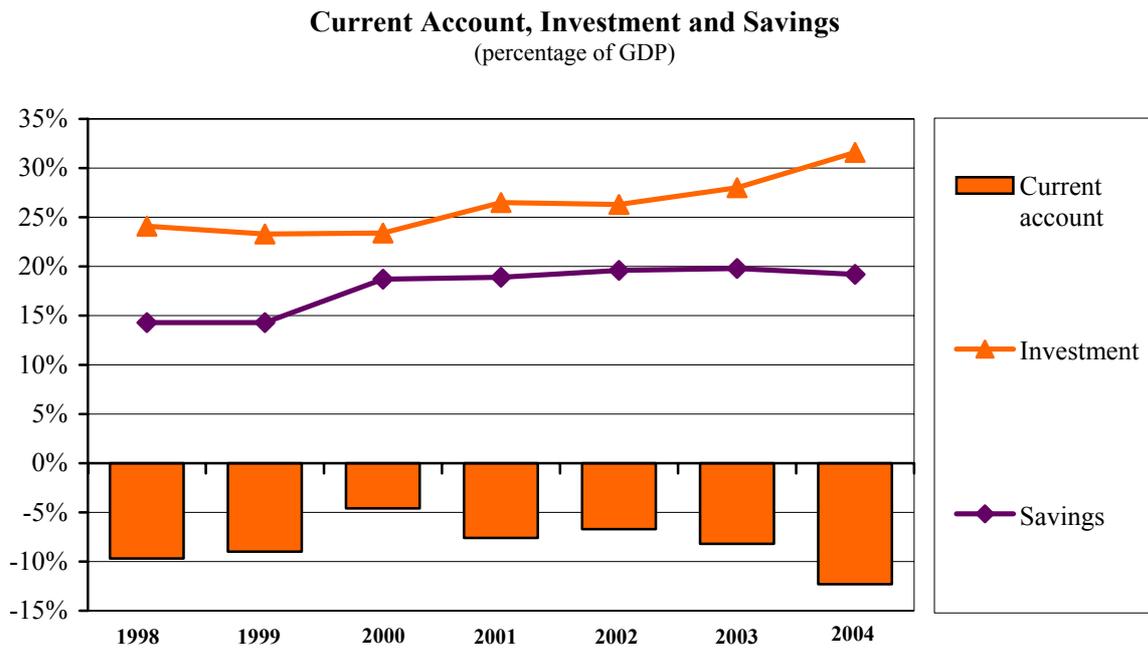
As already noted, growth of current account deficit in 2004 was mostly determined by deteriorating trade balance. Although the increase in exports of goods was considerable (by 25% in real prices), the increase in exports was even faster (by 27%). Imports of all groups of goods (capital, intermediate and consumption goods) increased considerably. Two-thirds of increase in imports were determined by growth of physical volume of goods, while one-third was determined by growth of prices. The absolutely highest growth was recorded for imports of intermediate goods due to substantial growth of industrial output. Imports of intermediate goods constitutes half of imports of Latvian goods, therefore the total imports are most essentially affected by fluctuations of other intermediate goods imports.

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 4.13, during the last years the level of savings in Latvian economy has not essentially changed and equals to approximately 20%. Investment, in contrast, grows at a more rapid rate.

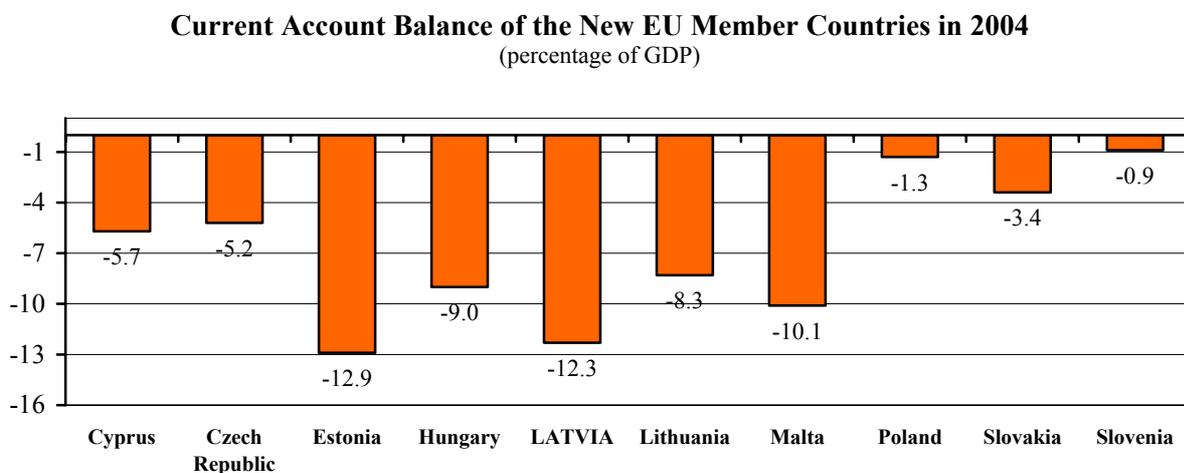
Thus, the imbalance between domestic savings and investment (deficit of the current account) is a regular phenomenon in Latvian economy. Until now, this has not caused problems for stability of economy as the deficit was mostly covered by non-debt flows. Moreover, faster growth of investment in comparison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

Figure 4.13



All EU accession countries have a negative savings–investment balance which is mainly linked with the relatively low level of savings. Domestic savings are too small to implement restructuring and modernisation of economy.

Figure 4.14



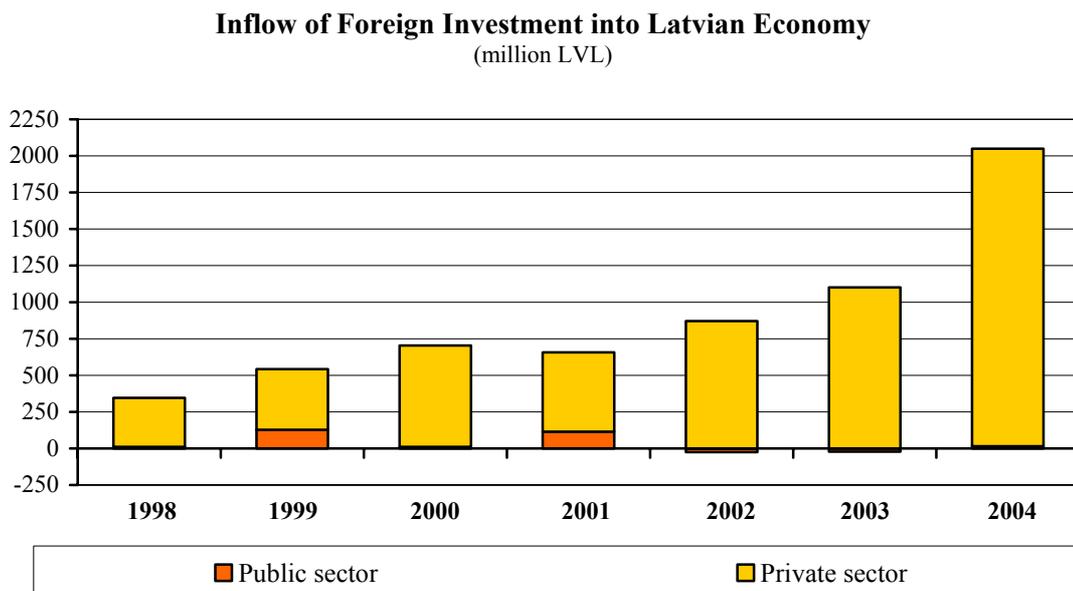
* Source: Statistical Annex of European Economy, spring 2005, table 44

In 2004 the Latvian current account deficit against GDP was the second highest among the new EU member countries (see Figure 4.14). A higher ratio was only reported in Estonia (-12.9% of GDP). No country was with a positive current account balance; the lowest current account deficit was in Slovenia (-0.9% of GDP).

4.3.2. Financial Flows

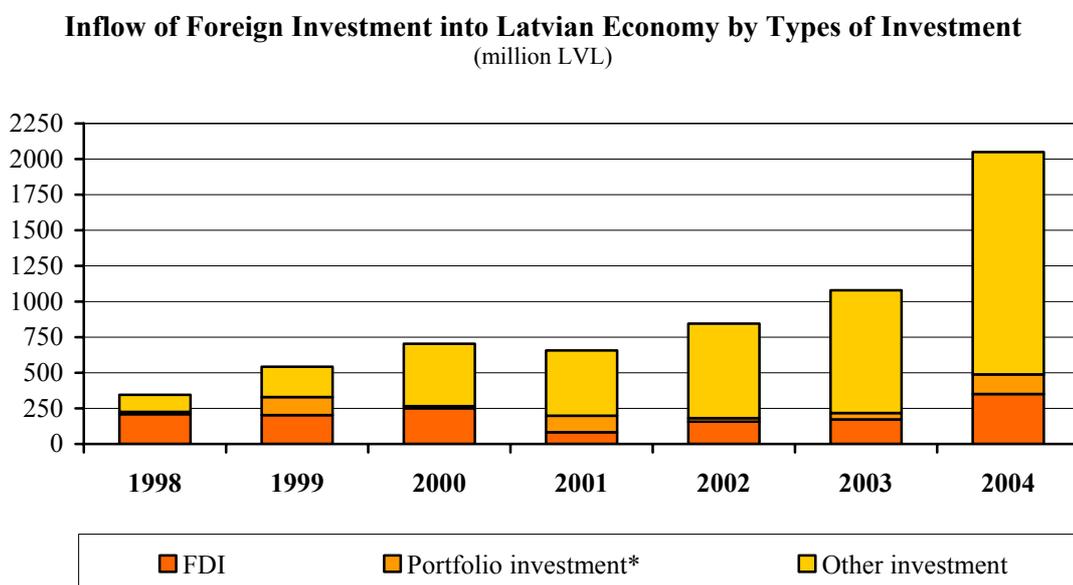
To balance the external sector in case of a large current account deficit, it is important to look at the nature of coverage of the current account deficit and **financial flows**.

Figure 4.15



An enhanced inflow of foreign capital, ensured by 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.

Figure 4.16

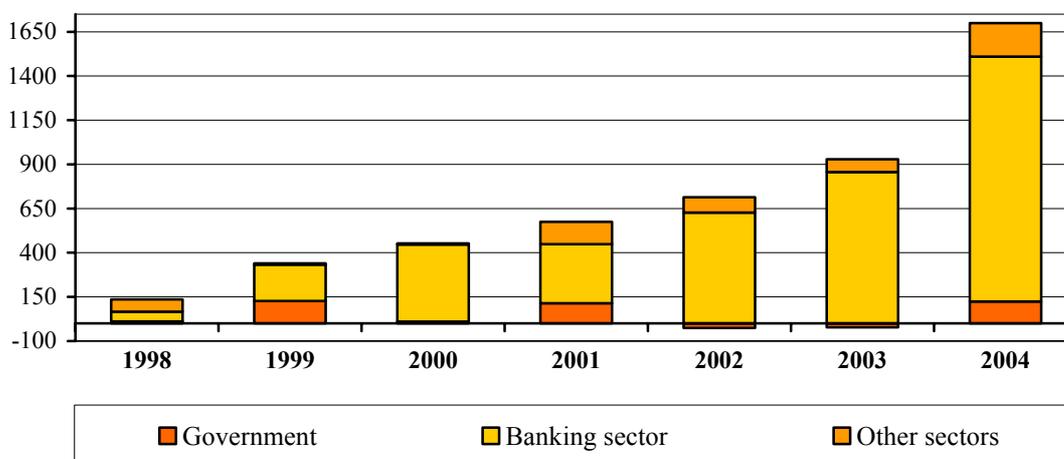


* portfolio investment with financial derivatives

Foreign investment is mainly drawn in by the private sector. In 2003 and 2004 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 resolution to continue the reforms in future, strong national currencies and accession to the EU. Therefore the majority of candidate countries have credit ratings favourable for investment.

Figure 4.17

Net Foreign Investment Flows in Different Sectors*
(million LVL)



* Excluding FDI

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.

The amount of portfolio investment has increased due to portfolio investment abroad and growth of investment made by non-residents in debt securities issued by banks, and emission of new Eurobonds by the government.

The majority of foreign investment consists of „other investment”, namely, financial transactions which are not included in neither direct nor portfolio investment. These are commercial 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 fosters free movement of funds in and out of the banking system.

Latvia, therefore, is a capital-attracting country. The attracted capital at the end of 2004 exceeded GDP by 16.5%, while the debt of Latvia to the rest of the world was 93.2% of GDP, including the government debt (7.9%). The amount owed to Latvia by the rest of the world equalled to 64.6% of GDP.

4.3.3. Foreign Direct Investment

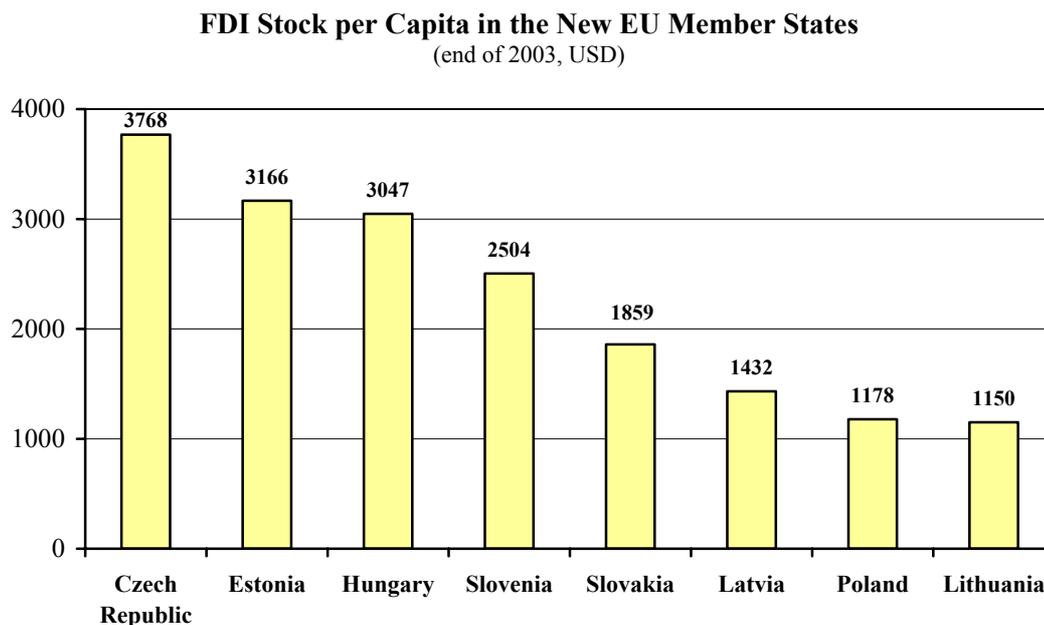
In the last years, the level of national savings in Latvia constituted 18-20% of GDP on average or 65-70% of investment in fixed assets. Therefore, in accordance with the savings-investment balance, the attracted foreign capital (mostly in form of foreign direct investment) covered 30% on average of funding for investment in fixed assets.

Until the end of 2004, foreign businesses had invested 1002 LVL or 1948 USD per capita in Latvia in form of direct investment.

At the end of 2004 the FDI stock amounted to 2318.3 million LVL or 31.5% of GDP, and the volume of the FDI inflow during the last four years equalled on average to 17% of investment in fixed assets.

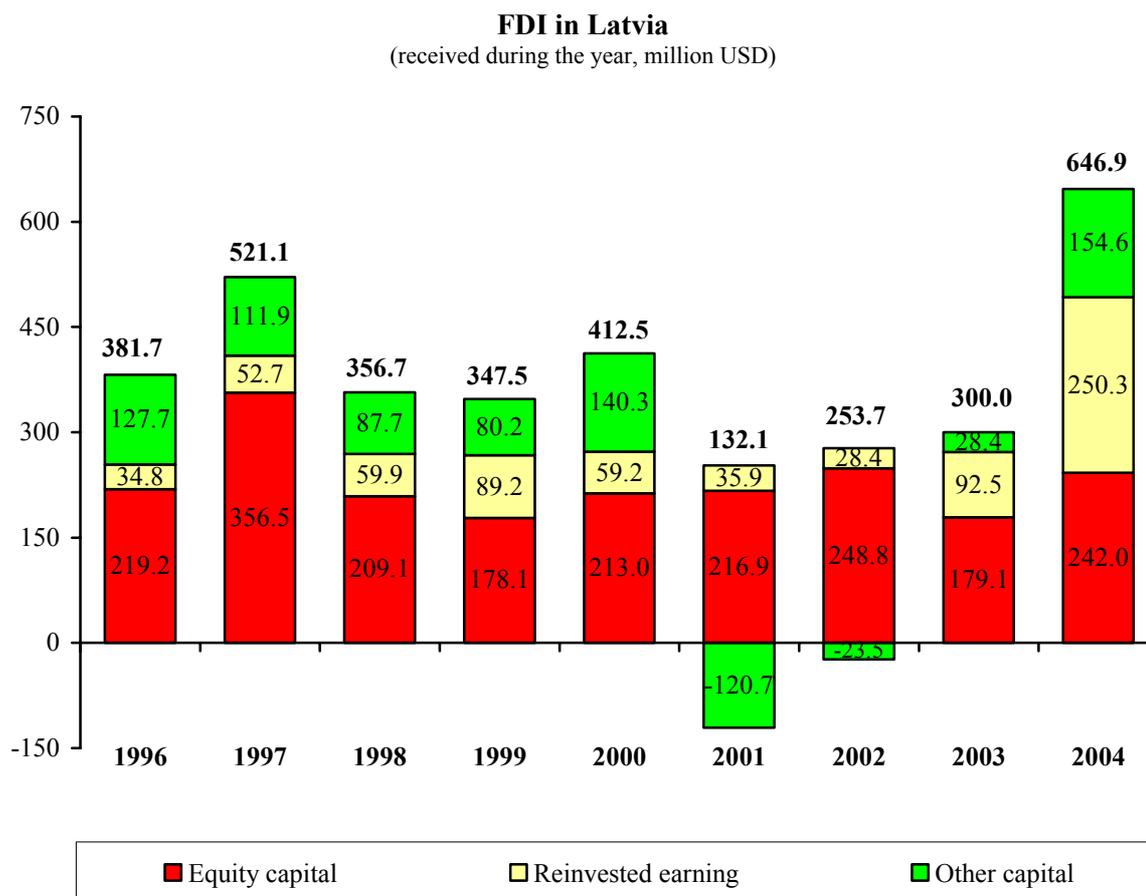
In 2004 the volume of the FDI inflow in Latvia reached 350.2 million LVL which was two times more than in 2003. The growth was mostly ensured by substantial increase in reinvested profit.

Figure 4.18



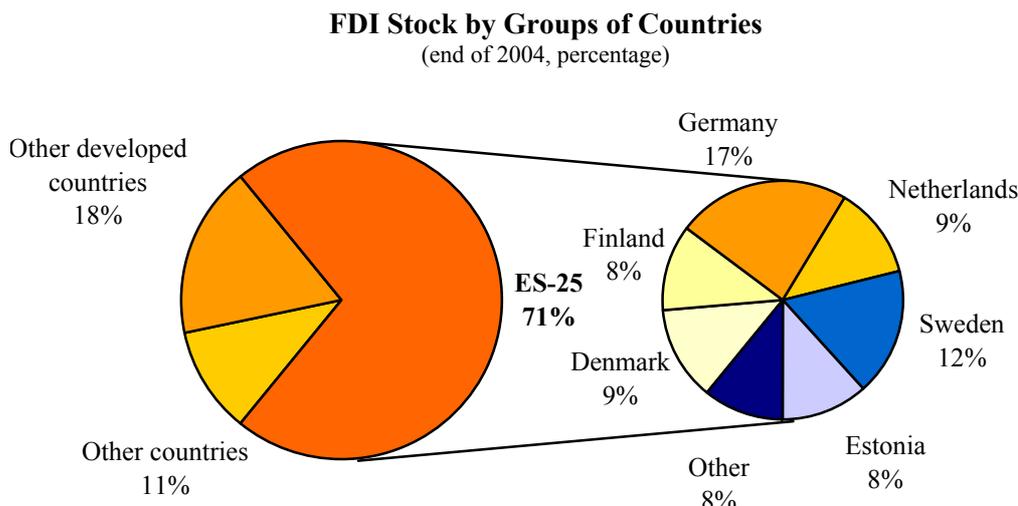
Source: UNCTD, World Investment Report 2004

Figure 4.19



Investment of developed countries dominate in the geopolitical structure of the FDI stock. In 2004, the FDI stock of developed countries increased by 28.1% and constituted 79% of the total FDI stock in Latvia. Investment of EU-15 countries increased by 34.1% in 2004 and equalled to 61.3% of the total FDI stock.

Figure 4.20



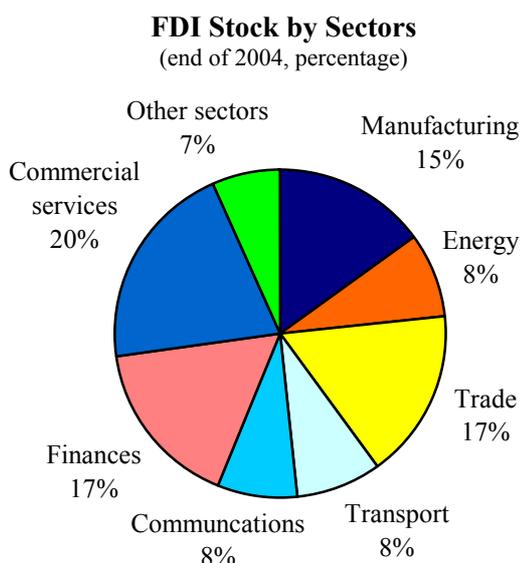
FDI stock from the new EU member states increased by 50.1% in 2004 and constituted 10.2% of the total FDI stock at the end of 2004.

According to data of the Bank of Latvia, the biggest amounts of investment have been received from Germany, Sweden, Denmark, Finland, USA, Netherlands, Norway and Estonia, contributing to almost 70% of all FDI stock in Latvia. Majority of these countries are also the biggest trade partners of Latvia.

In 2004 the most significant amounts of direct investment in Latvia were made by German, Russian, Dutch, Estonian and Danish entrepreneurs, contributing 70.6% of all investment inflow.

The highest share in the sectoral structure of FDI stock belongs to the commercial services sector, although the share of this sector in the structure of FDI stock diminished by almost 5 percentage points in 2004 in comparison with 2003. It was affected by faster increase of FDI in other sectors. Especially fast growth of FDI in this period was in sectors of energy (3 times), communications (by 98%) and financial mediation (by 41%). In 2004 the FDI in production sectors grew by 57% or almost twice faster than in services.

Figure 4.21



Amount of FDI stock in manufacturing increased at a more moderate pace, and the share of this sector in 2004 equalled to 14.9% which was 1.7 percentage points lower than at the end of 2003.

The biggest investments in manufacturing were made by Germany (17.2% of total investment in manufacturing), mostly in low and medium technology sectors. Also the United Kingdom, Sweden and Estonia have invested in these sectors. The biggest investment in medium technology sectors were made by Netherlands (33.3%).

Table 4.10

**Foreign Investment in Equity Capital of Manufacturing Enterprises
Registered in Latvia at the End of 2004**

(manufacturing = 100)

	TOTAL	incl. biggest investors							
		Germany	Sweden	United Kingdom	Netherlands	Estonia	USA	Switzerland	Other countries
TOTAL	100.0	17.6	12.3	10.2	9.9	7.5	6.0	4.8	31.6
Food industry	28.1	0.4	5.9	4.7	3.4	4.2	1.5	–	8.0
Light industry	14.6	10.0	0.9	0.1	0.2	–	–	–	3.3
Woodworking	17.5	2.3	3.8	4.7	0	1.7	1.1	1.5	2.5
Paper production and publishing	2.8	–	0.9	–	–	–	1.3	–	0.5
Chemical production and related sectors	7.0	–	0.3	0.4	–	–	0.2	3.3	2.8
Production of other non-metallic mineral products	11.8	2.6	0.2	–	6.2	–	0.7	–	2.1
Production of metals and metalwork	4.1	1.3	–	–	–	–	0.8	–	2.0
Machinery	12.4	1.0	0.3	0	–	1.6	0.4	–	9.2
Other sectors of manufacturing	1.6	0.1	–	0.3	–	–	0.1	–	1.2

Only a few so-called greenfield projects, involving introduction of new and modern technologies by foreign investors, have been implemented in Latvia. Even in sectors which have the highest potential to implement such projects, only that part of work, which requires a relatively low labour qualification, is being performed in Latvia. To ensure long-term development of Latvian economy, it is necessary to continue development of infrastructure, investment into education and creation of other preconditions to lure foreign investors to invest in knowledge-intensive and high technology sectors.

4.4. Financial and Capital Markets¹

4.4.1. Monetary Policy and the Exchange Rate

The Law on the Bank of Latvia² stipulates that the main goal of monetary policy in Latvia is to maintain price stability. The central bank is an independent decision making-institution not subordinated to decisions or orders of the government or governmental institutions. The Bank of Latvia performs its functions under supervision by the Saeima.

Since the middle February 1994 the Bank of Latvia had unofficially pegged the exchange rate of the lat (LVL) to the SDR³ basket of currencies (1 SDR = 0.7997 LVL) thus *de facto* implementing policy of fixed national currency exchange rate. As from January 1, 2005 the peg of the LVL 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 meeting 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 lat against the euro, namely, 1 EUR = 0.702804 LVL. Latvia will have to participate in the ERM II for at

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

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. SDR currency basket from January 1, 2001 consists of: the US dollar (45%), the euro (29%), the Japanese yen (15%) and the British pound (11%).

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.

least two years, implementing the Maastricht criterion of 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 corridor of lat fluctuations, which was habitual to financial market, has existed since pegging the lat to SDR in 1994 and was kept when the lat was pegged to the euro on January 1, 2005. A narrower exchange rate corridor will provide more stability to prices and lesser possibilities for speculative transactions.

The Bank of Latvia and the government have set a target date of January 1, 2007 by which all criteria for introduction of the euro should be met.

As soon as the EU 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 an independent monetary policy. According to estimates of the Bank of Latvia this can happen at the beginning of 2008. Until then the lat will remain the national currency of Latvia.

Still it must be noted that the introduction of the euro in Latvia is an issue of EU multilateral relations, affecting the common interests of all EU member states, and official negotiations on this issue with member states and institutions of the EU have been started only after Latvia's entry in the EU.

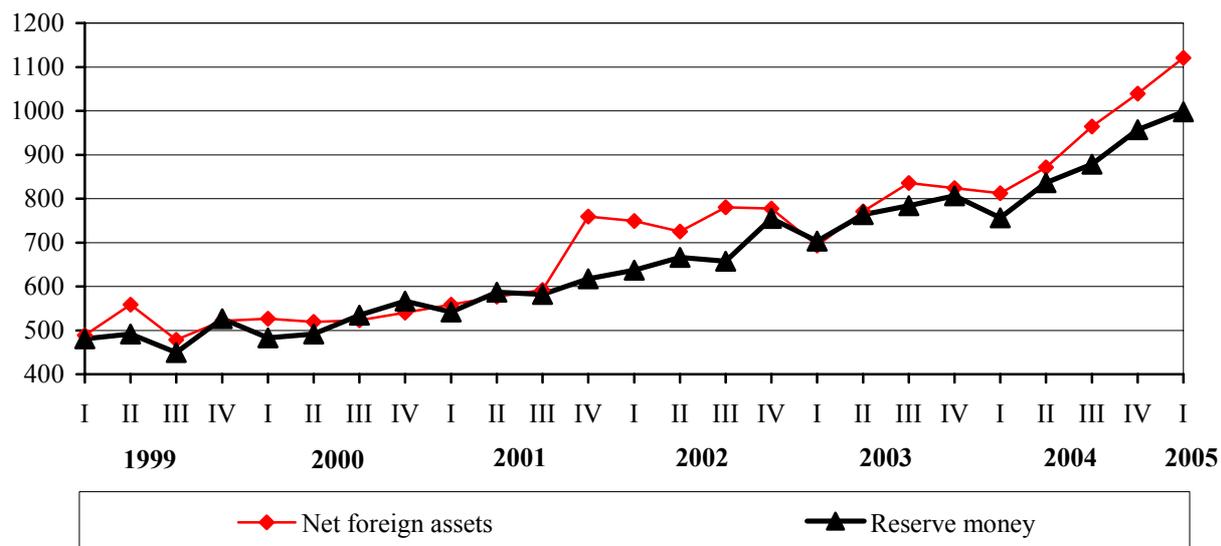
The Bank of Latvia operates like the so-called currency board, freely buying and selling foreign currencies. The Bank of Latvia has managed to gain confidence without use of a formal currency board system and to get experience, at the same time using wide range of market-oriented monetary instruments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

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. Net foreign reserves of the Bank of Latvia fully cover the reserve money (see Figure 4.22) 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 112.3% at the end of March 2005. Net foreign assets of the Bank of Latvia had gone up by 37.9% in comparison with the end of March 2004.

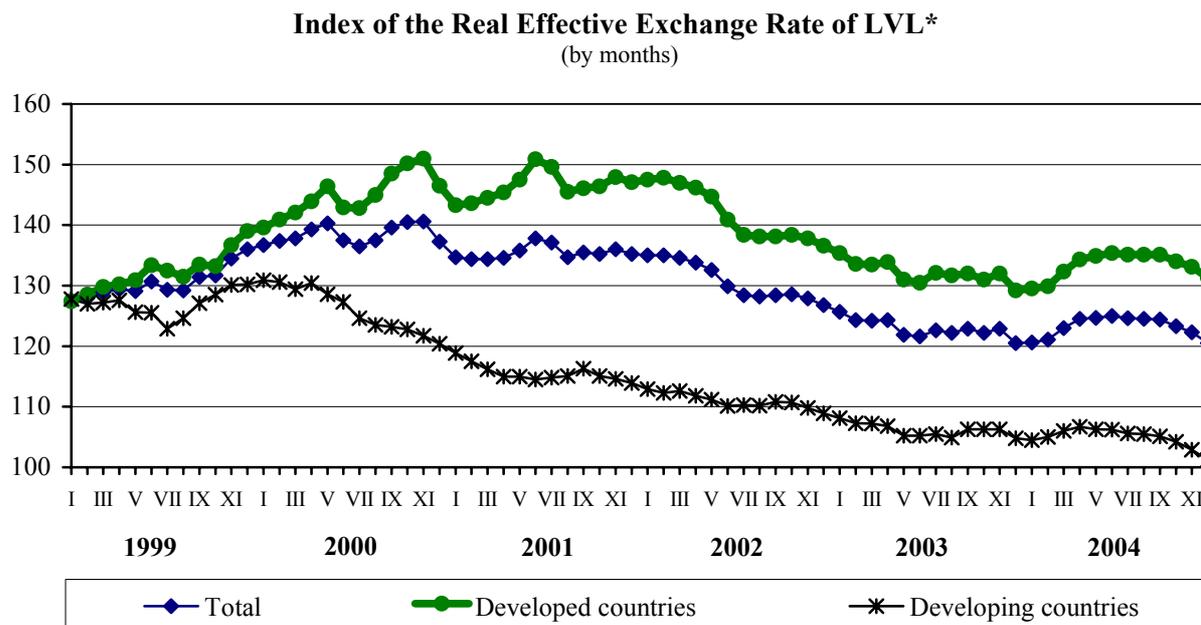
Figure 4.22

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



Foreign currency reserves are invested in safe and liquid financial instruments, mainly in debt securities issued by 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) at the end of 2004 equalled to 2019 million USD (1535 million USD at the end of 2003).

Figure 4.23



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

The Bank of Latvia calculates the real effective exchange rate of the lat¹ against the currencies of 13 countries which are the main trading partners of Latvia². This shows the relative competitiveness of Latvian exports in the world markets (see Figure 4.23).

Over the last years the real exchange rate of the lat tends to depreciate with regard to currencies of both the developing and the developed countries. Decline of the real effective rate of the lat is favourable for exporters.

4.4.2. Market Structure and Development

In the financial and capital market of Latvia, bank assets make the biggest share (over 90%) in total assets.

22 **banks** and one branch of a foreign bank³ operated in Latvia at the end of 2004. Besides, 52 notifications by financial sector supervision bodies of European Economic Area countries on the intention of banks of these countries to start providing financial services in Latvia without opening a branch in Latvia were received by the end of 2004.

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 2004 the state owned only 5.9% 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 57.8% of the total paid-up equity capital of banks at the end of 2004 (53.9% at the end of 2003). Eight banks were subsidiaries of foreign banks (their market share in the total bank assets was 43.5%).

Market share of five biggest banks has not essentially changed in the last years and amounted to 62.4% of total assets, 73.6% of loans and 65.9% of deposits at the end of 2004.

Total amount of bank assets reached 7850.1 million LVL at the end of 2004, growing by 37% during one year while the amount of issued loans went up by 46% and the volume of attracted investment increased by 36.6%. To a great extent, this growth occurred due to rapid development of

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

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

³ To compare: there are 7 banks in Estonia and 13 banks in Lithuania.

crediting and improved efficiency of banking activity. Credit portfolio of banks was dominated by loans issued to companies. Substantial growth was observed in loans issued to households.

Commercial banks operate with profit. In 2004 the total profit of banking sector reached 116 million LVL which was by 62% more than in 2003. Return on assets (ROA)¹ reached 1.7% at the end of 2004 while return on equity (ROE)² reached 21.4% (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 the sector has great potential for 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 end of 2004, of which five were life insurers and 12 provided non-life insurance. In the Latvian financial and capital market, the share of insurance companies in the total assets constitutes 2-3%.

Total of gross premiums written in the insurance market reached 131 million LVL in 2004, which was by 5% more than in 2003, while the volume of paid gross indemnities was 56.6 million LVL (by 29% more than in 2003).

Entry in the EU has encouraged increase of competition in this sector. Since May 1, 2004, non-bank financial institutions of EU countries no longer need to receive licence or to open branch in Latvia in order to offer their services in Latvia. Foreign companies now are allowed to insure assets of their subsidiaries in Latvia not only with local insurers, and this has reduced growth of real estate insurance volumes in Latvian market. 109 notifications by insurance supervision bodies of European Economic Area countries on the intention of licensed insurers of these countries to use principle of service provision freedom in Latvia were received by the end of 2004.

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 necessary for functioning of this base have been set up. Yet, the stock market in Latvia is poorly developed, therefore its influence on the economic development of the country is modest.

At the end of 2004, market capitalisation of Latvian companies at Riga Stock Exchange (RSE) was 849 million LVL or 11.5% of GDP (608 million LVL or 9.6% of GDP at the end of 2003). 39 companies were listed on the stock exchange at the end of 2004.

Activity of RSE is gradually increasing. RSE index RIGSE reached 414 points (January 1, 2000 = 100) 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 is incorporated in the Baltic branch of the HEX Group.

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 practical integration of Latvian capital market into united markets of the Nordic countries.

As of July 1, 2001, supervision over the financial sector is being performed by the **Financial and Capital Market Commission** (FCMC). The commission took over functions which 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 to support development and stability of financial and capital market.

¹ ROA – ratio of profit/losses to assets.

² ROE – ratio of profit/losses to capital and reserves.

Normative acts regulating activity of Latvian banks essentially comply with requirements of 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 gradually increased (at the moment it equals to 6000 LVL). The law stipulates that the compensation will reach 13 000 LVL by January 1, 2008. As of January 1, 2003 the compensation is guaranteed also to legal persons in the same amount as to physical persons.

4.4.3. Deposits and Loans

Stability of the banking sector, growing welfare of population and increasing economic activity predetermine stable growth of the basic monetary indicators of the banking system of Latvia. Growth of monetary indicators, which had been observed over the previous years, was retained also in the first half of 2005 (see Table 4.11 and Figures 4.24 and 4.25).

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

Table 4.11

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

	2000	2001	2002	2003	2004
(million LVL)					
Net foreign assets	536.9	517.9	352.1	75.4	-231.0
Net domestic assets	739.0	1023.6	1512.8	2183.4	3098.9
Domestic loans	1057.3	1433.8	2004.3	2822.0	3910.4
to government (net)	153.1	79.1	154.7	250.2	173.4
to companies and individuals	904.2	1354.7	1849.6	2571.8	3774.7
Other assets (net)	-318.3	-410.2	-491.4	-638.6	-849.3
Broad money M2X	1275.9	1541.4	1864.9	2258.7	2867.9
Currency in circulation (less vault cash balance)	427.7	485.2	543.1	601.1	645.4
Deposits of individuals and companies	848.2	1056.2	1321.8	1657.7	2222.5
of which:					
demand deposits	508.0	622.1	776.8	941.7	1295.6
time deposits	340.2	434.1	545.1	716.0	926.8
(changes over the preceding period, %)					
Domestic loans	43.6	35.6	39.8	40.8	38.6
of which:					
to companies and individuals	37.8	49.8	36.5	39.0	46.8
Broad money M2X	27.9	20.8	21.0	21.1	27.0
Currency in circulation (less vault cash balance)	13.3	13.4	11.9	10.7	7.4
Deposits of individuals and companies	36.9	24.5	25.1	25.4	34.1
GDP (in current prices)	10.9	10.3	10.1	11.1	16.4

The share of **deposits** of companies and individuals in GDP amounted to 30% in 2004 (26% in 2003 and 18% in 2000). 62% of all deposits drawn by residents were deposits in LVL, whereas the rest was deposited in foreign currencies.

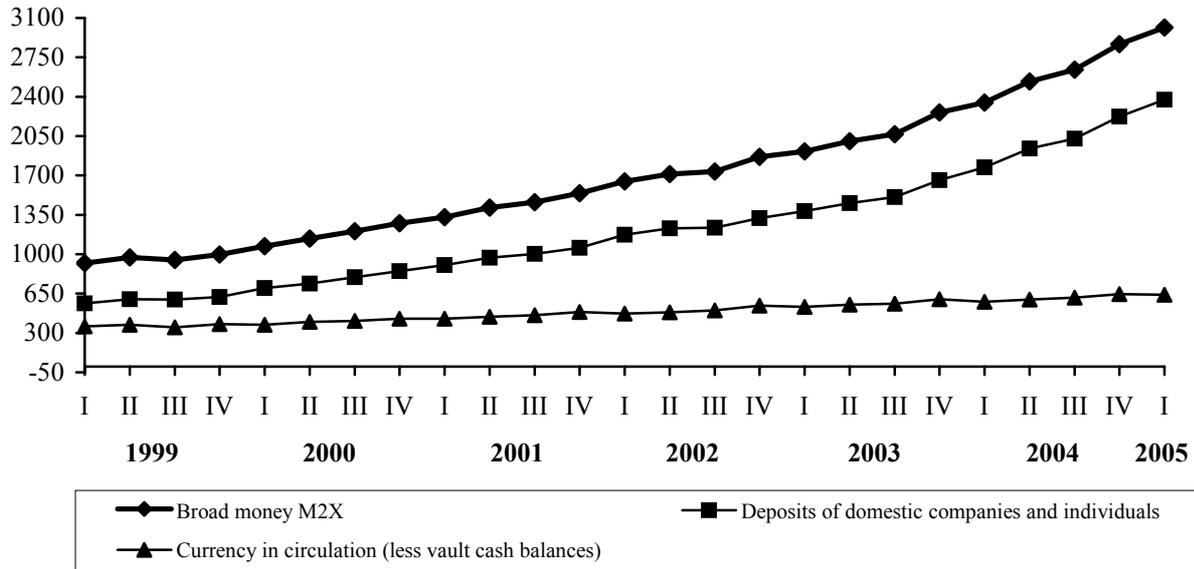
Dominant role in deposits is played by demand deposits; their share in the total deposit structure was 72% at the end of 2004.

Deposits of non-residents make slightly more than a half of the total volume of deposits. The relatively high share of short-term deposits and non-resident deposits is a certain factor of risk. 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 hardly possible. 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 4.24

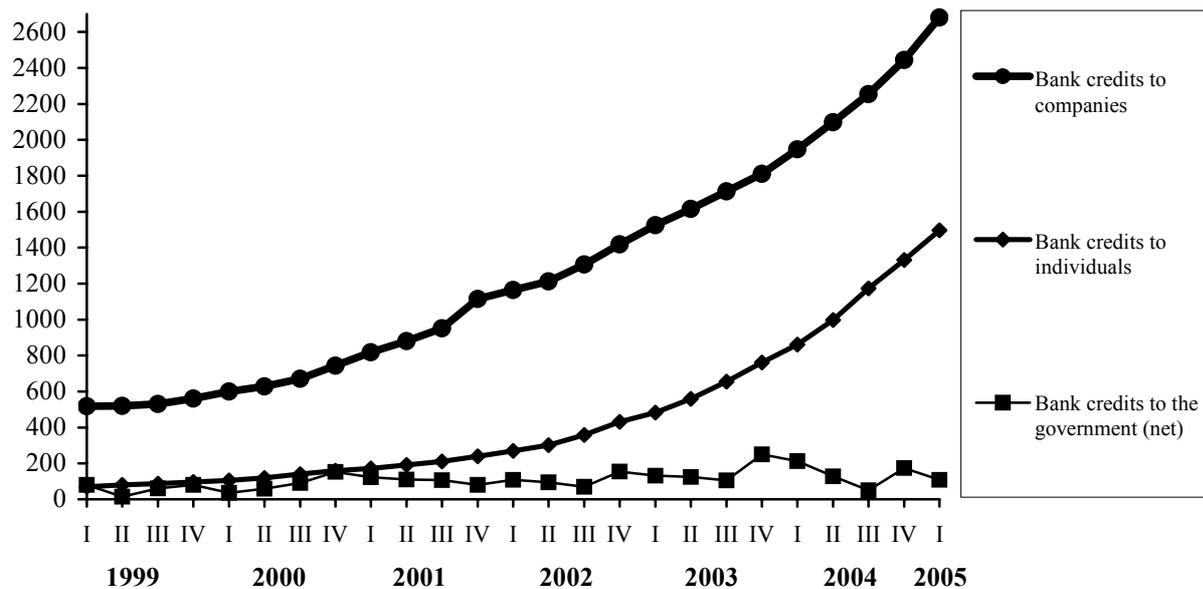
Quarterly Dynamics of Broad Money (M2X) and Its Components
(end of period, million LVL)



The share of **loans** to companies and individuals in GDP equalled to 51% in 2004 (40% in 2003 and 19% in 2000)¹. Both the enlivened economic activity and the reduction of credit risks have encouraged growth of crediting.

Figure 4.25

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



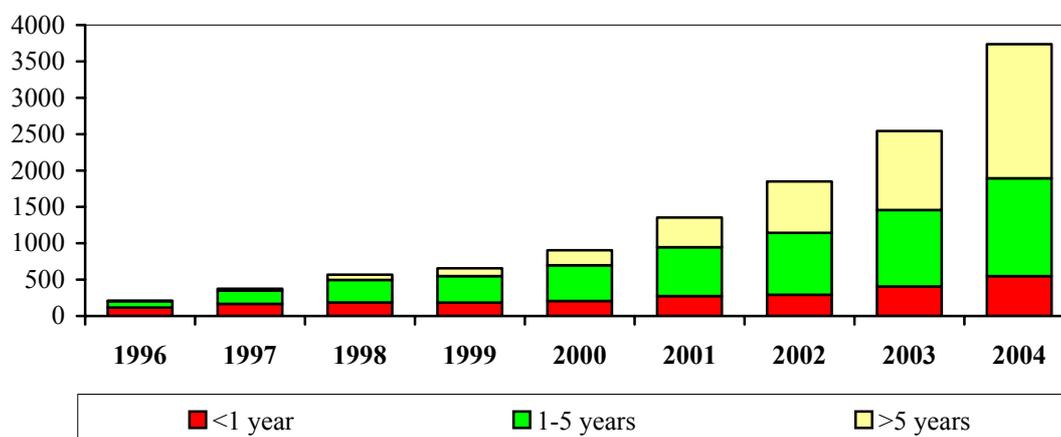
¹ To compare: in eurozone the proportion of loans against GDP was 98% at the end of 2003.

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 4.26). Share of long-term loans in the total credit portfolio was 47% at the end of 2004 (42% at the end of 2003).

Figure 4.26

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 deteriorating. At the end of 2004 the quality of loans issued by banks was as follows: 98% of all issued loans were evaluated by banks as standard, 0.9% as “close watch” and only 1.1% as loans generating no income (substandard, doubtful, or lost)¹. In compliance with requirements of the Bank of Latvia, loans generating no income are secured by special savings, therefore this category of loans does not present a serious threat to stability of banks. Total amount of special savings has dropped from 2.9% of the total issued loans at the end of 2000 to 1.1% at the end of 2004.

By the end of 2004 the biggest amounts of loans had been granted to the following sectors of the national economy: trade (18.5% of total domestic loans), real estate operations (16.8%), financial mediation (16.4%), and manufacturing (15.5%). Real estate operations and construction were the sectors where the volumes of issued loans in 2004 increased most rapidly (by 84.7% and 56.6% respectively).

By the end of 2004, 87% of total issued loans had been granted to resident borrowers, including 51% to companies and 34% to individuals. 39% of total loans granted to resident borrowers were loans in LVL.

Banks are mainly providing loans for increase of working capital. At the end of 2004, commercial loans amounted to 28% of total issued loans (for increase of working capital). Share of industrial loans intended for buying fixed assets and financing long-term investment projects equalled to 20% of the total credit portfolio of commercial banks. Mortgage crediting increases rapidly and the volume of issued mortgage loans rose by 77.6% in 2004. The share of mortgage loans in credit portfolios of banks has grown from 17% at the end of 2001 to 22% at the end of 2002 and 28% at the end of December 2003, reaching 33% at the end of 2004.

Reacting to the increasing domestic demand, the Bank of Latvia raised the refinancing rate by 0.5 percentage points in March and November of 2004 and increased the norm of reserves from 3% to 4% in July 2004, in order to slow down the rapidly growing lending.

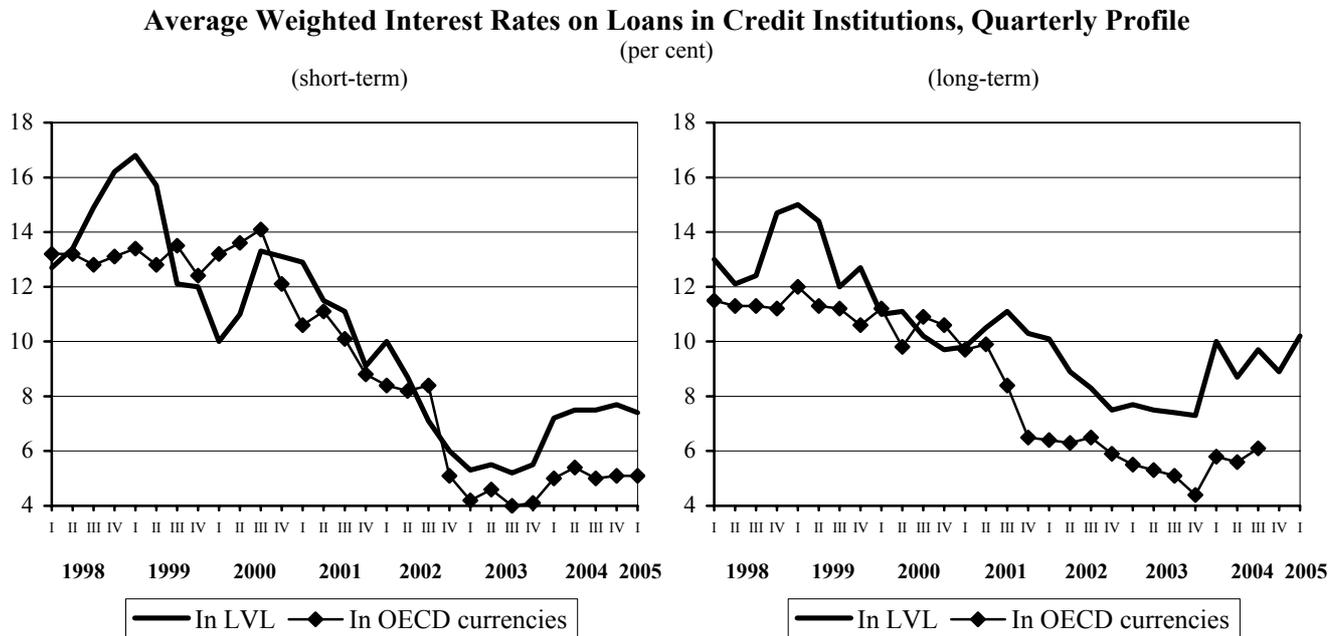
However, the effectiveness of these measures in Latvia has been limited by the fixed currency exchange rate regime and several specific factors, such as the low share of loans granted to resident borrowers in GDP, relatively easy access by banks to foreign resources, and a relatively high share of loans issued in foreign currencies in the total structure of loans.

¹ To compare: at the end of 2003, 1.4% of issued loans were evaluated as generating no income in comparison with 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, 10% at the end of 1997.

To unify conditions of mutual competition between banks and to slow down the rapidly increasing borrowing by Latvian banks in foreign banks, the Bank of Latvia has decided, as from January 24, 2005, to include 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 services.

The dynamics of loan interest rates is displayed in Figure 4.27.

Figure 4.27



Average weighted annual interest rate for short-term loans in LVL to companies and individuals was 7.4% in the 1st quarter of 2005, the rate for long-term loans in LVL was 10.2%, while the respective rates for loans in OECD currencies were 5.1% and 5%¹.

Meanwhile, average weighted annual interest rate for short-term deposits in LVL was 3.2% in the 1st quarter of 2005, whereas the rate for long-term deposits in LVL reached 4.4%. The respective rates for deposits in OECD currencies were 2.2% and 3.3%.

Decline in loan interest rates in the next years will depend on the pace of domestic savings formation and on competition in the banking sector.

¹ Short-term with floating interest rate.

5. Labour Market

5.1. Employment and Unemployment

Economic development in recent years has made a positive impact on the situation in labour market. Although the population of working age (15-64 years) continues diminishing, the number of economically active persons is increasing and the rate of employment is growing. In 2003 the proportion of economically active persons in this age group was 69.2% but in 2004 it increased by 0.5 percentage points.

Table 5.1

Main Indicators of Employment and Unemployment¹

Indicators	2000	2001	2002	2003	2004
Population aged 15-64 years (thousand)	1597.3	1592.8	1590.4	1588.4	1586.1
Economically active persons aged 15-64 years (thousand)	1074.7	1082.0	1094.8	1099.6	1105.5
Employed persons (thousand)	917.6	937.5	962.5	981.5	988.2
Participation rate (%)	67.2	67.7	68.8	69.2	69.7
Employment rate (%)	57.5	58.6	60.4	61.8	62.3
Unemployed persons (thousand)	158.3	144.6	134.5	119.2	118.6
Unemployment rate (%)	13.7	12.9	12.6	10.4	9.8
Registered unemployed persons (end of year, thousand)	93.3	91.6	89.7	90.6	90.8
Registered unemployment rate (end of year, %) ²	7.8	7.7	8.5	8.6	8.5

¹ In table and further text indicators of employment for population aged 15-64 and unemployment for population aged 15-74.

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

In the last five years (2000-2004) the **employment rate** has increased by 3.5 percentage points. In 2000 the employment rate in Latvia was 5 percentage points lower than the EU-25 average but in 2003 the lag behind was only 1.2 percentage points and in 2004 – only 1 percentage point.

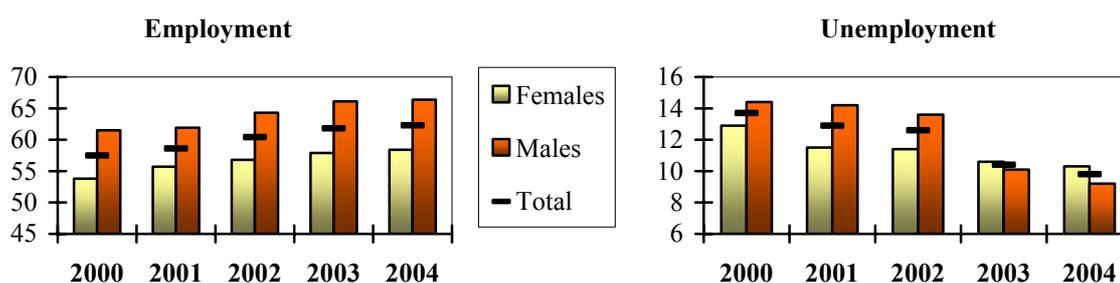
The Lisbon Strategy has set a goal to achieve general employment rate of 70% by 2010. This goal is already achieved by Denmark, Sweden, Netherlands and the United Kingdom. Cyprus, Austria, Finland and Portugal have reached an intermediate goal – employment rate of 67% by 2005.

Female employment in Latvia is still higher than in the EU-25 on average, and this difference tends to grow, as in 2002 the female employment rate in Latvia exceeded the EU-25 rate by 2.1 percentage points but the difference reached 2.8 percentage points in 2003 and 2.7 percentage points in 2004. This can be explained by 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-25 rate (by 6.8 percentage points in 2002, 4.8 percentage points in 2003 and 4.5 percentage points in 2004).

Figure 5.1

Employment and Unemployment in Latvia (percentage, 2000-2004)



Source: Eurostat, New Cronos, 01.06.2005.

Male employment exceeded female employment by 8.2 percentage points in 2003 and 8 percentage points in 2004.

Male employment increased by 1.8 percentage points in 2003 and 0.3 percentage points in 2004, while female employment went up by 1.1 percentage points in 2003 and 0.5 percentage points in 2004.

Employment rates in Latvian regions still are very different. In 2004 the employment rate in Riga increased by 1.3 percentage points and reached 67.3%, in Kurzeme region it increased by 1.2 percentage points to 62%, while in Latgale region the employment rose by 1.5 percentage points and reached 53.6%. Employment decreased by 0.4 percentage points to 60.2% in Vidzeme region and by 2.6 percentage points to 59.6% in Zemgale region.

70% of all employed persons in 2004 were employed in cities and towns, while 30% were employed in the countryside.

The number of employed persons has markedly increased since 2000 (by 7.7%). 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.

Number of employed persons both in 2003 and 2004 grew at a slower pace than in the previous years; the number increased by 2% in 2003 but by merely 0.7% in 2004. The highest growth in the number of employees in 2004 was observed in the electricity, gas and water supply (by 18.4%), construction sector (by 16.9%) and financial mediation (by 14.7%) (see Table 5.2).

Table 5.2

Number of Employed Persons by Kind of Activity
(Labour Force Surveys by CSB, thousand persons, aged 15-64)

	1996	2000	2001	2002	2003	2004
<i>Total</i>	925.6	917.6	937.5	962.5	981.5	988.2
Agriculture	128.4	104.4	107.4	103.4	96.7	88.5
Forestry	20.1	19.4	22.9	34.6	30.6	34.9
Manufacturing	180.9	168.3	164.2	164.0	171.2	161.1
Electricity, gas and water supply	20.9	20.3	19.3	22.0	20.7	24.5
Construction	50.4	55.1	66.6	59.6	73.5	85.9
Wholesale and retail trade; repair of motor vehicles, motorcycles, personal and household goods	116.3	144.7	150.2	146.3	150.4	148.7
Hotels and restaurants	15.6	22.0	22.1	24.2	24.4	25.4
Transport, warehousing and communications	83.3	78.3	77.3	84.8	93.2	93.5
Financial mediation	14.3	12.3	13.7	12.7	15.6	17.9
Commercial services	30.6	43.6	39.5	37.1	40.5	38.4
Public administration and defence; compulsory social security	59.5	69.9	66.9	66.7	66.5	71.6
Education	91.9	83.6	85.8	84.5	75.7	79.2
Health and social care	57.0	46.5	47.9	58.5	57.0	52.8
Other services	48.1	43.3	48.1	51.2	55.2	57.9

In 2004 Latvia was the 16th among EU member states by the employment rate but the **unemployment** rate indicators in Latvia were among the worst in the EU. Only Lithuania, Spain, 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 10.6% in 2003 and 10.4% in 2004 (according to data of Labour Force Survey by CSB).

The highest unemployment remains in Latgale region. At the end of 2004 the unemployment rate exceeded 25% level in three districts of Latgale region: Ludza (27.2%), Rēzekne (26.2%) and Balvi (25.9%) districts. The high unemployment is determined by poorly developed business, poor self-employment and insufficient traffic infrastructure.

The lowest unemployment levels are in Riga city and Ogre, Riga, Tukums and Saldus districts (4.5%, 5.5%, 5.7%, 6.2%, and 6.5% respectively).

Share of the unemployed which have not been able to find a job during one year in the total number of unemployed people is gradually decreasing; this share equalled to 39% in 2004 and 41% in 2003.

The majority of all unemployed are representatives of simple low-skilled professions, while the highest employment rate is among the people with higher education (83.6% of people with higher education were employed in 2004).

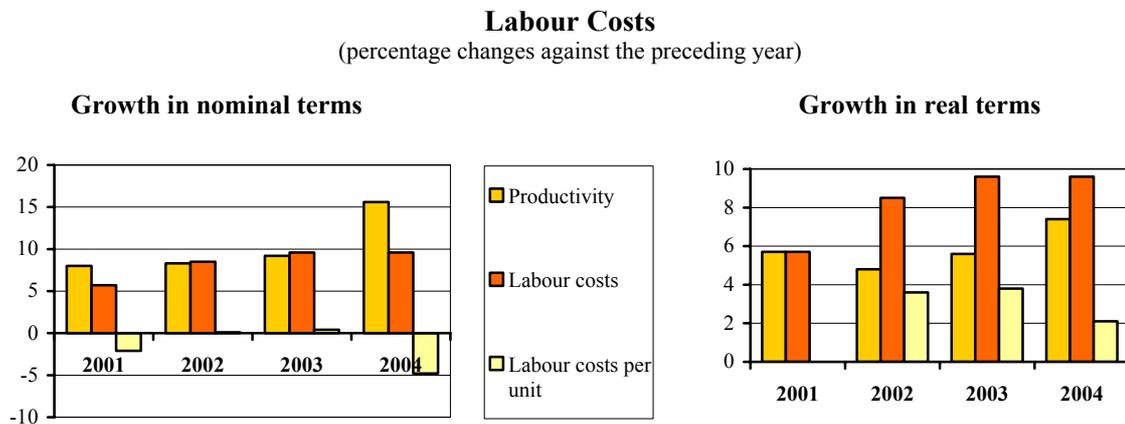
More than a half of the unemployed at the end of 2003 was aged 30-49 years. The share of pre-pension age unemployed in the total number of unemployed persons increases every year and this is mostly related to increase of pension age according to the law on pensions.

Registered unemployment rate in Latvia was 8.6% at the end of 2003 and 8.5% at the end of 2004.

5.2. Labour Costs

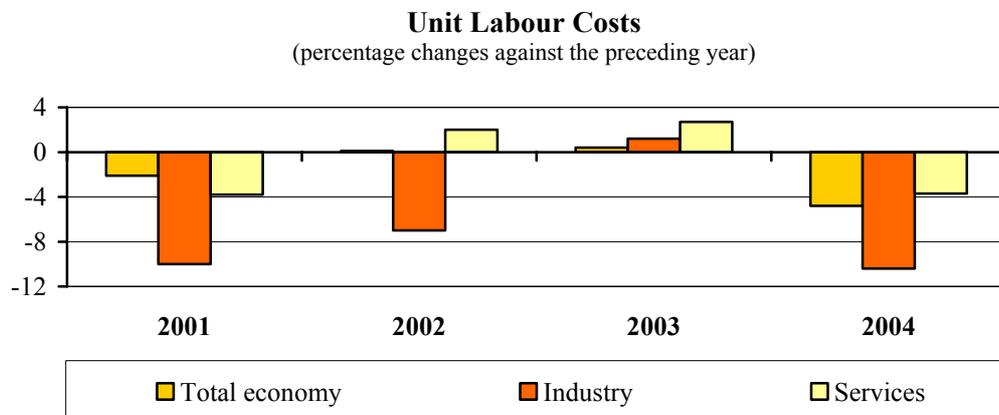
In 2002 and 2003, as wages grew slightly faster than productivity (in nominal terms) in the national economy, labour costs per production unit increased, but in 2004 productivity went up at a more rapid pace. Increase of wages for growth in real terms considerably exceeded growth of productivity.

Figure 5.2



This process is not equally fast in all sectors of national economy. Labour costs increase much more rapidly in service sectors or so-called non-trading sectors which are not related to external competition. Unit labour costs in manufacturing decreased instead of growing.

Figure 5.3



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

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

The second process is related to rise of general level of prices. Equalisation of prices mostly pertains to increase in prices for services, which in turn is closely connected with the third process, namely, rise of wages in sectors of services.

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 equalisation (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 in 2004 labour costs per production unit decreased also in service sectors.

It is clear that equalisation of wages is an objective process to be taken into consideration in the future. The main question is how fast this will happen. It is affected by several factors, and productivity increase in export sectors has the determinant role in long term.

5.3. Employment Policy

The key goal of the employment policy in Latvia is to increase the level of employment, in order to reach in future the strategic indicators set by the EU, and to address issues of unemployment on the basis of successful economic growth (see Box 5.1).

Taking into account the specific situation of Latvia in labour market in relation to employment policy priorities of Latvia, the following tasks have been outlined in employment plans and other documents in the recent years:

- to develop active and preventive employment policies, with an emphasis on assistance in finding jobs, encouraging geographical mobility and accessibility of training; reducing high unemployment rates, especially among young people and long-term unemployed; modernisation of the State Employment Agency and its services;
- to reduce regional differences and socio-economic differences between urban and rural areas, including in the fields of employment and unemployment;
- to encourage faster development of business activities and creation of new jobs, especially in the sector of services and in economically weaker regions;
- to expand opportunities of joining the labour market for young people, low-skilled and low-educated persons or persons with learning or other problems;
- to eliminate the present disparity between education and skills and requirements of the labour market, to promote the accessibility of education, professional training and life-long education, to reduce the number of students leaving educational establishments without finishing their courses;
- to transform the undeclared work into officially registered employment, to carry out measures aimed at decreasing the level of undeclared employment.

The European Commission, assessing results of implementation of the Employment Plan 2004, noted that, despite the positive development of labour market on the whole, Latvia has to pay bigger attention to stimulation of faster inclusion of the unemployed and economically inactive people into employment, improving tax – benefit systems and more widely implementing active labour market policies. The low labour productivity level is a reason for concern. Insufficient formation of inclusive labour market for young people and job seekers with low professional skills was assessed especially critically.

The big number of young people leaving educational establishments without finishing their courses, and the insufficiently active employment measures for inclusion of representatives of risk groups into process of general education and vocational training were noted. The Commission pointed at the necessity to solve issues of reducing the regional differences more actively.

At the same time it was acknowledged that the employment policy in the country pays a considerable attention to improvement of business environment, support to creation of new companies, prevention of undeclared employment, improvement of vocational education, and inclusion of people from risk groups into active employment measures.

Box 5.1

EU employment policy

Article 128 of the EC Treaty prescribes drawing up guidelines for implementation of employment strategy, annual development of employment plans and their submission to the European Council and the European Commission, outlining in them the principal measures of employment policy, examination of these plans in the European Commission, summing up results of these plans' implementation and submitting them to the European Council in a form of a joint employment report about all EU member states. On the basis of this report, the European Council approves recommendations to every member state for improvement of employment policy.

During the Lisbon Summit in March 2000 a new phase in the EU employment strategy was defined and the programme "From fighting unemployment to mobilising economically inactive human resources" for the period until 2015 was adopted, three key targets for longer time period (achieving full employment, improving quality and productivity at work, ensuring social cohesion and inclusion) were set up, and several quantitative targets were set up for the period until 2010, which were supplemented with targets until 2005 at the EU summit in Stockholm.

In the sphere of full employment, the following targets were outlined: to reach by 2010 an overall employment rate of 70% in the EU (including 60% for women and 50% for pre-pension age population aged 55-64 years), reduction of regional disparities, elimination of undeclared work, and promotion of economic activity, preventing obstacles to employment.

To ensure higher quality and productivity at work, it is necessary to achieve harmonisation of mutual interests of employers and employees by creation of new jobs, modernisation of work organisation, raising qualification of workers, and improvement of working conditions. In parallel to this, formation of knowledge-based economy has to be advanced (promotion of innovation, gradual restructuring of industry and sectors to sectors where goods with high added value are produced).

To achieve social cohesion, the most important factors are reduction of unemployment, creation of new jobs, and inclusion of representatives of risk groups into employment measures.

On July 22, 2003 the European Council approved 10 specific guidelines for attainment of these targets. A guideline was outlined for improvement of employment strategy implementation management, strengthening the link with social partners, non-governmental organisations and elected institutions.

Yet analysis of the situation indicated that the European development rate considerably lags behind the one set in Lisbon.

To improve situation in the sphere of economy, employment and productivity at work, the European Commission on proposal by the European Council established the High Level Working Group chaired by Wim Kok. In November 2003 the group prepared the Report „Jobs, jobs, jobs" with proposals for reaching Lisbon targets in **employment and labour productivity sphere**. The report identifies 4 main requirements: 1. Improve the adaptability of workers and enterprises; 2. Attract more people to the labour market; 3. Invest more and more effectively in human capital; 4. Ensure an effective implementation of labour market reforms through better governance and wider involvement of social partners, non-governmental organisations, local governments and parliament.

In November 2004 the group prepared Report on achievement of Lisbon targets in a wider context. The proposals mentioned in the previous report remained valid but the new document closely associates employment with economic growth. In the employment sphere a special attention was paid, first of all, to creation of favourable climate for promotion of business activity (improvement of legislation, accessibility to venture capital, training of business launchers, etc.); secondly, to formation of inclusive labour market which could ensure employment to all groups of population, including risk groups; thirdly, to ensure development of knowledge-based economy and to increase investment in formation of highly skilled labour force (improving quality of life-long and vocational education, etc.).

To ensure successful reorientation process of the Lisbon Strategy, in spring of 2005 the European Council adopted decision to start new strategy management cycle, reducing the number of targets and focussing them on the key indicators of economic development and employment policy. Instead of the Economic Policy and the Employment Guidelines existing separately up to now, a joint action plan will be developed in accordance with the package of integrated guidelines, reflecting in it the basic problems of economic growth and employment. In the employment sphere, 8 guidelines in 3 blocks are envisaged; the first block outlines measures for inclusion of bigger number of people into employment, at the same time modernising social security systems; the second block outlines measures for improved harmonisation of mutual interests of employees and employers and for increase of labour market flexibility; the third block outlines measures for increase of investment into human capital, improving mastering of general and vocational education.

To implement successfully the requirements of the Lisbon Strategy, Latvia like any other EU member state has to contribute to achieving three goals of the comprehensive general employment guidelines – full employment, quality of working conditions and productivity, social cohesion and prevention of social exclusion.

In the sphere of increasing the employment rate, the Latvian National Action Plan for Employment sets a target to reach average employment of 67% by 2010 (62% for women and 48% for people aged 55-64 years). This means that reaching Lisbon targets is only envisaged in female employment where Latvia already exceeds the EU average.

To achieve *full employment*, public institutions have to promote labour market processes more actively. They have to carry out measures for development of knowledge-based sectors of the national economy, continue structural reforms of labour market more successfully, improve the system of taxes and social benefits, and to promote further development of the welfare of Latvian population.

It is important to ensure growth of employment in all groups of population, especially groups where employment rate is much lower than the country average.

With regard to the population ageing issues, public institutions in co-operation with social partners and non-governmental organisations have to take measures supporting growth of employment rates among young people and old people as well as making it easier to become re-employed for persons after long-term unemployment and for economically inactive persons. Employment rate for persons aged 55-64 years is increasing in the recent years and reached 48% in 2004 but it still lags behind the Lisbon target (50%). Situation is worse among young people (aged 15-24 years) where employment rate is only 30.5% and has even decreased by 1 percentage point in comparison with 2003.

To ensure development of knowledge-based economy, greater attention should be paid to improvement of general and vocational education quality, achieving closer link with preparation of required specialists for labour market. At the same time, educational establishments lack financial means. Share of general government consolidated budget expenditures for educational needs even decreases in the last years (it was 6.5% in 2002 and 6% in 2004).

Raising the *labour quality* envisages to ensure life-long learning and promote career, modernise work organisation, balance opportunities of 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 the EU member states in many aspects. In 2004, less than one-tenth of employees aged 25 to 64 years has participated in vocational training activities or attended some educational establishment. Number of people injured in accidents at work is still very high (154 cases per 100 000 employed in 2004), which has slightly decreased (by 4.3%) in comparison with 2003 but still is among the highest in the EU member countries. Number of people suffering from occupational diseases tends to grow. Total number of first-time occupational patients has increased 1.8 times during this period. 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.

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 the last two years this difference has somewhat decreased (from 8.2 to 8 percentage points). Despite a marked difference between female and male wages to women's disadvantage, positive changes have to be noted because this difference has decreased from 16.1% in 2003 to 14.3% in 2004.

Low level of *productivity* exists in Latvian economy on the whole, especially in agriculture and manufacturing industry. It is being compensated by longer working week. The average working week in 2004 was 41.6 hours (42 hours in 2003), including 42.5 hours for men, and is among the longest in the EU member states. The share of employees working overtime in the total number of employees has also increased.

The main advantage for the current competitiveness of Latvian industry is the low labour costs, which determine the predominance of labour-consuming sectors in industry and the resulting low level of productivity. The task of Latvian economic policy is to foster transition from labour-consuming economy to knowledge-consuming economy, which can be achieved by growing investment into human capital. Developing competitiveness in the main export-oriented sectors of Latvia, i.e., raising their productivity, will increase opportunities to raise incomes in other sectors of services as well, including the majority of service sectors where people with relatively low skills and education are employed.

The governmental policy aimed at strengthening the *social cohesion* and reduction of *social exclusion* is described in the Joint Inclusion Memorandum which defines the key political objectives, priorities, medium-term and long-term tasks in this area.

To ensure social cohesion, Latvia has developed the National Action Plan on reducing poverty and social exclusion, which is harmonised with activities of the National Action Plan for Employment.

To implement Latvian employment policy in close compliance with targets outlined in Lisbon, the National Action Plan for Employment is worked out every year. Development of the plan is co-ordinated by a management group appointed by the Cabinet of Ministers, which includes

representatives of ministries and other bodies related to solution of labour market issues and representatives of social partners – Latvian Employers' Confederation and Free Trade Union Confederation of Latvia.

More than 20 million LVL from the budget are earmarked every year for employment promotion measures. After Latvia's accession to the EU, the European Social Fund (ESF) and the European Regional Development Fund are developing into the main source of financial means for this purpose. ESF is the key financial instrument of the EU for development of human resources and improvement of labour market functioning.

Attraction of ESF resources in the amount of approximately 119 million LVL is envisaged for funding the priority "Development of human resources and promotion of employment" in the period of 2004-2006. Activities to be implemented in its framework are harmonised with EU employment policy guidelines and the joint declaration of Latvian government and the European Commission on Latvian employment policy priorities for promotion of employment, development of education and further education, and reduction of social exclusion.

Resources of the European Regional Development Fund in the amount of approximately 26 million LVL are envisaged for attraction to education, development of health care and social infrastructure.

6. Economic Policy and Priorities of Structural Policy

6.1. Targets and Priorities of the State Economic Policy

To ensure development of Latvian economy, a single base and proper and purposeful use of instruments available to government are necessary. It is particularly important now as Latvia has become a full-fledged member of the European Union and gained favourable preconditions for sustainable and fast growth.

The Single Strategy of National Economy (hereinafter in the text – strategy), which was approved by the Cabinet of Ministers on August 17, 2004, has started to fulfil the role of such single base. The strategy defines state policy to be pursued in order to achieve stable, balanced and sustainable growth, by linking long-term targets and priorities (for 10-30 years) with medium-term (5-10 years) and short-term (1-3 years) targets and measures in a single system.

To develop the document, it was necessary to improve the current short-term, medium-term and long-term strategies, and what was the most essential task – to integrate these strategies in a single document. State policy and targets are identified, basing on the assessment of existing economic situation and forecasts, and they outline in detail the country's economy model provided under the *Long-term Economic Strategy of Latvia*.

The main goal of Latvia's long-term development is to reach the EU average GDP per capita level over the next 20-30 years, whereas in the medium-term perspective it is vital to ensure essential growth of the GDP level from the present 42% to 62% in 2010. To meet this target, annual GDP growth of 8% should be ensured in the medium-term (see Table 6.1).

Raising the employment rate to the level of 70% (65% in the medium-term) and reducing the unemployment rate to the natural level (7% in the medium-term) has been set out as the key goal for ensuring social development.

Table 6.1

Main Targets of the Single Strategy of National Economy

Indicators	Current level				Target		
	Latvia		EU-15 average		Short-term (2004)	Medium-term (till 2010)	Long-term (till 2030)
	Indicator	Year	Indicator	Year			
GDP per capita (% of the EU-15 level according to purchasing power standards, PPS)	41.5	2003	100	2003	45	62	100
Annual GDP growth rate (%)	7.3	2001-2003 annual average	1.1	2001-2003 annual average	8.0	8.0 (period's average)	5.0 (period's average)
Employment rate (%)	61.8	2002	64.3	2001	62	65	70
Share of job seekers (unemployment rate) (%)	10.7	2003	8.0	2002	10	7	4

During the process of Latvia's convergence to the EU average development level, not only the production output level (GDP per capita) is important but also the real convergence in all spheres characterising the quality of life, including social development, environmental protection, innovation and research, infrastructure, market integration, etc.

The strategy defines more than 60 performance indicators, which are to be reached by sectors in a fixed period of time. The strategy outlines the current level of these indicators in Latvia and the EU average, as well as targets to be met in a short-term (in 2004), medium-term (till 2010) and long-term (till 2030) perspective. Such approach serves as a disciplinary factor for the economy of Latvia and puts reference system in order. If the figures characterising development of economy in short-term are achieved it means that the axes co-ordinating the development of the country are precise. Meanwhile, if

the figures outlined in the strategy are not achieved in a certain time period, it is necessary to analyse the situation and find out and eliminate factors hindering development. The *Single Strategy of National Economy* fulfils the role of both a development scenario and monitoring at the same time.

Development of the system of quantitative target-characterising indicators is not just a base providing control over the implementation of the economic policy, its adjustment and identification of short-term objectives, but it will also ensure gradual integration in the EU economic policy co-ordination process. Most of the indicators included in the system conform to structural indicators of the EU economic policy co-ordination process and goals of the Lisbon strategy.

The underlying principle of the economic policy defined by the strategy is that the state would not interfere whenever the market forces are sufficiently effective and flexible, competition is active and healthy, and majority of enterprises are able to sustain foreign competition as well (provided that this competition is honest and the methods of competition are fair). The main objective of the state is to create orderly, stable and favourable environment for the market development. A targeted state support will be granted to sectors capable of creating higher added value and where Latvia has comparative advantages.

Table 6.2

The Single Strategy's of National Economy Targets of Macroeconomic Stability

Indicators	Current level				Target		
	Latvia		EU-15 average		Short-term (2004)	Medium-term (till 2010)	Long-term (till 2030)
	Indicator	Year	Indicator	Year			
Fiscal balance of the general government consolidated budget (% of GDP)	-2.3	2002	-1.9	2002	-2.0	corresponds to Maastricht criteria	
Balance of current account (% of GDP)	-6.7	2002	0.5	2002	-8.0	-5.0	0
Inflation (changes of harmonised CPI in comparison with previous year, %)	2.0	2002	2.1	2002	5.5	corresponds to Maastricht criteria	
State debt – consolidated central government debt (% of GDP)	13.3	2002	62.5	2002	15.5	corresponds to Maastricht criteria	

To meet the set targets, the *Single Strategy of National Economy* defines as basic directions of the economic policy:

- ensuring macroeconomic stability;
- developing conditions favourable for entrepreneurial activity and functioning of economy;
- stimulating development of efficient and competitive structure of sectors;
- lessening socio-economic differences and ensuring sustainable development.

Stable macroeconomic environment is an indispensable precondition for ensuring balanced growth in the long-term. After accession to the European Union Latvia is consistently ensuring that it meets the Maastricht criteria (see Table 6.2).

As of January 1, 2005 Latvia plans to replace the current peg of lat (LVL) to the SDR currency basket with peg of the LVL to the euro. Meanwhile, at the start of 2005 Latvia envisages to enter the European currency exchange rate mechanism (ERM II) and join the European Economic and Monetary Union after all required Maastricht criteria are met.

Regarding development of favourable environment for functioning of economy, the main tasks include ensuring an attractive institutional environment for business activities, as well as a functioning base infrastructure and healthy competition environment. The target is to achieve significant growth in the number of enterprises, boosting the current number of 18 enterprises per 1000 inhabitants to 30 in 2010 and 50 in 2030 (see Table 6.3).

Table 6.3

The Single Strategy's of National Economy Targets of Establishing Favourable Conditions for Economy Functioning and Indicators to Measure Progress Towards Meeting These Targets*

Indicators	Current level				Target		
	Latvia		EU-15 average		Short-term (2004)	Medium-term (till 2010)	Long-term (till 2030)
	Indicator	Year	Indicator	Year			
Number of enterprises per 1000 inhabitants	18	2002	40-60	2002	19	30	50
FDI inflow over the year (% of GDP)	2.8	2002	8	2001 (Germany)	5	5	4.5
Investment – expenditure for gross capital formation (% of GDP)	26.4	2002	19.4	2002	27	25	20
Public investment (% of GDP)	4.1	2002	2.3	2002	4.5	5	2.5

* extract. This category defines 27 targets or indicators to measure progress towards meeting these targets.

Measures aimed at improvement of institutional environment for business activity, provided under the *Single Strategy of National Economy*, embrace a whole line of various spheres, creating the aggregate of measures setting out the way an enterprise comes into business, what are its opportunities to expand production and carry out restructuring and modernisation, as well as how normally and naturally a liquidation of an enterprise proceeds.

The objective is to ensure clear, apprehensible and predictable tax policy. A reform of the corporate income tax has been completed, whereby the corporate income tax rate was gradually reduced from 25% in 2001 to 15% in 2004. The state tax policy will be aimed at reducing the tax burden on businesses in the future as well, which is designed to enhance economic development and ensure competitiveness of economy.

The aim of the strategy is to ensure a well-functioning base infrastructure, devoting a particular attention to development of the energy sector, establishment of electronic communications and information systems, improvement of transport infrastructure quality and development of efficient network, raising quality of waste and water management facilities, and improvement of heat supply system, in order to stimulate balanced development of the country across all regions and to ensure that users have access to advanced and cost-competitive infrastructure services. Access to the EU Structural Funds and Cohesion Fund provides better chances for infrastructure improvement than previously.

The aim of Latvia's competition policy is to ensure free, equal and honest competition in all sectors of the national economy. Opening of monopoly markets to competition will impose an obligation on dominant providers of services to ensure that services are accessible for new market players, thereby creating efficient competition. The government will continue fighting corruption and opportunities to operate in the shadow economy.

The present dominant model of the economy of Latvia, which is characterised by using advantages of cheap labour and available natural resources and manufacturing products with low added value, will not be able to ensure high development rates of economy and promote achievement of higher level of prosperity in the future. The strategy foresees to change this model, implementing reorientation from labour-intensive to knowledge-based economy and intense use of knowledge and high technologies. The target set out under the strategy is to expand the share of medium and high-tech sectors in the industry structure from the present 30% to 50% in 2010 and to match the EU structure in 2030 (see Table 6.4).

The main objectives of the formation of effective and competitive sectoral structure are: increase in productive capacity, development of human resources, and formation of economy that is open to innovation.

Table 6.4

The Single Strategy's of National Economy Targets for Promoting Formation of Effective and Competitive Sectoral Structure and Indicators to Measure Progress Towards Meeting These Targets*

Indicators	Current level				Target		
	Latvia		EU-15 average		Short-term (2004)	Medium-term (till 2010)	Long-term (till 2030)
	Indicator	Year	Indicator	Year			
Number of innovative enterprises in industry (against all enterprises, %)	23	1999-2001 (average)	51	1996	25	45	50
Exports of high-technology products (% of the total exports of industrial products)	6.6	2002	20	2001	6.8	9	20
GDP per employee (% of the EU average)	40.7	2002	100	2002	42	60	100
<i>Structure of industrial sectors (according to added value)</i>							
Low-technology sectors (%)	72.4	2002	30	2002	–	50	Close to the EU average structure
Medium-technology sectors (%)	24.2	2002	51	2002	–	40	
High-technology sectors (%)	3.4	2002	19	2002	–	10	

* extract. This category defines 18 targets or indicators to measure progress towards meeting these targets.

The target of raising the productive capacity will be attained by concentrating the state support to attraction of investment to the most prospective high-tech sectors as well as sectors where Latvia is enjoying relative advantages. This will be done by ensuring access to highly skilled specialists in line with labour market requirements, promoting exports, encouraging entry in new markets and consolidation in the existing ones, introducing quality assessment system and European standards, and furthering development of clusters of enterprises.

Among the traditional sectors, good development opportunities are anticipated for:

- sectors related to utilisation of forests;
- sectors involving intense use of labour, like textile industry, several apparatus and equipment assembling industries, ship building and repair;
- food industry sectors operating on basis of local raw material, which are mainly exporting their output;
- production of ecologically clean food, as well as development of non-traditional sectors of agriculture (including non-food);
- development of service sectors, which will proceed amid growing economic activity, improvement of infrastructure, more efficient support to small enterprises, as well as development of demand for new types of services;
- transit services, whose volumes will continue to grow in absolute terms (although the proportion of transit services will decrease);
- tourism; the preconditions for its development are favourable geographic position, economic activity, clean and diverse environment featuring beautiful landscapes, cultural resources and original cultural and historical heritage.

The economic development will be increasingly based on new high-tech industries amid successful development of science and growing investment in new technologies.

Latvia has good development prospects for those high-tech industries where certain groundwork has been done and potential of specialists exists, such as information technologies, new sectors of services (logistics, commercial and financial services), specific sectors of chemistry and pharmacy, sub-sectors of material technologies, etc.

The strategy foresees development of human resources both through improvement of quality of general education and raising the level of higher and vocational education. It is planned to draw the higher and vocational education closer to present and future requirements of the labour market by developing a broad system of life-long learning. To help knowledge-intensive sectors to strengthen their

positions, two thematic groups have been set as priority for the higher education, namely, engineering sciences and technologies, as well as natural sciences and mathematics.

The perspective of financing the employment measures is related to the European Social Fund which is the key financial instrument of the EU for development of human resources and improvement of labour market functioning.

Improvement of business environment, infrastructure, quality of labour and education, and state support efficiency will promote growth of production output volumes and changes of industry structure in favour of high-tech and knowledge-based industries. It will form a base for increasing employment and welfare standard of people.

The key tasks defined in the strategy for lessening the socio-economic disproportion and risks are:

- promoting balanced regional development and employment;
- lessening social disproportion;
- creating efficient environmental protection system.

Reduction of unemployment has been set as the primary goal towards lessening the socio-economic disproportion because unemployment is the main reason behind poverty and social exclusion. Particular attention will be devoted to creating incentives for development of less developed regions. To ensure sustainable development of Latvia, it is planned to develop and improve environmental protection system by raising environmental quality standards of Latvia to the EU level and by taking measures ensuring that Latvia meets its international commitments regarding environmental protection (see Table 6.5).

The *Single Strategy of National Economy* is incorporated in the economic policy planning system and improves the mutual tieback of strategic documents and working strategies of institutions.

Table 6.5

The Single Strategy's of National Economy Targets for Lessening the Socio-Economic Disproportion and Risks and Indicators to Measure Progress Towards Meeting These Targets*

Indicators	Current level				Target		
	Latvia		EU-15 average		Short-term (2004)	Medium-term (till 2010)	Long-term (till 2030)
	Indicator	Year	Indicator	Year			
Gini index	0.34	2002	0.25-0.36	2002	0.34	0.32	0.29
Unequal distribution of incomes (ratio between incomes in the lowest and highest quintile)	5.5	2000	4.6	2000	5.3	5	4.6
Emission of greenhouse gases – changes as of 1990 (according to CO ₂ equivalent) in percentage – 1990=100	34.1	2000	96	2000	34.5	45	54
Energy intensity in economy (total domestic consumption of energy against GDP (current prices) – (kg of oil equivalent) per 1000 euro 1995 = 100	840.7	2000	193.9	2000	840	670	420

* extract. This category defines 11 targets and indicators to measure progress towards meeting these targets.

The basic elements of economic policy planning co-ordination process are as follows:

- the *Long Term Economic Development Strategy of Latvia* sets out vision of development of the country (global objective) and key tasks (priorities) for a long-term period;
- sectoral strategies and programmes for medium-term (5-10 years) set out tasks and measures in accordance with priorities defined under the long-term strategy;
- measures are specified in plans for 1-3 years and are backed with the possible sources of financing;
- the *Single strategy of National Economy* defines long-term targets and priorities (10-30 years) of the government's economic policy in a single system, tying them with tasks for medium-term (5-10 years) and current measures (1-3 years);
- every year, before defining budget priorities, implementation of the *Single Strategy of National Economy* is assessed by uniform criteria which are based on a system of quantitative indicators compatible with structural indicators of the EU economic policy co-ordination process;
- financing for short-term measures is provided under the law by the regular national budget.

Approval of the document of the *Single Strategy of National Economy* by the Cabinet of Ministers will thereby substantially improve co-ordination of economic policy in the country, which is essential to ensure balanced and sustainable growth.

Approving the strategy, the government decided that the Ministry of Economics as responsible for implementation of the strategy has to annually develop the *Report on Implementation of the Single Strategy of National Economy*. Fulfilling the government's decision, in May of this year the Ministry of Economics, in co-operation with other ministries and institutions, prepared the ***Report on Progress in Implementation of the Single Strategy of National Economy 2005***. The report assesses the progress in attaining the key strategic objectives and gives appraisal of the socio-economic policy in line with the objectives and tasks set out in the strategy.

The *Report on Progress in Implementation of the Single Strategy of National Economy 2005* gives the following main conclusions and proposals.

1. If Latvia manages to maintain the current high growth also in future years then GDP per capita in 2010 can be very close to the level set in the strategy, namely, 62% of the EU average. Unemployment rate of 65% also can be reached by 2010.

However, analysis of the system of the strategy's target indicators shows that growth in future years may be hindered by development trends of several economic policy spheres characterised by indicators whose dynamics does not correspond to the trajectory set up by the *Single Strategy of National Economy*.

2. Stability of the macroeconomic environment is not to be rated unambiguously. Although it should not be characterised as critical which needs quick and cardinal interference, still the high inflation rate and increased imbalance of the external sector is to be noted.

Maintaining macroeconomic stability requires co-ordinated fiscal and monetary policy that is mostly related to limitation of demand. Competition plays an important role in curbing of inflation. For that reason, competition supervision has to be strengthened and competition development has to be promoted in all sectors of the national economy to public benefit, limiting administrative and other obstacles to competition.

3. Conditions for functioning of economics are improving, as with full coming into force of the Commercial Law an essential stage in business legislation reform has concluded, tax burden has been reduced, structures and normative acts for absorption of the EU Structural Funds have been developed, and liberalisation of monopoly sectors continues.

At the same time, there is no considerable progress in improvement of the country's road network, and the poor financing for programmes which are not priorities of the common EU structural policy has to be noted as a general shortcoming. Hence activities directed to business promotion, such as the integration of state information systems, which ensures accessibility and quality of electronic services in all territory of the country, and establishment of united state fire protection and rescue system which ensures timely and high-quality help in case of accidents, may not be implemented in due time.

Therefore it is necessary to create a stable financing system for these programmes which are not priorities of the common EU structural policy and to ensure co-ordinated action of the state and EU regional development assistance instruments.

Latvia still occupies one of the last positions in the EU by the number of enterprises per 1000 inhabitants. It is important to continue creating favourable conditions for business activity and to encourage higher business culture. Improvement of tax administration, waiver of compulsory invoices for goods, reduction of the entrepreneurship risk state fee (so called "cheat fee"), simplification of accounting forms and bookkeeping, and streamlining of processes related to construction have to be envisaged in improvement of business environment. Unification of corporate income tax (CIT) for all enterprises is one of the most pressing tasks.

An essential obstacle to drafting of high-quality legislation and normative acts and hereby to shaping and implementation of structural policy is the insufficient administrative capacity. The markedly high labour turnover in public institutions pretty often does not allow to shape successive and weighted policy.

4. There is no pronounced progress in establishment of effective and competitive sectoral structure, as the share of high-tech sectors in the national economy increases slower than set out in the strategy's target indicators, and the share of high-tech products in exports also does not grow at such rate that is set by the dynamics of achieving strategy's target indicators.

Essential shortcomings that hinder structural changes are:

- low public and private sectors' investments in research and development;
- non-compliance of educational structure with long-term labour market requirements;
- low level of internet accessibility; one of the main hindrances to development of the e-government is the fact that the electronic signature is still not introduced;
- insufficient financing for promotion of Latvian export, that does not allow to improve competitiveness of Latvian entrepreneurs in external markets.

It is vital to increase effectiveness, capacity and quality of the educational and training system, as well as its compliance with long-term labour market requirements. Although Latvia occupies the 3rd place in Europe by number of university students per 10 thousand inhabitants, the present educational structure is one-sided, as only about one-fifth of these students acquires knowledge of the technical and natural sciences. If priorities in the educational policy will not change, then a lack of technical sciences specialists and superabundance of social sciences specialists will arise in the future.

It is necessary to increase contribution of both the public and the private sector to research and development. State support to innovative enterprises and infrastructure for development of research and knowledge centres, technological centres, business incubators, and knowledge-intensive technology enterprises has to be ensured.

Further rapid increase in number of internet users both in cities and the countryside is impossible without substantial funding and additional measures. The electronic signature must be introduced.

To ensure further effective operation of the state support granting system, it is necessary to assess influence of the existing state support programmes on Latvia's competitiveness. As a result of this assessment, it is necessary to define the state support programme's priorities for the next planning period, to make changes in support granting conditions in order to direct funds to activities where the state support will be needed the most, and to improve the existing state support programmes, making them an effective instrument for strengthening the long-term competitiveness of Latvian entrepreneurs.

5. There is no progress in lessening the socio-economic disproportion and risks, as regional stratification increases and inequality in distribution of incomes grows.

In regions outside Riga the economic activities grow at a markedly slower pace than in Riga and its vicinity. To a great extent, the uneven development of regions also causes the growing stratification in the society. Due to the high unemployment and low social benefits a great part of population is subjected to poverty risk.

Formation of new amalgamated local governments has been a too slow process so far, and for that reason there has been a lot of economically and administratively weak local governments in Latvia for a long time, which cannot perform all local government functions and do not spur local economic activities.

To encourage lessening the mentioned disproportion, the most important pressing tasks are:

- to accelerate the process of local governments formation;
- to improve the existing active employment activities and to develop new ones;
- to revise the tax and benefit system in order to make work pay more, to raise effectiveness of social expenditures and to increase the untaxed minimum.

6. To implement the *Single Strategy of National Economy* and to achieve objectives set in the strategy, it is essential to continue improving the economic policy co-ordination in the country.

Firstly, a high-quality National Development Plan (NDP) and documents related to absorption of EU funds envisaged in 2007-2013 have to be developed; their development is just started. The NDP as a medium-term strategic document is meant to specify the country model foreseen by the *Single Strategy of National Economy* and to determine public investment priorities for medium-term period.

Secondly, to ensure purposeful, far-sighted, co-ordinated, lucid and result-oriented use of available resources and tieback of the *Single Strategy of National Economy*, NDP and strategic plans of ministries with the budget, medium-term budget planning has to be introduced more consistently.

According to a governmental decision, the *Report on Progress in Implementation of the Single Strategy of National Economy 2005* will be one of the basic documents, which will be taken into account when the Cabinet of Ministers will make decisions on priorities of state budget for 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 a member state of the European Union has access to financial aid from the EU Structural Funds, which is an instrument for the implementation of the EU regional cohesion policy.

The goals regarding the planned use by Latvia of the aid from the structural funds are set out under Development Plan or the Single Programming Document whose final version was bilaterally co-ordinated by the Cabinet of Ministers of the Republic of Latvia and by the European Commission in December 2003 (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 communications technologies;
- 1.4. development of education, health care and social infrastructure.

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

- 2.1. support to development of innovations;
- 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 development (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 agriculture and fisheries development (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 to 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 of fishing effort;
- 4.2.2. renovation of fleet 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 fishing in small volumes, socio-economic measures, promotion of conquering new markets 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 final beneficiaries will be able to apply are made up of financing from the EU Structural Funds (75%) and co-financing from the national budget of the Republic of Latvia and budgets of local governments (25%). To apply for the aid from the Structural Funds, the final beneficiary will additionally have to provide its own co-financing.

The aggregate financing in the Structural Funds framework accessible to Latvia in the period from 2004 through 2006 amounts to 845 million EUR (including 626 million EUR financing from the EU Structural Funds and 220 million EUR financing from the national budget of the Republic of Latvia) (see Figure 6.1).

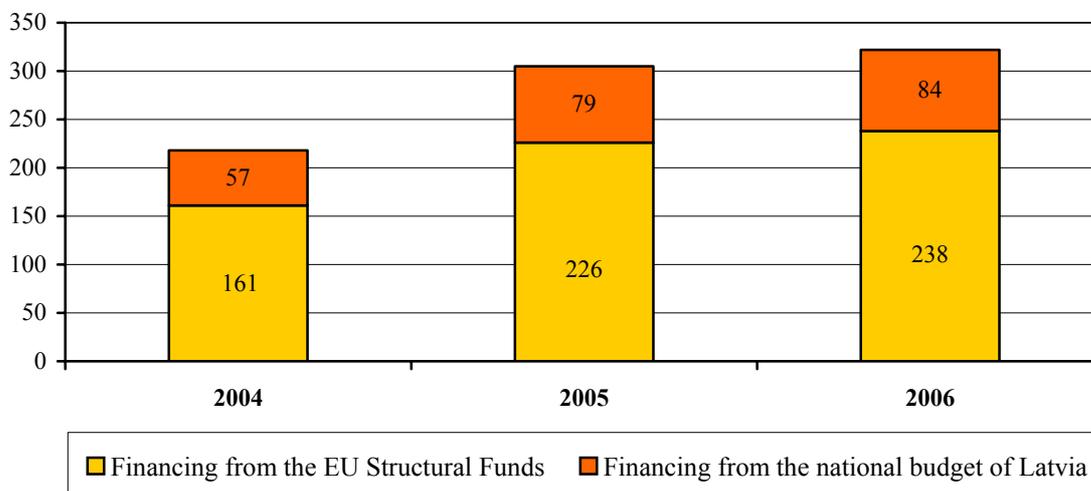
The financing of 626 million EUR from the EU Structural Funds is made up of resources from the following funds:

- European Regional Development Fund (369 million EUR);
- European Social Fund (139 million EUR);

- Management Division of the European Agricultural Guidance and Guarantee Fund (93 million EUR);
- Fisheries Management Financing Instrument (24 million EUR).

Figure 6.1

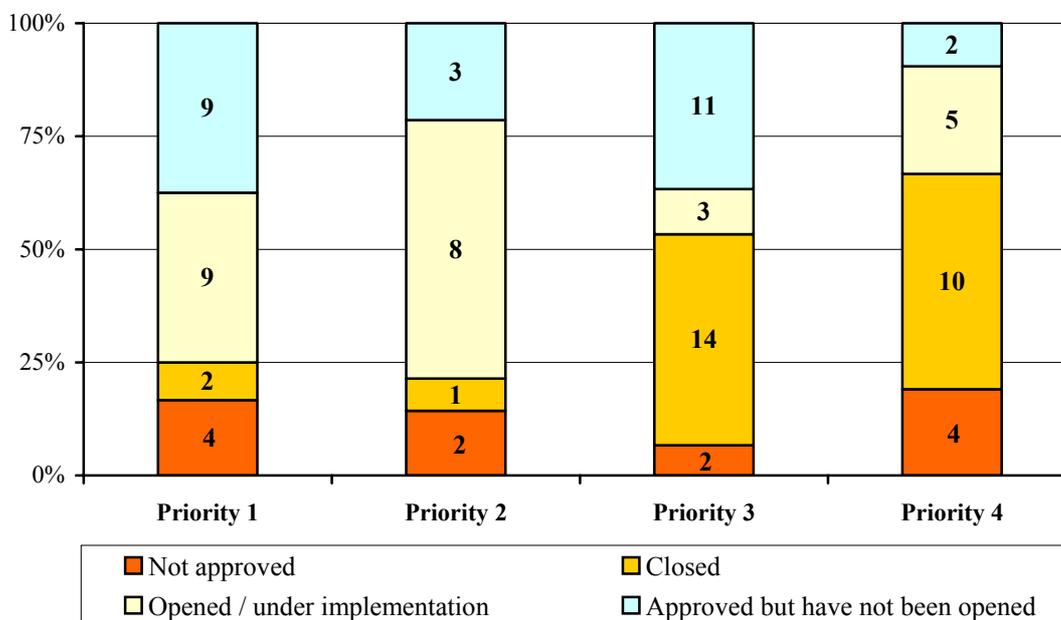
Financing from Structural Funds to Which Latvia has Access, Broken down by Years
(million EUR)



The informative report of the Ministry of Finance¹ on the process of implementation of activities under the Single Programming Document indicates that the absorption of the European Union’s financial resources proceeds successfully in Latvia. As on February 10 of this year, 77 out of 89 activities were approved (see Figure 6.2).

Figure 6.2

Status of Activities under the Single Programming Document as a February 10, 2005



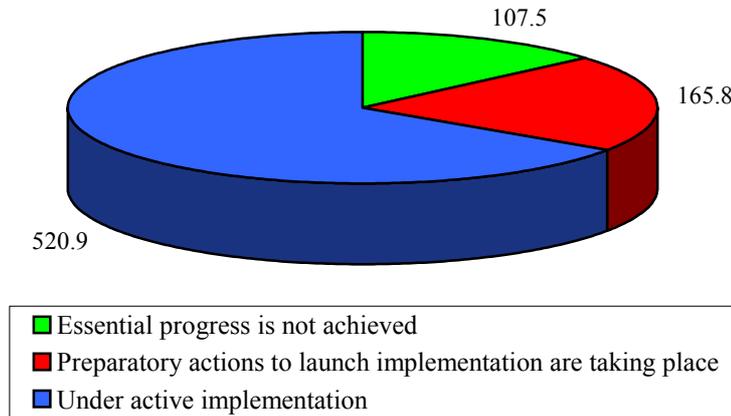
As can be seen from the Figure 6.2, 27 activities are already closed, the reasons for their closure are various. The main reason behind closing the activities is the high number of projects applied. The requested financing significantly exceeds the financing planned for these activities.

¹ The March 1, 2005 informative report „On readiness of Latvia for absorption of the European Union’s financial resources” of the Ministry of Finance

As on February 22, 2005, active work goes on in 59 of all Single Programming Document activities. Tenders have been announced or accepting the project applications is already ceased, and the assessment, approval and implementation of projects take place. These 59 activities contain approximately 66% of the accessible public financing or 520 million EUR (see Figure 6.3).

Figure 6.3

Process of Implementation of the Single Programming Document Activities as on February 22, 2005
(million EUR)

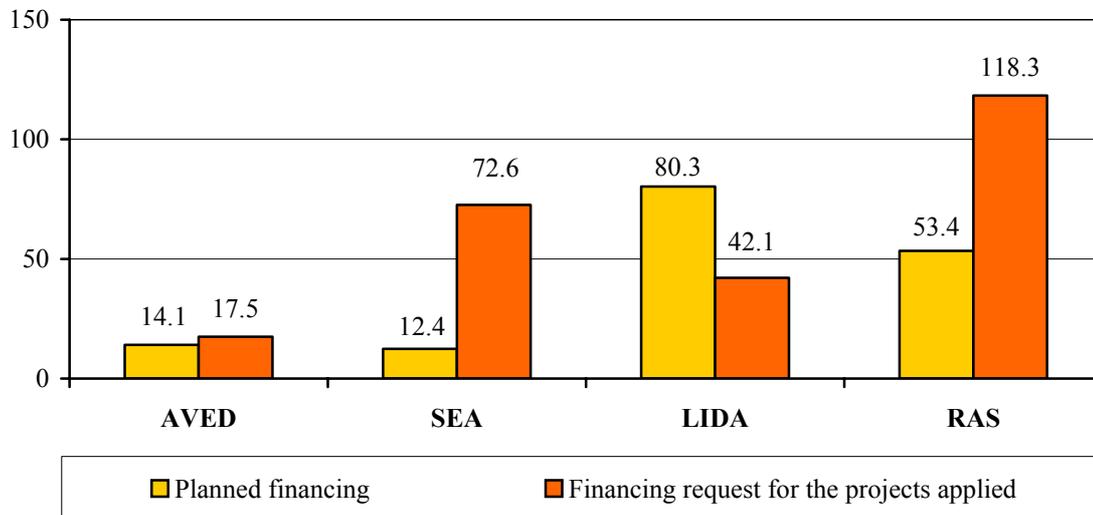


As on February 22, 2005, as much as 22.5 million EUR was paid to beneficiaries receiving the financing. This sum amounts to 3.6% of the total accessible financing from the Structural Funds for 2004–2006.

Since the day when the tenders were announced a very active absorption of the Structural Funds was observed within all institutions administering programmes of the Structural Funds (see Figure 6.3). As on February 10 of this year the Rural Assistance Service has received 1908 projects, and 1152 of them in amount of 66.6 million LVL are already approved; the total financing requested for the projects applied as on February 10, 2005 equals to 118.3 million LVL, but only 53.4 million LVL are accessible. The Latvian Investment and Development Agency has accepted 133 projects in amount of 42.1 million LVL, which makes 52.4% of the total financing for 2004-2006. Large activity was observed also in programmes administered by the Agency for Vocational Education Development and the State Employment Agency, where the financing requested for the projects exceeds the accessible financing (see Figure 6.4).

Figure 6.4

Activity of Project Applicants in Absorption of the EU Structural Funds as on February 10, 2005*
(million LVL)



* AVED – Agency for Vocational Education Development; SEA – State Employment Agency; LIDA – Latvian Investment and Development Agency; RAS – Rural Assistance Service

To level out differences between the EU member states Latvia, after entry to the EU, has access to resources from the **Cohesion Fund**, which replace the ISPA funds that were available to Latvia before the entry. Aid from the Cohesion Fund is available to the EU member states in which the GDP per capita is below 90% of the EU average. The principal goals of the Cohesion Fund are to provide support to environmental protection measures and improvement of transport infrastructure.

Like with the Structural Funds, the resources from the Cohesion Fund are also granted only 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 where financing is raised from the Structural Funds as well. The total project costs have to reach at least 10 million EUR.

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

- transport sector – roads, railways, ports, airports, public transport;
- environmental sector – management of household waste (regional waste landfill sites), effluent 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 make the financing for projects that are under implementation at present (former ISPA projects), 230 million EUR are earmarked for the Cohesion Fund project applications of 2004, 170 million EUR makes the financing for the Cohesion Fund project applications to be submitted in 2005 and 2006.

As on the beginning of March 2005, 35 Cohesion Fund projects for Latvia have been approved with the total financing in amount of 930.5 million EUR (including the Cohesion Fund financing of 530.6 million EUR), of them 20 are environmental sector projects, 14 are transport sector projects and one is a technical assistance project of the Extended Decentralised Implementation System (EDIS).

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 amount of 312.2 million EUR (the total financing for the projects equals to 563.6 million EUR).

In the 1st quarter of this year the European Commission has granted 0.7 million EUR for the project “Technical Assistance to Implementation of the Extended Decentralised Implementation System (EDIS) for the Administration of ISPA in Latvia” in order to strengthen the ability of Latvia’s institutions, involved in implementation of the Cohesion Fund (former ISPA) projects, to successfully carry out administration of the EU financial instruments in Latvia.

Box 6.2

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

Being one of the branch ministries, the Ministry of Economics is responsible over management of 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 improvement” 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;
- business infrastructure development;
- strengthening of measures in support of the small and medium-sized business activity;
- access to financing for small and medium-sized enterprises;

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

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

Box 6.2 continued

Measures and activities of 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 under the Law on Control over Support to Commercial Activities.

As on April 1 of this year almost all activities falling under the responsibility of the Ministry of Economics have been approved. This May it is planned to submit the following remained activities to the Steering Committee for approval:

- Activity 2.4.1 "Loans (including microcredits) for launching commercial activity";
- Activity 3.1.3 "Training and consultations for persons launching commercial activity and activity as a self-employed person".

Since November 1, 2004 the LIDA accepts project applications from enterprises for co-financing from the EU Structural Funds in the state support programme (SSP) "Support to raising qualification of employees, their retraining and continued education".

On October 29, 2004 the Management Committee of the European Regional Development Fund approved the national programme "Development of the loan guarantees system". In accordance with this national programme, the first increase in the equity capital took place on December 28, 2004 (by 3.45 million LVL). In the next two years the equity capital will be increased annually, all in all by the remained sum i.e. by 6.9 million LVL. With attraction of additional financing, the guarantees given by the Latvian Guarantee Agency (LGA) will become even more accessible for businessmen both in the aspects of goal, volume and costs.

On March 30 of this year the Management Committee of the European Regional Development Fund (ERDF) approved the national programme "Venture capital financing" developed by the Ministry of Economics.

The goal of the national programme "Venture capital financing" is to ensure efficient creation and functioning of instruments co-financed by the public sector, which would promote accessibility of venture capital and encourage commercial activity in Latvia. In the framework of this programme it is envisaged to carry out the project of venture capital system development, and the LGA in co-operation with the Ministry of Economics will perform functions of its implementation.

The total financing for the national programme equals to 10.6 million LVL. Financing from the ERDF and the state budget will be used for implementation of the programme project.

As of August 12, 2004 the Latvian Investment and Development Agency has announced a tender on application of projects for receiving co-financing from the EU Structural Funds in the following state support programmes and sub-programmes:

1. Support to modernisation of commercial company infrastructure:
 - 1.1. Creation and reconstruction of connections required for infrastructure development;
 - 1.2. Creation of shared infrastructure;
 - 1.3. Improvement of a commercial company in line with requirements of international standards (acceptance of project applications in this sub-programme is temporarily suspended as of October 5, 2004),
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 on April 15 of this year, 193 projects were submitted to the LIDA, of which 82 projects make an infrastructure grant scheme "Improvement of commercial activity in line with requirements of international standards". The total required financing makes 44.5 million LVL, while the total amount of contracts concluded for receiving support equals to 29 million LVL (see Table 6.6). The most active businessmen were in Riga and Riga district (106 projects submitted); as for the other regions, 30 projects were submitted from Zemgale, 27 from Vidzeme, 21 from Kurzeme and 7 from Latgale.

Table 6.6

**Projects Submitted to the LIDA for Receiving the Structural Funds Financing
by Types of Grant Schemes as on April 15, 2005**

(LVL)

Grant scheme	Amount planned in SSP 2004-2006 (LVL)	Accepted project applications		Concluded contracts	
		Number	Amount of support planned by applicant	Number	Amount of support
Creation and reconstruction of connections required for infrastructure development	5 000 000	12	2 467 798	3	241 227
Improvement of commercial activity in line with requirements of international standards	37 689 023	82	40 147 101	56	28 122 006
Creation of shared infrastructure	5 000 000	2	159 888	1	60 837
Support to development of new products and technologies	10 273 580	13	1 006 905	4	343 166
Consultation services	9 233 144	50	401 557	20	164 498
Participation of commercial companies in international exhibitions, fairs and trade missions	3 077 714	18	117 010	10	72 408
Support to raising qualification of employees, their retraining and continued education	10 045 870	16	186 407	3	15 562
Total	80 319 331	193	44 486 666	97	29 019 702

6.2.2. Foreign Trade Policy

The **Article 133 Committee** of the EU Council of Ministers has the determinant role in adopting decisions on the EU common trade policy. The Committee is established by the European Council on the basis of Article 133 of the Consolidated Treaty Establishing the European Community as an advisory institution of the European Commission (EC) in development and implementation of the EU foreign trade policy.

Every EU member state delegates a full-fledged representative, his deputy and experts (in steel, textile, services and other areas) for work in this committee where such issues related to international trade as introduction of general preference regime, application and development of the World Trade Organisation (WTO) rules are being solved.

The European Council mostly solves political problem issues and approves decisions adopted by the Committee. Several issues after their adoption on the level of full members of the Article 133 Committee are examined at the COREPER (Permanent Representatives Committee of EU member states) and the EU Council of General Affairs and External Relations.

World Trade Organisation

On August 1, 2004 the WTO General Council approved the “July package” which contains conceptual positions and serves as a confirmation of further progress of Doha Development Agenda (DDA) negotiations. It has to be appreciated as an important success for acknowledgement of WTO multilateral trade talks forum and as a good framework document for further negotiations.

Determination of the US, Australia and Canada to carry out agricultural policy reform that was already performed in the EU in 2003 is important for the EU. Determination of WTO member states to eliminate export subsidies which constitute one of the trade most disturbing policies has additional importance. The following DDA sections are in Latvia’s interests:

- Non-Agricultural Market Access (NAMA);
- market access for services;
- trade facilitation.

Increased activity is taking place in all groups of negotiations, acknowledging the technical discussions and observance of parallelism in all sections as the most important ones. Progress evaluation and planning of further activity until the 6th WTO Ministerial Conference which will be held on December 13-18, 2005 in Hong Kong is envisaged to carry out in July 2005. In order for the WTO member states to come to an agreement and achieve remarkable results in the negotiations in December 2005, 80-90% of the work must be done beforehand, in WTO regular and special sessions in Geneva.

Successful negotiations on further **liberalisation of services market** are one of Latvia’s priorities in the framework of DDA negotiations. Latvia is interested in further progress of services trade negotiations. It is important that WTO states take new services commitments, especially in 1st ¹ and 3rd ² Mode of supply, thus promoting further liberalisation of services market and exports of Latvian services to other WTO member states. In the nearest future WTO plans to admit CIS states which are strategically important business partners for Latvia (Russia, Ukraine, Belarus, Kazakhstan, etc.) thereby applying requirements and rules of WTO treaties also to these countries. Commitments of these countries on their accession to WTO will ensure Latvian services providers a remarkably freer access to the services markets of these countries. Latvia supports the elaboration of new binding rules in the framework of WTO GATS, taking into account the guidelines included in the “July package” of August 1, 2004. Active negotiations on reduction of trade barriers are to be supported.

EU has greatly contributed to services negotiations already since their start in 2000 and has actively encouraged participation of all WTO member states in this process.

Latvia supports further negotiations also on increase in market accessibility of **non-agricultural goods**, elimination of non-tariff barriers and tariff level harmonization, including introduction of tariff formula, and considers this area an important priority of negotiations. In order to ensure fast implementation of the advantages of the multilateral trade system, it is important that the developing countries gradually undertake commitments. As a result of negotiations, WTO member states have to

¹ Mode 1 – supply of services across the border, using post, telecommunications or information technologies.

² Mode 3 – commercial presence – provision of services abroad through subsidiary or representative office of home country company.

achieve elimination or considerable reduction of tariffs for all non-agricultural goods, allowing some exceptions to benefit the exports of developing and the least developed countries.

As regards **trade facilitation**, Latvia supports DDA negotiations on trade facilitation issues. Latvia will considerably benefit from improvement of GATT Articles X¹, VIII² and V³ because import and export duties and clearances and freedom of transit will be defined more accurately and more unambiguously. Improvement of transit freedom rules (Article V of GATT) is especially important for Latvia because transit services constitute a large share of Latvian GDP. The current version of the article does not envisage rules regarding oil pipelines as a type of transit. Up to now, WTO Trade negotiating group on trade facilitation has held four meetings in Geneva. During these meetings WTO member states presented their proposals on improvement and explanation of GATT Articles VIII and X.

In April 2005 Latvia prepared and submitted to the EC its proposals for improvement and explanation of GATT Articles V, VIII and X.

During the 6th WTO Ministerial Conference a decision will be adopted on development of norms and rules of multilateral trade in the future and on further liberalisation of the market.

Influence of the new General Preference System on Latvian import from third countries

Initially it was planned that the new General Preference System (GSP) would come into force on July 1, 2005 and would last until December 31, 2008 but due to Asian tsunami on December 26, 2004 the European Community decided to apply the new GSP regime earlier in order to help the countries affected by the tsunami. As an exception, a transition period until July 1, 2005 has been introduced; during this period it will be possible to choose between advantages of the current GSP scheme and the new GSP scheme. The new draft regulation foresees a comparatively simpler system of preferences with 3 regimes instead of the previous 5 regimes applicable to all receiver states and territories, and 2 of them are special regimes taking into account the different developmental needs of the developing countries in similar situation.

According to the data of the Central Statistical Bureau, the most important GSP receiver countries to Latvia are Russia, Ukraine, Belarus and China. With regard to goods from the mentioned countries, imports of chemical products and textiles are important for Latvia.

The new regulation envisages to exclude from GSP lists product groups or sections by the Combined Nomenclature from countries whose import share vis-à-vis the EU total imports of these goods in the framework of GSP regime has exceeded 15% during the last 3 years, which generally means that the product is competitive in the EU market.

As the product volumes were determined on the basis of statistical data of all 25 EU member states, the following Combined Nomenclature sections for Russia were excluded from GSP list – products of the chemical or allied industries (VI Section of the Combined Nomenclature) and pulp of wood or of other fibrous cellulosic material; recovered (waste and scrap) paper or paperboard; paper and paperboard and articles of paper pulp, of paper or of paperboard (X Section). This means that import duty tariff for these products will grow by 3.5 per cent on average.

Steel

The importance of steel sector in the EU economy stems from the fact that steel is a strategically important product, and the European Coal and Steel Community (ECSC) Treaty concluded in 1952 is an evidence of this importance. In view of the changes in industrial sector, the expiry of the ECSC Treaty in 2002, growing globalisation tendencies in steel markets and changes in these markets, it is necessary to be able to forecast clear directions of further development, at the same time envisaging an adequate legal base. Analysis of the mentioned issues and adoption of respective decisions take place in working groups of the Article 133 Committee/Steel of the EU Council of Ministers.

In 2004 the steel consumption growth rate in the world was 2.8% in comparison with 2003, and a slightly lower growth is forecasted also in 2005.

As steel consumption grows, availability of raw materials necessary for steel production is a pending matter. For EU producers, scrap metal and coke are among the main raw materials in steel production. Due to a huge demand for coke in China which is the largest exporter of metallurgic coke (more than 50% of total coke exports in the world in 2004) and to the export duty imposed to scrap

¹ Publication and administration of trade regulations

² Import and export duties and clearances

³ Transit freedom

metal by traditional exporters of scrap metal (Russia, Ukraine), supplies to EU producers were hindered. This caused additional costs and rise in prices of finished articles.

At present Latvia applies conditions of double control system with quantitative restrictions to imports of particular steel products from Russia, Kazakhstan and Ukraine, as well as conditions of prior surveillance system to imports of particular steel products from all third countries. The quantitative restrictions (quotas) within the framework of the double control system prescribe a fixed amount of steel products which can be imported into the EU for free circulation from Russia, Kazakhstan and Ukraine. In 2004 the set amount of quota from the respective countries was sufficient for Latvian entrepreneurs.

Textile

Textile sector takes an essential place in international trade: in 2002 the total world exports of textiles and clothing made up 353 billion EUR amounting to almost 6% of the total world exports. During the last years the role of several third countries (such as China, India, Pakistan) in textile trade has grown particularly.

In view of the sensitivity of textile sector characterised by high number of employees, trade of textiles and clothing between WTO member states is regulated by the Agreement of Textiles and Clothing, which came into force on January 1, 1995 along with the WTO Treaty. The Agreement prescribes gradual abandonment of quotas between WTO member states, which were fully abolished on January 1, 2005.

In the European Union, the Article 133 Textile Committee of the EU Council of Ministers reviews issues regarding textile trade.

At present Latvia as the EU member state applies double control system with quantitative restrictions (quotas) to imports of textile products from Belarus, Serbia and Montenegro, and North Korea, while double control supervision system without quantitative restrictions is applied to imports of textiles originated from Uzbekistan.

Quantitative restrictions to textile imports between WTO member states were lifted as of January 1, 2005 according to the WTO Agreement on Textiles and Clothing. As a result of textile trade liberalisation, import of Chinese origin textile products into EU has rapidly increased. China's commitments to the WTO determine that, until 2008, WTO member states are authorised to introduce market protection measures in case if there are well-grounded proofs that import of Chinese textiles may pose a threat to traditional trade flow and its development. To ensure equable transition to non-quota regime as of January 1, 2005, automatic licensing is applied against imports of Chinese origin textiles and footwear into the EU, and customs supervision is applied additionally.

The European Commission has also approved guidelines for introduction of special (accelerated) protection measures regarding imports of textiles. The guidelines serve as a base to establish and control development of textile and clothing import from China, and they also determine the procedure how every particular case is investigated and decision on introduction of such measures is taken. The Commission has also determined the permissible level of import amount (it is calculated, taking into account the total EU import increase and China's share in it); if this level is exceeded, investigation may be started in the respective categories of goods.

Trade defence instruments

Trade defence instruments (TDI) in the European Community are administered by European Community institutions in accordance with unified principles because TDI are a constituent part of the common trade policy of the European Community. The European Commission is the main institution in this field. Latvia as EU member state has decision-making and advisory rights in trade defence procedures performed by the Commission and draft decisions.

TDI (antidumping, anti-subsidy, and safeguard measures) are aimed at ensuring fair competition between local producers of the European Union and importers from third countries. Application of these instruments is based on conclusions made through analysis of broad and complicated economic factors and data that a subsidised or dumped imports have taken place, which has caused injury to the Community industry. Determinant for application of the safeguard measures is a substantial import growth which causes injury to Community industry but does not constitute an unfair competition.

As of January 1, 2005, 56 antidumping and 13 anti-subsidy measures as well as 2 safeguard measures (against imports of preserved mandarins and farmed salmon) against imports of various goods are in force in the European Community. As of April 11, 2005 there are 47 active cases in the Commission, and the Ministry of Economics in co-operation with other state institutions performs

analysis and evaluation of these cases, prepares national positions and actively defends economic interests of Latvia.

The trade protection proceedings most essential for Latvia, where the Ministry of Economics has actively protected interests of Latvia, are the following:

- anti-dumping proceeding concerning imports of ammonium nitrate originating in Russia and Ukraine;
- anti-dumping proceeding concerning imports of Belorussian, Russian and Ukrainian potassium chloride;
- anti-dumping proceeding concerning imports of certain iron or non-alloy steel seamless pipes and tubes originating in Croatia, Romania, Russia and Ukraine;
- safeguard investigation concerning imports of farmed salmon.

The Ministry of Economics as a state administration institution cannot individually represent interests of particular enterprises in the TDI proceedings. Therefore it is very essential that enterprises themselves actively participate in proceedings conducted by the Commission, rendering their arguments and evidence in order to achieve as effective protection of their interests as possible.

Bilateral relations: economic dialogue with Russia, Ukraine, US

EU member states, including Latvia, support entry of **Russia** into WTO at the WTO Ministerial Conference planned at the end of the year but the results of the negotiations are more important than the proposed time schedule. Russia has completed 80% of bilateral negotiations but several issues are left unsolved, such as US financial services, civil aviation and market accessibility of agricultural goods. EU Trade Commissioner Peter Mandelson has indicated the difficulties and problems resulting from the fact that Russia does not fully observe its commitments which it undertook by signing the bilateral agreement between EU and Russia. The main issues are sanitary and phytosanitary measures, railway tariffs and machine building investments, pharmaceutical data protection, alcohol turnover, and energy market.

Establishment of the Common European Economic Space (CEES) between the EU and the Russian Federation, in order to promote and diversify trade between the EU and Russia, create new opportunities for economic integration and convergence, and encourage market accessibility and development of infrastructure, is also significant. Latvia just as other EU member states believes that all four action plans on the common spaces have to be adopted simultaneously. Since November 2004 progress has been achieved in the economic space context and almost all issues have been solved, hence both sides will have new opportunities to improve mutual co-operation. In negotiations with Russia, issues of Siberian overflights, energy, railway tariffs, veterinary and phytosanitary certificates, and CEES Road Maps project have not been solved yet.

Regarding the energy dialogue between the EU and Russia, further development of this dialogue and faster ratification of Energy Charter by Russia are in interests of Latvia.

Entry on **Ukraine** in WTO is also substantial for Latvia. The majority of EU member states support Ukraine's entry in WTO during the WTO Ministerial Conference planned in December 2005 in Hong Kong. Thereby further mutual trade relations would be grounded on the WTO legal base, which in turn would provide an opportunity to solve issues important for Latvia such as application of non-transparent procedures (duties, import licensing, etc.) by Ukraine.

With Ukraine's entry in WTO, EU should make the next steps in extension of EU-Ukraine economic relations. Latvia is especially interested in conclusion of free trade agreement (FTA) between EU and Ukraine and creation of free trade area in the nearest future. At present, relations between EU and Ukraine are regulated by the 1998 Partnership and Co-operation Agreement (PCA) which has to be reviewed 10 years after its coming into force. It is decided to start technical draft of economic justification on conclusion of FTA.

On February 21, 2005 the EU-Ukraine Action Plan was adopted in the framework of the European Neighbourhood Policy. The plan was elaborated, taking into account the possible conclusion of FTA, and it envisages spheres of action rules and trade, which would promote harmonisation of Ukrainian legislation in line with EU requirements.

Most EU member states support the idea that special integration relations with Ukraine should be formed after its entry in WTO. The decision to conclude FTA or association agreement with Ukraine would be a positive signal of progress in its reforms.

Latvia in co-operation with the US highly appreciates the present legal and contractual base, which encourages development of bilateral economic relations, and wants to maintain its trade agreements with the US.

Co-operation between the EU and US takes place within the framework of the Transatlantic Dialogue. Latvia supports initiatives of the Transatlantic Dialogue because each of them helps improving economic co-operation and integration between the US and EU, which make up the biggest share of international trade in the world. The close co-operation of Latvia with the US, which has taken place up to now, is a good contribution to the Transatlantic dialogue, and Latvia is ready to actively participate in this dialogue, representing its interests.

EC has started consultations with member states on strengthening of the EU-US Economic partnership – Stakeholder Dialog. The goal of these consultations is to explore proposals of entrepreneurs and social partners, which would encourage strengthening of further transatlantic dialogue, improve investment and trade flow between the EU and US, and overcome obstacles in the way to competitive economy. The most important issues needing attention in EU relations with US are trade and investment.

On the whole, the general opinion suggests that regulation compatibility and integration between the US and EU would create big economic advantages for economic operators of both parties in comparison with increasingly competitive operators of third countries.

Bilateral economic co-operation agreements

To continue and activate bilateral economic co-operation after accession to the EU, Latvia has started preparing and concluding bilateral agreements with the most important trade partners.

In 2005 in Riga it is planned to hold the 2nd meeting of the Joint Committee of the Latvia–China Economic Co-operation Agreement, the 1st meeting of the Intergovernmental Commission of the Latvia–Belarus Economic Co-operation Agreement, the 1st meeting of the Intergovernmental Commission of the Latvia–Ukraine Economic Co-operation Agreement, and to sign economic co-operation agreements with Uzbekistan and Azerbaijan.

6.3. Sectors Development Policies

6.3.1. Industrial Policy

One of the main goals of national economy development in Latvia is to create an effective and competitive industry which would ensure high and stable growth. Industrial policy in Latvia is being shaped in view of 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 which represent industrial enterprises. Industrial policy is closely connected with innovation, business activity, education and other policies. The most essential documents formulating industrial policy in Latvia are:

- Single Strategy of National Economy (approved by the Cabinet of Ministers on August 17, 2004);
- 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).

Industrial Development Guidelines of Latvia for 2004-2013 is a long-term policy planning document which includes basic principles, objectives and priorities of state policy for promotion of competitiveness of the industrial sector. Action Plan developed for implementation of the Guidelines was approved on May 8, 2004 by the Decree No. 180 of the Minister of Economics. Several ministries and non-governmental organisations actively involved in development of both the Guidelines and the Action Plan. Co-operation between ministries is particularly important in implementation of the industrial policy because issues and problem spheres topical for the sector are under competence of different ministries in line with distribution of competence.

The Action Plan was updated in February 2005, at the same time harmonising and consolidating it with action plans of the National Innovation Programme and SME Development Programme in Latvia and establishing a single plan of activities for strengthening of competition.

It is envisaged to continue consolidation of different policies and improvement of co-operation. Integration of policies is set as a priority also at the EU level, which is acknowledged by the Integrated Guidelines for Growth and Jobs (2005-2008) that were submitted to discussion in 2005 (see Box 6.3).

Box 6.3

Integrated Guidelines for Growth and Jobs (2005-2008)

The Integrated Guidelines are to be considered the most important recent EU strategic document which, inter alia, affects also the industrial policy. Development of Integrated Guidelines is based on the fact that the EU continues lagging behind global competitors on several indicators which characterise competitiveness and attainment of goals set in the Lisbon strategy is threatened. To improve management process of Lisbon strategy, the European Council made decision to launch new management cycle of the strategy. This envisages to develop action plans for three-year cycle at national and EU levels, basing on Integrated Guidelines worked out by the Commission and approved by the European Council, which unite the Broad Economic Policy Guidelines and Employment Guidelines. The Commission believes that these novelties will considerably facilitate strategy management process and they should ensure that the set priorities are successfully implemented at national levels.

One of the main principles of the new management is that incorporation of several policies into a single document ensures possibility to give clear strategic vision of European challenges in macroeconomic, microeconomic and employment areas both at member state and EU levels.

Integrated Guidelines contain 24 guidelines which are divided in three blocks: macroeconomic, microeconomic and employment guidelines.

Both in the EU on the whole and in Latvia the industrial policy basically is horizontal in nature, which means that it aims at securing framework conditions favourable for development and strengthened competitiveness of industries. At the same time, it is essential to take into account specific problems and development distinctions of particular sectors. At the end of 2004 a study on development prospects of **textile and clothing production** sector in Latvia was completed. Due to liberalisation of trade conditions the textile sector in the EU faces strengthened competition with Chinese products in the internal market, and this has reduced production volumes and threatens competitiveness of the sector. Analysis of the situation in Latvia shows that during the last years production and export volumes of textile and clothing production sector are diminishing and at the same time also the share of light industry in the total added value of manufacturing decreases. The most essential traits of light industry in Latvia are:

- textile and clothing production sector is markedly export-oriented and the EU countries are the most important market for these products;
- majority of enterprises operate on a contractual basis as sub-contractors for EU textile enterprises;
- the sector is dominated by SME which have the advantage of possibility to rapidly re-orient production according to market demand;
- enterprises employ skilled labour force which is cheaper than in the EU but the advantage of low labour costs gradually fades away;
- problems may arise in the nearest years when terms of agreements concluded with EU enterprises will expire and level of labour costs will be even closer to the EU average level, thereby channelling of these orders to countries cheaper in terms of costs is expected.

The main prospects of the sector's development are linked with orientation on narrow and specific segments of the market, improvement of productivity and raising added value. Opportunities to enter the mass product market dominated by products from China and other low-cost countries are to be evaluated as low. Production of flax products is a potential niche for Latvian textile and clothing production sector. Latvia has objective conditions for development of flax growing, procession and finished goods production, creating cluster of enterprises, which would include all production stages. Development of their own design and brand for textile sector enterprises in Latvia is essential.

Industrial design is an essential factor that can improve competitiveness of products in almost every industrial sector, especially production of consumer goods. Since 2004, development of industrial design is one of industrial policy priorities in Latvia. In 2004 the project "**Forming the strategic and operational basis of intensified use of professional design measures in Latvian enterprises**" organised by the government of Denmark and the Ministry of Economics was carried out. This is the first project of this kind in Latvia, which focuses on industrial design as one of competitiveness factors. The project is aimed at improvement of professional design use in Latvian enterprises hence raising the added value and competitiveness of products. Implementation of the project included evaluation of the

situation and analysis of professional design in Latvia with regard to supply of designs, appropriate education and demand by industrial enterprises for design services.

Looking closely at the current situation in Latvia with regard to use of professional design in industrial enterprises leads to conclusion that big opportunities for its development and improvement exist because at present co-operation between industry and designers is rather weak.

In 2005 the Ministry of Economics plans to continue supporting development of industrial design, mostly by organising seminars and providing informative assistance to strengthen link between industrial and design sectors.

With development of innovation, linkage between science and production, and share of knowledge in the added value, the issue of intellectual and industrial property protection becomes a pending matter. In February 2005 the *Twinning* project “**Protection of Intellectual and Industrial Property Rights for Investment in Latvia**” between Latvia and the United Kingdom was started; the project is financed by the EU PHARE programme and its conclusion is planned in 2006. Long-term and short-term British experts are involved in implementation of the project. From Latvian side the project is administered by the Ministry of Culture, and its implementation involves several bodies operating in spheres related to promotion, registration and rights protection of intellectual and industrial property, such as the Ministry of Finance, Ministry of Justice, Ministry of Economics, Patent Office, Latvian Investment and Development Agency, Prosecutor General’s Office, higher education and research institutions and non-governmental organisations. The project is oriented to the main forms of intellectual and industrial property – patents, trademarks and brands, design samples, and issues of audio/visual sectors. Accordingly, a practical example for more profound analysis will be chosen in each of these spheres. A separate working group of the project deals with legal aspects of intellectual and industrial property protection and fight against violations of these rights.

From the point of view of industry and business activity, the most essential tasks of the project are: performing analysis of the existing administrative, legal or other obstacles which hinder patenting and development of other intellectual and industrial property forms in Latvia; offering UK experience in solution of these issues; in joint work with representatives of Latvian institutions, developing recommendations for improvement of the situation. An important component of the project is ensuring information to enterprises and other involved parties on issues of intellectual and industrial property and opportunities which it can provide for strengthening of enterprises’ competitiveness. In this regard, seminars and round-table discussions will be organised within the framework of the project.

6.3.2. Energy Policy

The main trends of energy policy are promotion of competition, increase of security of energy supply, encouragement to use renewable and local energy resources, and environmental protection.

The dominant role in electricity supply is played by the SJSC Latvenergo which provides more than 90% of all electricity generated in Latvia and ensures its import, transmission, distribution and supply to consumers. In addition there are more than 100 small power plants and 10 licensed distribution and sales companies. Natural gas is supplied only by JSC “Latvijas Gāze” but about 70 companies are competing in the supply of liquefied gas.

Creation of market conditions in the **electricity sector** is one of priorities of the government. This will be accomplished by creation of legal environment that would ensure equal rights for all electricity users in Latvia to freely choose their energy suppliers and be qualitatively and securely supplied with energy in the necessary amount for lowest possible prices. At the same time Latvia as EU member state must ensure compliance with unified requirements set out in EU legal acts. In the electricity supply sector it means that the electricity market in Latvia must be gradually opened and operate in accordance with provisions of Directive 2003/54/EC of June 26, 2003 concerning common rules for the internal market in electricity.

The most important precondition for creation of market relations in electricity supply sector is changes in the sector’s structure, hence separating elements of a natural monopoly (transmission and distribution services) from competing elements (production and trade). The goals of energy policy in creation of the sector’s organisational structure correspondent to market conditions will be achieved by new wording of Section 20¹ of the Energy Law and adoption of the Electricity Market Law which determines structure of the sector.

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 problems which currently hinder opening the Latvian electricity market and implementation of electricity users' rights of choice. The draft of guidelines is prepared, taking into account the Directive 2003/54/EC of the European Parliament and of the Council concerning common rules for the internal market in electricity. To create legal environment for efficiently functioning and competitive electricity market, on May 5, 2005 the Saeima passed the Electricity Market Law, basing on the guidelines.

At present the JSC "Latvijas Gāze" is the only merchant in **natural gas market** of Latvia. According to licences issued by the *Public Utilities Commission*, "Latvijas Gāze" carries out transmission, distribution, storage and sales of natural gas.

The Energy Law in its current wording makes no provision for liberalisation of natural gas market or third party access to infrastructure of natural gas transmission, distribution and storage. On April 6, 2004 the Cabinet of Ministers approved the draft law "Amendments to the Energy Law" which will set up the legal regulation for opening the natural gas market and is drafted in view of the Directive 2003/55/EC of the European Parliament and of the Council concerning common rules for the internal market in natural gas. The draft includes issues which concern operation of systems, duties and rights of market participators, and competition opportunities in natural gas market.

By choosing regulated procedure of access, the 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 which are to be complied with when the system is used. At the same time the draft law envisages specification of particular definitions of terms used in the law.

Box 6.4

Harmonisation of laws and regulations with EU directives

The key fields in harmonisation of laws and regulations with EU legislation are: oil and oil product stocks, security of supply, energy efficiency, and introduction of market principles in the energy sector:

- **security of supply and creation of oil product reserves.** On August 14, 2001 the Cabinet of Ministers adopted the Concept on Formation of the State Oil Product Reserve. According to the Concept, a package of laws and regulations and amendments to the current legislation had to be drafted. On January 29, 2002 the Cabinet of Ministers adopted Regulation No. 40 "By-laws of the State Energy Crisis Centre". On March 12, 2002 the Cabinet of Ministers Regulation No. 106 "On the Procedure of Energy Supply and Fuel Sale to Users During an Energy Crisis" was adopted. On March 26, 2002 the Cabinet of Ministers adopted Regulation No. 138 "Procedures for the Establishment and Storage of Petroleum Product Reserves". On May 28, 2002 the Cabinet of Ministers adopted Regulation No. 218 "On Energy Information System". The National Programme PHARE 2003 was approved on July 10, 2003 where one of the projects is linked to administration of the oil product reserve system. Implementation of this project was started in October 2004;
- **electricity sector.** On January 12, 2005 the Cabinet of Ministers adopted Instruction No. 21 "On Annual Consumption Volume of Electricity to Get Status of Qualified Electricity User in 2005". As of January 1, 2005 the status of qualified electricity user is available to all electricity users with the exception of users which buy electricity for consumption in household and do not use it for commercial or professional activity (the population sector). On April 12, 2005 the Cabinet of Ministers adopted "Regulations regarding Total Volume for Installation of Capacities in 2005 and Specific Volume for Each Type of Electric Power Generation if Renewable Energy Resources are utilised for Electric Power Generation" which prescribe that the total volume for installation of capacities in 2005 is 23 megawatts, of which the volume for generation of hydro-power (energy potential of water) is zero megawatts, of wind power – zero megawatts, of energy acquired from biomass, wood or peat – 20 megawatts, of energy acquired from municipal waste or their processed products (biogas) – three megawatts, of solar, sea wave and geothermal energy – zero megawatts. On May 5, 2005 the Saeima adopted the Electricity Market Law which is aimed at creation of preconditions for operation of effectively functioning electricity market, so that electricity would be supplied to all electricity users safely, qualitatively and for justified prices, ensuring all electricity users' rights to freely choose electricity merchant, and promotion of electricity generation by use of renewable energy resources. On April 1, 2005 the law "Amendments to the Energy Law" (in force as of April 15, 2005) was promulgated, which includes Section 20¹ of the Energy Law in new wording according to the market requirements.
- **gas sector.** On April 6, 2004 the Cabinet of Ministers accepted the draft law "Amendments to the Energy Law" developed by the Ministry of Economics. The aim of the draft is to create conditions for competition in the natural gas market of Latvia and harmonise regulatory normative acts with requirements of EU legislation. On May 12, 2005 the draft law was approved by Saeima in the 2nd reading. On April 12, 2005 the Cabinet of Ministers approved regulation "Amendments to the Cabinet of Ministers' Regulation No. 23 of January 20, 1998 "Gas Supply and Use Regulations"". The approved amendments determine user's responsibility for safety of his gas supply system and prescribes procedure how new users are connected to gas supply systems owned by user. The amendments restrict user's rights to install liquefied gas cylinder equipment himself. Pattern of "Instruction on transportation, replacement and use of liquefied gas cylinders" is determined in the amendments.

Investment in energy sector

The energy sector typically absorbs large investment (see Box 6.5). Energy companies such as SJSC Latvenergo and JSC “Latvijas Gāze” contribute voluminous own resources to implementation of projects and are able to attract considerable credit funds.

Box 6.5**Investment projects in energy sector**

In 2004 the total investment by SJSC Latvenergo reached 113 million LVL in comparison with 94 million LVL in 2003. The largest investments in 2004 were made in distribution networks (41 million LVL) including almost 40 million LVL for connection of historically non-electrified rural houses and project of Riga CHP-1 reconstruction. In 2004 the most important investment project for SJSC Latvenergo was the reconstruction of CHP-1 production unit. Plan of reconstruction foresees to invest 70 million LVL in the renovation of the power plant.

In November 2004, the first stage in reconstruction of Mārupe substation was concluded, switching on the reconstructed part of 110 kV outdoor electrical box, the transformer TNo. 3 and newly constructed 20 kV and 10 kV indoor electrical boxes.

In 2004 the JSC “Latvijas Gāze” spent 22.4 million LVL for implementation of capital investment programme. Development of the project of modernisation and supply security increase of Inčukalns underground gas storage facility is continued. Total costs of this project are forecasted in amount of more than 16 million LVL.

The priorities of capital investment programme in 2005 are:

- continuing the modernisation and reconstruction of Inčukalns underground gas storage facility;
- construction of gas distribution pipelines, gasification of towns and villages;
- completing the reconstruction of gas regulation stations;
- development of information technologies and systems.

State support in the energy sector is given only to projects which are linked to adjustment of heating systems.

In the framework of absorption of the EU Structural Funds, support to public and non-governmental sector is envisaged. The priorities for use of the Structural Funds are listed in the Single Programming Document; these priorities are sub-divided into measures, the measures 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); this measure includes several activities which are in competence of the Ministry of Economics, and one of these activities is aimed at provision of support for public sector institutions in modernisation of heating systems according to environmental requirements and improvement of energy efficiency of heating systems both in production and distribution and for end consumers. In the framework of the EU Structural Funds for 2004-2006, 14.96 million LVL will be channelled for the mentioned projects; the indicative breakdown of the finances by years (in million LVL) is 3.89 in 2004, 5.39 in 2005 and 5.68 in 2006.

Open tender has been announced for financing from the EU Structural Funds – European Regional Development Fund (ERDF). The projects have to envisage modernisation of heating systems according to environmental requirements and improvement of energy efficiency of heating systems both in production and distribution and for end consumers. The project was started on March 1, 2005 and its total costs are 7 million LVL.

Applicants can see guidelines of the open tender on the Ministry of Economics website containing information on the Structural Funds.

The guidelines:

- provide information which will help to apply for ERAF financing;
- specify the set priorities, measures and activities to be implemented in Latvia in the framework of this tender;
- explain the basic requirements to be complied with in application for financing from the Structural Funds.

6.3.3. Construction Policy

The construction policy is aimed at creation of conditions to meet demand of the national economy for environmentally friendly, healthy, energy-saving and resources-saving, aesthetic and contemporary buildings.

Implementation of the construction policy in the country is determined by the *National Programme on Construction*. This complex target programme for development of the construction

sector from 2002 till 2012 was accepted by the Cabinet of Ministers on August 30, 2002. The main goal of the programme is to achieve development of competitive construction by providing the Latvian construction sector with 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, assessing the results.

On the whole, situation of the construction sector in the country is as follows:

- Amount of construction in 2004 increased by 13.1% and reached 635.8 million LVL, while construction exports exceeded imports 1.6 times;
- Manufacturing of up-to-date construction products continues developing;
- Developed system of crediting is in place;
- Improvement of normative acts of construction, development of standards and adaptation of EU standards continue.

Despite the reached stability of the sector:

- In 2004, the territorial distribution of investment and construction activities in the country was very uneven: 49% in Riga, 8.2% in Riga district, 5.8% in Ventspils and 4.7% in Liepāja;
- Development rates of scientific potential in construction are low;
- Various violations exist in construction at the pre-design stage, in the purchase process of public procurement, and during construction work and operation of buildings;
- The growing demand for skilled specialists in construction is not fully met because the rate of state co-financing costs for architecture and construction studies is unduly low.

Although 8.5% of all employed people in Latvia work in the construction sector (i.e. every 12th employee), with increase of construction amounts, shortage of both the highest-level specialists (engineers and architects) and skilled workers keeps growing. As the construction market expands but wages in Latvia do not change, some specialists leave for other EU countries where payment for work is considerably higher.

Lack of professional specialists affects also the public institutions managing and controlling construction and the cases of public procurement.

Development of construction sector is hindered by the complicated launch of construction, interpretation of the requirements of normative acts by institutions involved in preparation of construction, frequent changes of normative acts regulating construction, lack of information at municipal level (about territorial planning, construction rules, public procurements), intransparency of processes which creates suspicions on possible corruption, and other factors.

Some of these obstacles may be removed by specifying the procedure during improvement of normative acts, however the “transparency” of decision-making is very important, therefore the Ministry of Economics has started to create a joint construction information system in the country. It is envisaged that such system will provide everyone with opportunity to see his/her local government decisions concerning all construction plans. This will discipline decision-makers and will give a chance to detect in good time an unwarranted construction and to prevent it.

Capacity of state supervision institutions of construction product conformity assessment system is still insufficient. A full-fledged institution which would be responsible for European Technical Approval (ETA) issuing in Latvia and for analysis of documents prepared by ETA issuing bodies of other EU member countries as regards their compliance with Latvian national interests is not established. It is planned to create such institution in the next year.

To achieve successful development of the construction sector, it is necessary not only to implement measures for reduction of administrative regulations and to improve construction procedures and legislation, but also to revise the administrative functions in order to prevent their duplication.

General supervision and co-ordination of construction in the country is carried out by the Ministry of Economics, yet supervision of particular branches is under the 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 local governments (7 cities, 59 towns, 453 rural municipalities) which 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, rural communities, or united boards) operate in Latvia.

Influx of investment and development of construction is often hampered by lack of municipal territorial planning because in such cases it is necessary to hold public discussion of intended construction and this considerably increases preparatory period of construction planning and thereby increases construction time as well.

To curtail unwarranted construction and violations of normative act requirements, amendments to the Code of Administrative Violations of Latvia stipulate higher penalties both for participants of construction and for officials.

To improve functions of construction management and control, it is necessary to establish a new informative system, including in it the register of building licences and commissioning of buildings, register of construction companies, register of building practice and architect practice, and other information which is necessary for construction supervision and control institutions, construction companies, customers, creditors and investors. Meanwhile the website of the Ministry of Economics provides information on so far licensed construction companies and the register of building practice and architect practice.

Amendments to the Construction Law stipulate compulsory insurance of civil liability in construction, and creation of the construction business register is started which will replace the licensing procedure. Regulations of the Cabinet of Ministers are drafted which would come into effect as of July 1, 2005. The construction business register will include all companies that are authorised to engage in construction according to the legislation.

Latvia as EU member country participates in creation of the EU single normative base. At the same time the transposition of European directives in force is continued, the existing national normative acts are improved preventing conflicting requirements, and adaptation and translation of European standards is carried on, including introduction of Eurocode (EN 1990 family) standards in design of building structures.

To promote informedness of building process participants, employees of national and municipal institutions, and other persons about normative acts, standardisation and other aspects of construction, monthly information days of the Construction Department include instructive seminars at the Ministry of Economics, seminars and discussions during exhibitions in Ķīpsala and Skonto hall, and regional seminars related to entry into force of the Administrative Process Law and on work safety in construction, visiting seminars on environmental accessibility and universal design, seminars and discussions in particular construction boards; also Russian-Latvian architecture days were held in Latvia.

Implementation of EU legislative requirements regarding energy efficiency of buildings is continued in Latvia. In 2005 and the next years, it is planned to improve conformity assessment system for construction products, to complete introduction of European standards (references) into normative base of construction, which is related to harmonisation with EU directives 89/106/EEC, 93/76/EEC and 2002/91/EC, and to improve construction supervision, market surveillance and control systems.

The Building Council of Latvia and non-governmental organisations play an increasingly bigger role in improvement of construction policy and development of normative acts. As active social partners one should mention 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, Union of Local and Regional Governments of Latvia, Latvian Wayfarers' 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 "Apeirons".

Tasks that need to be solved urgently are:

- Improvement of educational system for training of highly skilled construction specialists in order to achieve increase of their number in the labour market;
- Establishment of single construction information system in the country;
- Creation of single construction control system;
- Promoting development of scientific disciplines related to construction.

6.3.4. Tourism Policy

3.03 million foreign travellers visited Latvia in 2004. Stable increase in number of foreign travellers in the country is observed for several years already, and comparison of tourism development trends of other EU member countries after their accession to the EU allows to forecast similar stable growth rate also for the next 5 years. In 2004 the share of the tourism sector in Latvian GDP amounted to 2%. Since 2000 a stable increase in the incoming tourism has taken place (by 10% on average annually), which indicates successful development of the sector on the whole in the last years and allows to expect even better results this year.

On August 11, 2004 the Cabinet of Ministers accepted the Guidelines of Tourism Development Policy for 2004–2008 (see Box 6.6).

Box 6.6

Guidelines of Tourism Development Policy

Guidelines of Tourism Development Policy is a medium-term policy planning document which defines basic principles of tourism development policy and its goals for the following years.

The Guidelines set up the **principal goal of Latvian tourism development for 2005-2008** – to attain increase of tourism share in the direct and indirect revenues of the Latvian economy.

To implement this principal goal, medium-term objectives of Latvian tourism development and lines of action for their attainment are identified:

1st objective – **Latvia as a distinctive and recognised country of tourist destination.**

Lines of action for attainment of this goal:

- strengthening of Latvian tourism image,
- identifying “new” visitors to Latvia,
- presence in priority and prospective travel markets;

2nd objective – **development of incoming and local tourism.**

Lines of action for attainment of this goal:

- providing favourable business environment,
- building a corresponding infrastructure,
- promoting development of diverse products and services,
- using achievements of ICT and e-commerce for development of tourism sector,
- introduction of quality management systems,
- development of human resources,
- research and development;

3rd objective – **development of co-operation.**

Lines of action for attainment of this goal:

- optimisation of co-operation between the public and private sector,
- international co-operation,
- representation of state interests.

While developing annual action plan of Latvian tourism development, the products and activities meant for popularisation of Latvia as an attractive tourist destination are being identified and activities for prevention of hindering factors are being envisaged on the lines of action defined in the Guidelines. According to this, the Action Plan of Latvian Tourism Development for 2005 was developed and approved, which was accepted by the Cabinet of Ministers on April 12, 2005.

To make Latvia a distinctive country of tourist destination, the Ministry of Economics (ME) and the State Tourism Development Agency (STDA) perform tourism marketing activities in priority target markets, particularly popularising and highlighting separate Latvian tourism products, and essentially increasing information flow on Latvian tourism opportunities.

In 2005 Latvia will be represented at 23 international tourism fairs, bigger amount of tourism promotion materials will be issued, especially highlighting the diverse Latvian tourism products, visits

of foreign journalists and tourism operators will be organised in co-operation with the airline AirBaltic. Latvian tourist information offices in Riga, Helsinki and London, Baltic tourist office in Berlin, regional representatives of the STDA in Latvian regions and representatives of the STDA in Stockholm and Moscow.

In 2005 a publicity campaign was started on the international TV network CNN.

Development of the existing tourism products and creation of new ones, as well as improvement of the public tourism infrastructure will be among the main priorities in 2005. Putting up road signs continues, and creation of car parking network and tourism information tableaux/kiosks will be a new direction of work.

Accordingly it is envisaged to continue investing in tourism infrastructure by attracting means of the EU financial programmes, creating new tourism products and popularising the existing and new ones, thereby positioning Latvia as a distinctive country of tourist destination in foreign tourist destination markets; it is also planned to make amendments to the Tourism Law.

The most important event in the international co-operation area is that on January 1, 2005 Latvia became a full member of the World Tourism Organisation (WTO) and henceforth will be able to enjoy all rights and fulfil all duties of a WTO member. Latvia has already gained the first benefit of this membership – the WTO has offered Latvia the unprecedented opportunity to organise the WTO regional seminar TOURCOM of 2005 in Latvia, thereby attracting broad international attention and ensuring opportunity for Latvian entrepreneurs to increase knowledge and skills in the field of tourism communications.

6.4. Business Environment

Business environment in Latvia is being consistently improved through developing the legal framework, co-ordinating it with the European Union requirements and monitoring the effects of administrative procedures on business.

On January 1, 2002 the **Commercial Law** took effect in Latvia, bringing about fundamental reform in business environment as it replaced the Law on Business Activity and systematised various provisions governing business activity in a single document.

As a result of enactment of the Commercial Law the number of types of enterprises was substantially reduced to five types such as sole proprietorship, general partnership, limited partnership, limited-liability and joint stock company. The Commercial Law provides detailed legal regulation for reorganisation of commercial companies and protection of third parties. Essentially, the Commercial Law ensures the compliance of Latvian national legislation with the requirements of the European Union directives.

Latvia has achieved great progress and improvement in registration of enterprises, tax policy, customs legislation, procedures and border crossing, construction and other spheres. The report “Doing Business in 2005” jointly prepared by the World Bank, International Finance Corporation and Oxford University Press and published in September 2004 places Latvia among 30 countries which have achieved the biggest success in the sphere of removing administrative barriers to entrepreneurship. However, there are several procedures in which Latvia substantially lags behind the leading countries of the world, for example, real estate registration.

The reforms are being implemented institutionally with the help of the **Action Plan for Improvement of Business Environment**. The *Action Plan* is an inter-ministry policy planning document setting out directions for implementation of business environment improvement 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. 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 state institutions.

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. From the total number of 147 recommendations 138 have been implemented, indicating that the Action Plan is being fulfilled at a high rate.

Directions and tasks of the *Action Plan* cover such spheres as tax policy and administration, improvement of legal environment for business, and readiness of Latvia to participate in the EU transit regime.

In order to make Latvia even more enticing for international investment and business activities, the *Action Plan* is based on a “reform cycle” which consists of: 1) identification of a problem, 2) dialogue between government/entrepreneurs, 3) decision-taking and 4) supervision and assessment of influence.

With the help of the latest *Action Plan* for 2005, it is envisaged to solve such problem issues of Latvian entrepreneurship as:

- increasing the untaxed minimum of the inhabitants’ income tax;
- setting unified corporate income tax rate at 15% for all business incomes;
- non-separation of printing services from delivery of printed/published editions and goods;
- improvement of the legal regulation of insolvency process;
- defining responsibility of institutions involved in public private partnership projects and preparation of the respective normative base;
- approximation of the educational system to the labour market, etc.

Simultaneously with efforts to remove administrative barriers to investment in Latvia and supplementing these efforts, one more important initiative is being implemented in Latvia. **Foreign Investors Council in Latvia** (FICIL), which comprises heads of foreign companies operating in Latvia, holds meetings with the top government officials once a year. In the top level meetings the Prime Minister, Deputy Prime Minister, Ministers of Economics, Foreign Affairs and Finance and other government officials take part. They meet with leaders of biggest international investor companies and other high-ranking officials who represent various sectors of economy and different countries. Starting with the second top level meeting the recommendations of FICIL are included in the *Action Plan*. The eighth high level meeting between the government of Latvia and FICIL representatives took place on October 22, 2004.

During the meeting the officials discussed the regulation of business environment after Latvia’s accession to the European Union, including matters of tax regulation, introduction of compulsory and permissive EU ES legislative norms, provision of free movement of goods in the territory of the EU and cross-border movement to and from third countries, the pace of absorption of the EU funds, macroeconomic situation in Latvia and long-term development prospects, including introduction of the euro currency, inflation, current account deficit, budget policy; development of tourism as a prospective sector for Latvia, including the development trends in hotel and restaurant operation business and other service sectors; transport infrastructure and transportation, as well as building a positive image of Latvia and co-ordinated distribution of information.

During the meeting the government of Latvia and FICIL agreed to continue co-operation and to plan the next top level meeting in summer of 2005.

From November 2003 till March 2004 the Latvian Investment and Development Agency in co-operation with the market and sociological research firm “Latvijas fakti” and the World Bank’s Foreign Investment Advisory Service (FIAS) conducted their regular **survey to assess the measures of business environment improvement**.

The survey covered such spheres as registration of enterprises, procedures of real estate and construction, environmental requirements, tax administration and submission of reports, licensing and certification, labour protection requirements etc. 502 enterprises from all regions of Latvia took part in the survey.

The survey data show that the overall business environment in Latvia has improved, however, this process has proceeded unevenly – according to business people, substantial improvements have been achieved in such spheres as eradication of corruption, combating shadow economy, and tax policy, whereas their sentiment towards some other developments is more critical, for example, substantial problems are caused by inflation, costs of infrastructure services, and certification and environmental requirements.

Improvement of business environment should be a constant and conscientious process which cannot be managed spontaneously and with campaign-like attitude because the survey shows that even in spheres where apparent progress has been achieved a fallback can occur if these spheres are not properly supervised. This concerns, for example, the increase of administrative payments before

commissioning the most important premises, spread of corruption related to commissioning of buildings, and procedures in free customs zones.

The ranking of administrative barriers to entrepreneurship has mostly remained on the previous level, however, some problems have exacerbated substantially, for example, the ones concerning accessibility of land, activities of other market participants restricting competition, and inspections. What concerns co-operation of enterprises with state administration and local governments, it should be noted that co-operation with municipal structures is being assessed more positively than co-operation with state institutions.

Over the last years one of the priority goals of the government has been the **reduction of tax burden** and simplification of tax administration procedures.

In 2004 several tax rates and tax administration procedure related to entrepreneurship have been changed, which on the whole diminish the tax burden for businesses and scales down corporate costs in tax administration.

As from January 1, 2004 the rate of corporate income tax (CIT) has been reduced from 19% to 15%, whereas the CIT relief applied to small enterprises and high technology products has lost effect. Property tax for buildings used in commercial activities amounts to 1.5% and is being calculated from the balance sheet or book value.

To reduce barriers to starting economic activity for persons without special knowledge on book-keeping and taxes, the Ministry of Finance has developed the draft concept “**On possibilities to introduce fixed income tax for small entrepreneurs** (performing economic activity)”.

The concept foresees simplified calculation of income tax for physical persons which perform small amounts of economic activity. Like in other EU countries, the aforementioned measures for simplification of tax calculation are not applied to businessmen which establish capital companies for economic activity, as well as to physical persons which perform economic activity by providing audit services, legal services and other advisory services, because simplified book-keeping and tax calculation cannot create problems for these physical persons with very high educational level.

As of May 1, 2004, when Latvia became a fully-fledged member state of the EU and the internal borders were removed, products in the internal market circulate without customs control and customs procedures are not applied to supplies of products from one EU member state to another. A reduced (5% lower) VAT rate entered into force in respect of medicines, medical goods and equipment for personal use by people with special needs and patients, mass media and books, admission fees in cinemas and sporting events, guest housing, water supply and sewerage, the collection, transportation and storage of household waste, etc. from the list approved by the Cabinet of Ministers. According to the amendments to the Law **On Value Added Tax**, which were adopted in December 2004, the 5% VAT rate is applied to domestic public transport services and all cartographic publications as of January 1, 2005.

As of September 2, 2004 the amendments to the Regulation No. 112 “Regulation on Income Subjected to Wage Tax” adopted by the Cabinet of Ministers on March 31, 1998 came into effect. These amendments provide that the tuition fee covered by the employer and the principal sum of study loans that is paid back can be excluded from income subjected to wage tax:

- for students studying for all kinds of doctor’s degree;
- for bachelor study programmes in the thematic group “Science, Mathematics and Information Technologies” or “Engineering, Manufacturing and Construction”;
- for every level of vocational study programmes in the thematic group “Science, Mathematics and Information Technologies” or “Engineering, Manufacturing and Construction”;
- for master study programmes in the thematic group “Science, Mathematics and Information Technologies” or “Engineering, Manufacturing and Construction”.

The above mentioned relief is applied to tuition fee, starting from the academic year of 2004/2005 till academic year of 2009, if an employee has presented employer with a respective statement from the higher educational institution.

Although at present the total tax burden in Latvia is relatively lower than the EU average, the current tax legislation in force does not include a particular norm which concerns investment promotion in spheres of national economy with high knowledge capacity and export potential. Tax policy is an instrument which helps to influence country’s economy and stimulate or decelerate development of a certain sector of national economy, affect development pace of a certain territory of the country, and to apply special conditions to certain category of taxpayers. It is necessary to review

the present system of tax relief for overall commercial activities, linking it with precisely defined horizontal targets.

To prevent ineffective and non-incentive system for violations of tax laws, the Ministry of Finance has prepared the report “**On Optimisation of the Penalty System**”. The goal of this report is to assess EU member states’ practice and experience in determination of responsibility for tax violations and to offer constructive suggestions for creation of flexible and proportionate penalty system in Latvia. On the whole, the reform of penalty system is aimed at improvement of complying with tax legislation norms and at ensuring utmost observance of fiscal interests and economic opportunities on behalf of taxpayer and state tax administration. The report provides the current situation characteristics, violations of tax laws and amount of punitive sanctions to be enforced, assesses shortcomings of the existing penalty system and offers proposals for improvement of the penalty system structure.

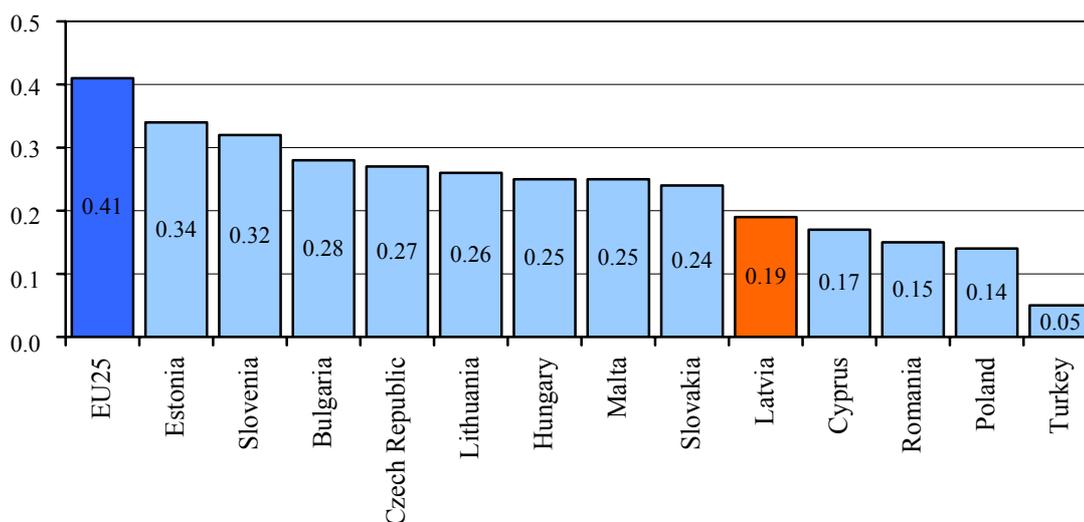
6.5. Innovation

As one of the main elements in knowledge-based economy one should mention successful development of innovation in all sectors of the national economy. (Successful development of innovation in all sectors of the national economy is one of the main elements in knowledge-based economy). Good-quality rapid acquisition, accumulation and application of new knowledge have become the main factor of competitiveness and source of added value of countries, regions and enterprises.

The European Commission’s spring 2005 report on the implementation of Lisbon strategy notes the insufficient progress of the Community and member states towards increasing competitiveness, and the European Council has repeatedly urged member states to pay bigger attention to promotion of growth and innovation in particular. Assessing the progress achieved by the EU member states in the field of innovation policy implementation, the European Commission has published the new *European Innovation Scoreboard 2004*.¹ Sweden and Finland have the best performance indicators among the European Union countries, while Estonia and Slovenia score the best among the 10 new EU member states in innovation policy implementation. By the Summary Innovation Index included in the 2004 report, Latvia occupies the 30th position among 34 EU states and associated countries.

Figure 6.5

The 2004 Summary Innovation Index of New EU Member States and Candidate Countries



Source: European Commission, European Innovation Scoreboard 2004

The fifth lowest index indicates that the national innovation system of Latvia at present is poorly developed and essentially lags behind the average level of EU countries.

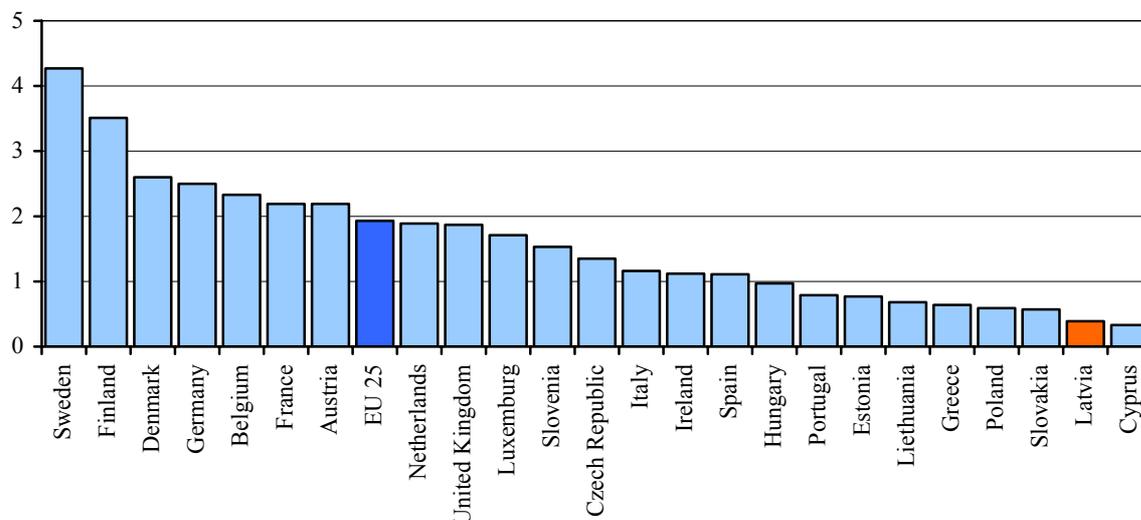
¹ The scoreboard includes 20 indicators which characterise development of human resources, processes of creation and application of new knowledge, and provision of the necessary finances. The indicators in the aggregate make the summary innovation index which allows to compare innovative performances of member states.

According to the innovation survey carried out by the Central Statistical Bureau in 2004, only 18.6% on average of all enterprises in Latvia are innovative in comparison with 45% in the EU. The factors hindering innovation development in enterprises are: lack of entrepreneur awareness of the innovation role in development of the enterprise and ensuring its competitiveness; insufficient availability of financial resources, especially the seed capital and risk capital; and poorly developed co-operation between enterprises both on local and international level and co-operation between educational, research and industrial sectors.

Hindering factor for development of applied research, commercialisation of research results and development of innovative business in Latvia is constituted also by the low investment of public and private sector into research and development. In 2003 the total financing for research and development in Latvia equalled to mere 0.38% of GDP (1.93% of GDP in the EU on average).

Figure 6.6

Investment in Research and Development in EU Member Countries in 2003
(% of GDP)



Source: Eurostat, R&D expenditure in the EU

Research financing by the public sector made 0.18% of GDP, at the same time the existing system of research financing does not act as a catalyst which would attract private sector investment. In 2003 the private sector investment in research equalled to mere 0.08% of GDP (0.73% of GDP in the EU on average).

To ensure favourable environment for innovative activity in Latvia and encourage formation of knowledge-based economy, in 2003 the Cabinet of Ministers approved the National Innovation Programme for 2003-2006. To implement the activities identified in the programme, the National Innovation Programme's Action Plan is worked out every year. The action plan for 2005 sets down the following main lines of action for implementation of the National Innovation Programme's goals and tasks:

- to improve environment promoting innovative activity;
- to create general awareness of the role of innovation in the development of the national economy;
- to encourage human resource development;
- to further introduction of innovative solutions into commercial activity;
- to promote international co-operation of scientists and entrepreneurs;
- to endorse formation of innovation support infrastructure;
- to support establishment of efficient link between industrial, educational and research sectors.

One of the main partners in implementation of activities of the action plan is the Ministry of Education and Science, which has envisaged several actions in order to promote scientific activity and support development of applied research in particular. In 2005 the Ministry of Education and Science, by attraction of financing from the EU Structural Funds, continues carrying out the national programme "Modernisation of scientific infrastructure in public research institutions". This year it is also planned to launch implementation of open competition of applied research in priority scientific areas. In the Law on the State Budget for 2005, the government has prescribed additional finances in amount of 2.5 million

LVL to start implementing public research programmes. These programmes will be carried out in such priority scientific areas as biomedicine and pharmaceutical chemistry, information technologies, material sciences, forest sciences and wood processing technologies. In the framework of public research programmes such applied research will be supported, where anticipated results will be applicable in some sector of the national economy and will make a significant contribution to promotion of the sector's competitiveness. The legislation is being improved in the field of science and innovation policy, and on April 14, 2005 the Saeima adopted the Law on Scientific Activity. This law sets out the principles of reorganisation of the state scientific establishments and their integration into universities. It envisages provision of base funding, by certain criteria, both to the state science institutions and research units at universities, which was not ensured up to now.

In 2005 the Latvian Investment and Development Agency continues implementing the state support programme "Support for the development of new products and technologies", and entrepreneurs have access to support for development of new products or processes in the form of a non-repayable grant up to 45% of the supportable project costs. 13 projects were submitted until April 2005 in the framework of this programme. In the next three years it is envisaged to invest 10.3 million LVL from the European Regional Fund and the state budget for promotion of research and development within this programme, and approximately the same amount will be attracted from the private sector.

In 2005 the Ministry of Economics continues supporting technology transfer within the framework of the Innovation Relay Centre Latvia and supports various informative activities to raise entrepreneurs' awareness of the innovation role in increased competitiveness. The funding allocated to the Ministry of Economics for implementation of the National Innovation Programme activities in 2005 has remained the same – 130 000 LVL. To ensure the necessary growth, the state financing must be increased not only for research but also for development, including activities for promotion of knowledge commercialisation. Additional funding is required in order to carry out the support programme for launching business activity in business and innovation incubators and to create network of technology transfer centres. In addition it is envisaged to develop a new state support programme, within which an initial financing for launching innovative business activity would be ensured under certain conditions.

Box 6.7

Project of Ampere Institute

For a long time scientists of Latvia and France co-operate in magnetohydrodynamics (MHD) research. After suggestion made by the French scientists, a project was developed to create MHD research centre of European scale in Salaspils, Latvia, where research will be done by international groups of scientists. The European-importance MHD research centre "Ampere Institute" (AI) on the basis of the Institute of Physics at the University of Latvia (IPUL) in Salaspils is being created in order to internationally put into practice the success and experience of Latvian scientists in the MHD area and to promote their commercial applications, to encourage more active participation of foreign scientists in this research and to shape the united European scientific space.

By the Order No 109 of Ministry of Economics of March 2, 2005, a work group was established for implementation of the Ampere Institute project, and the main task of this group is to develop proposals to the French stakeholders for creation of the joint research institute – Ampere Institute.

It is planned to establish Innovation Centre parallel to the Ampere Institute. The main task of Salaspils Innovation Centre is professional commercial application of developed new technologies in Latvia, development of international co-operation and connections, attraction of foreign industrial partners and investors, conduction of potential market research and assessment of product profitability. Financing in the framework of PHARE or state long-term investment project might be attracted for creation of the Innovation Centre.

6.6. Information Society

Information society is a social development phase which is based on free mutual exchange of information and develops knowledge-based economy. Information society consists of the technological base (infrastructure, software), range of information services available to 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 entry in the EU, the European Union initiatives in regard to building the information society (see Box 6.8) have become binding for Latvia.

Box 6.8**European Union initiatives in building the information society**

In December 1999 the European Society 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 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 countries, 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 which 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).

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 an 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 (ICT) 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 to ensure availability and wide choice of modern and efficient communication services for customers in all 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 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 public administration structure, eradicating unnecessary stages, ensuring transparency and increasing efficiency as well as broadening participation of society in 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.

From January 1, 2004 the functions of the Ministry of Transport and Communications, which are related to supervision of the informatics sector, were taken over by the Information Society Bureau (ISB) at the State Chancellery. The functions of ISB include ensuring co-ordination of information society and e-government policy implementation in Latvia. In December 2004 the Cabinet of Ministers

decided to establish the Secretariat of the Special Tasks Minister for e-Government Affairs, which took over the functions of ISB and started working from January 1, 2005.

At the beginning of 2004 the ISB developed the national programme “Development of e-Government Infrastructure Base for 2004-2006” in order to absorb EU structural funds and solve the most important issues of e-government and its infrastructure. The course of the programme is determined by the progress of Latvia in building the information society (see Box 6.9).

Box 6.9

Progress of Latvia in building the information society

Infrastructure of information technologies

At the end of 2004 the total number of fixed phone lines was 631 thousand and 90% of the lines were connected to digital system, while the number of mobile telecommunications subscribers reached 1.55 million.

Since the market was completely opened to competition in January 2003, the number of electronic communications merchants continues increasing. Until the end of 2004, more than 300 merchants received licences and permits, including 89 merchants which operate or plan to operate in domestic/local voice telephony services sector, 95 merchants operating or planning to operate in international voice telephony services sector, 116 merchants planning to provide leased line services, 293 merchants which will offer internet and data transfer services, 14 merchants which will offer payphone services, 11 merchants which will offer radiocommunication services, 48 merchants which will offer television and sound spread services, and two merchants (LLC “Latvijas Mobilais Telefons” and LLC “TELE2”) which will offer UMTS services. In December 2004 the auction of the third mobile operator licence (for UMTS/GSM standard) was announced; as a result, the licence was acquired by Lithuanian company “Bite GSM” which is subsidiary of Danish telecommunications company “TDC” for 6.707 million LVL. The state still retains controlling stake (51%) in the biggest fixed telecommunications operator LLC Lattelekom.

Computer and internet usage

According to a CSB survey, in the 2nd quarter of 2004 computers were used by 41% of Latvia’s inhabitants and internet was used by 33% of inhabitants, while 54% of inhabitants had ever used computer and 43% had ever used internet.

At the beginning of 2004, 53% of companies in Latvia used computers, 41% of companies had internet connection, 15% of companies had an internet website. 51% of all connections were broadband, 25.3% were ISDN based, 16.8% had a dial-up access, and 6.9% were wireless internet access. Computer usage in big and small companies differs considerably. In the group of companies employing 1 to 9 people, computers were used by 43% of companies, 31% of companies had internet connection and 10% of companies had a website on internet; for companies with 10 or more employees these indicators were 85%, 72% and 32 per cent respectively.

At the beginning of 2004/2005 school year, 100% of higher educational establishments and colleges, 98.1% of vocational education establishments and 99.9% of comprehensive schools had computers, while 100% of higher educational establishments and colleges, 97.1% of vocational education establishment and 93.4% of comprehensive schools had internet connection. Number of computers per 100 students was 5.6, while the number of internet connections amounted to 4.2 per 100 students.

In 2004, 26% of households in Latvia had computers and 15% had access to internet at home. Main reasons for inaccessibility of internet were the following: equipment is too expensive, there is no wish to use internet, usage fee is too high, internet is available elsewhere, there is no sufficient knowledge.

e-education

At the beginning of 2004/2005 school year, 72.4% of all pedagogical employees at comprehensive day-schools had knowledge on IT, 35.8% used internet on a regular basis, and 24.4% regularly used internet for preparation of teaching materials.

According to the survey “Development of information and communications technologies in education” carried out by the social and market research centre “Latvijas Fakti”, pedagogues consider the insufficient number of computers and lack of financing as the main obstacles to integration of ICT into education, while the interest of teachers and state support are mentioned as contributing factors. In the last years no finances from state budget are granted for acquisition of new computers and replacement of outdated computers, hence there is a risk that the attained level will be lost gradually. At present, computer parks are mainly replenished and renewed for local government funds.

In 2004 computer training for adults was provided by 78 institutions where the number of persons to be trained was 9.7 thousand.

e-government

The main applications of e-government are: searching governmental information, download of forms and documents, getting consultations, providing information and settling payments for received services. According to the *World Association of Research Professionals* survey on e-government usage in 2003, Latvia where 14% of inhabitants use these services is among the countries with a low usage of e-government. Up to now, the government of Latvia has been rather inactive concerning introduction of e-government, as in December 2003 only 3.5% of inhabitants downloaded official forms of electronic documents (the CEE-10 average is 4.7%) while 3.5% of inhabitants sent filled-in forms to governing bodies electronically (the CEE-10 average is 2.3%). In summer of 2004, Latvian Internet Association conducted a survey regarding contents of websites of Latvian towns in order to size up the situation by 45 different criteria, such as current events in these towns, information on activities, history and tourism, information for entrepreneurs, discussions of visitors, opportunities to get in touch with local governments in e-environment, information in foreign languages, etc. The survey indicated that no website has fulfilled all rules but the websites of Cēsis, Aizkraukle, Rīga, Ventspils and Saldus showed the best performance. Approximately one-fifth of websites are not being updated regularly. Discussions for visitors are organised in 35% of websites of towns. Using tools placed in e-environment provides opportunity to communicate with only one-third of local governments. Incomplete information in foreign languages is only available in 65% of websites. Big differences between websites in terms of contents, owners and structure were detected.

Box 6.9 continued**e-health**

In December 2003 only 22% of general practitioners (GPs) had computers in their consulting room and only 12% had internet access in this room, and these percentages were the lowest in CEE-10 countries. 53% of GPs used electronic patient records, and also this was the lowest percentage in CEE-10. However, the indicator of electronically prepared data exchange is the 2nd highest among CEE-10 countries (24%). According to assessment made by the European Commission, the low wages of medical employees due to protractedly postponed health system reforms have become the most essential factor hampering development of e-health.

e-commerce

In December 2003 only 1.5% of Latvia's inhabitants shopped online, which is considerably lower than the CEE-10 average (3.5%). At the same time this contrasts with the fact that Latvians have more than 1 million credit cards and 8.6% of population use e-banking services (against the CEE-10 average of 4%). This points to the huge potential for e-commerce, which remains unused because online payments are offered and made by relatively small number of Latvian companies – 17% of companies have purchased online, while only 3.3% received online payments. In December 2003 approximately 10% of Latvian companies sold to other companies via specialised internet market places.

ISB is updating the programme 'e-Latvija 2005-2008'. In the framework of this programme it is envisaged to promote shaping of environment fit for e-business. The programme sets up the following key goals of e-government:

- 1) lessen administrative burden on society, providing public institution services which are more convenient and simpler to use, as well as faster and better quality solution of issues in administrative institutions;
- 2) use more effectively the human resources of state administration and local governments, introducing information technology systems;
- 3) ensure use of Pan-European services in Latvian territory and use of Latvian services in Europe, integrating Latvian administrative institutions into European Union structures;
- 4) implement e-democracy mechanism (elections, referendums, polls and political communication in internet).

In accordance with the *eEurope 2005 Action Plan*, the Ministry of Transport and Communications is drafting broadband development strategy, foreseeing by 2008 to make Latvia a leader in the area of accessibility of broadband internet connections in the Baltic region. It is also planned to ensure 100% broadband accessibility in local governments, schools, libraries, health care institutions, as well as small and medium-sized enterprises, and increase the number of internet users to 75%. It is intended to achieve the target of 15 computers with internet access per 100 students to ensure learning process. Approximately the same number of computers with internet access and ensured use free of charge is planned for 100 pupils. It is also intended to establish a joint broadband network of public institutions. Broadband development in context of the strategy includes development of infrastructure, broadband content, namely, services and available information, as well as demand and user skills.

On June 13, 2005 the Cabinet of Ministers committee accepted basic guidelines "e-Health in Latvia" developed by the Ministry of Health. The guidelines will be a single strategic document for various e-health projects in the next 10 years. The guidelines foresee, using opportunities provided by IT, to ensure operative exchange of health care information between society, patient, health care specialists, policy makers and implementers, improve efficiency of provision of health care services, and ensure veracity and safety of health care data.

On November 4, 2004 the Saeima adopted the Information Society Services Law which transposes provisions of the EU Directive 2000/31/EC "On certain legal aspects of information society services, in particular electronic commerce, in the internal market". These provisions set up the procedure of providing information society services.

The law prescribes freedom of information society services provision, information to be given in provision of information society services, and supervision authorities. The law will encourage providers of information society services to fully use advantages of the internal market and will build confidence of consumers in information society services. The law provides for prohibition of sending unsolicited commercial and other messages, thereby protecting internet users against various unauthorised mail.

To observe requirements of the Information Society Services Law, the Instruction No. 197 of the Cabinet of Ministers was developed and adopted on March 30, 2005, which determines the Consumer Rights Protection Centre as the responsible institution that will co-ordinate exchange of information between Latvian supervisory institutions, supervision bodies of the European Economic Area, and the

European Commission countries about decisions adopted by various institutions, which restrict provision of particular information society services.

Amendments to the Administrative Violation Code are being worked out, that will fix penalties for physical and legal persons for sending unsolicited commercial messages.

On May 3, 2005 the government approved the schedule of activities for introduction of safe electronic signature, which envisages to start issuing first e-signature certificates from March 2006. The LLC Lattelekom and “Latvijas Pasts” have been chosen as certifiers of the safe e-signature and will jointly implement this project. On June 14, 2005 the Cabinet of Ministers supported draft trilateral agreement between the state, LLC Lattelekom and “Latvijas Pasts”, which prescribes that “Latvijas Pasts” will become a reliable certification service provider but the LLC Lattelekom will be a project’s technology partner and will ensure the information technology infrastructure necessary for certification services provision and operation of this infrastructure. The state in its turn will undertake to ensure “Latvijas Pasts” a data processing opportunity with population register data and to grant finances to the Office of Citizenship and Migration Affairs for establishment and maintenance of the necessary infrastructure.

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 which are implementing e-government and will prepare proposals for solution of issues related to e-government.

In 2004 the level of computer piracy in Latvia reached 58% (58% in Lithuania and 55% in Estonia) and has increased by 1% in comparison with 2003, according to the study on computer piracy in the world in 2004 conducted by the Business Software Alliance (BSA) and the IDC which is the leading market analysis agency in information technologies and telecommunications sector. Losses caused by computer piracy or the total value of illegal software in Latvia in 2004 increased by 3 million US dollars, exceeding 19 million US dollars or 10 million LVL.

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 employment and GDP growth in Latvia like elsewhere in Europe.

In the 1st quarter of 2005 according provisional data, there were 48 252 economically active enterprises in Latvia, of which 47 907 or more than 99% fell in the category of SME (taking into account only the number of employees). The distribution of economically active SME in Latvia according to their size is similar to the one in the EU member countries: micro enterprises – 76%, small enterprises – 20%, medium-sized enterprises – 4%. 69.9% of private sector employees are employed in SME and create 63.2% of GDP.

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 6.10

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.

Statistical data of the recent years indicate positive trends in growth of the number of newly founded enterprises. Lursoft data show that 7690 newly founded enterprises were registered in 2003. 10 228 newly founded enterprises were registered in 2004, which is by 33% more than in 2003, and this growth was the biggest during the last eight years.

The main problems hindering SME development in Latvia are the following.

1. Business environment. Competitiveness of SME sector cannot develop without environment favourable to business activity, and this is greatly determined by competitiveness of the state tax policy, efficiency of capital market, infrastructure, educational system and state aid, alignment and stability of business legislation. Results of business surveys and conclusion reports of meetings and conferences of non-governmental organisations representing SME interests allow to draw 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 SME and among business beginners. Guarantee and investment funds are not sufficiently developed yet. Problems in the field of external financing availability are more pronounced outside Riga, problem of availability of finances have an explicit territorial dimension.

3. Personnel resources. SME often face problems in 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 global economy.

4. Competitiveness of SME. Latvian enterprises, while working with EU directives on quality, lack information about product standards and new production methods, and this also is a pressing problem. Product quality assessment instruments are not available in Latvia.

5. Regional differences. In the last ten years, negative trends are observed in Latvian socio-economic development, namely, rapid development of Latvian economic centres and stagnation or even regress in development of the other territory at the same time. This created increased differences between cities and rural areas as well as between the central part and periphery of the country. Integrated development of rural territories, 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 utilisation of the EU Structural Funds is insufficient at present. The main causes of that are: insufficient opportunities of financing from 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**. 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, to spur initiative of entrepreneurs and lessen the total risk, to prevent obstacles to business activity, to promote stability and effectiveness of financial system and capital market in order to improve competitiveness of the enterprises in the market.

The *Basic Guidelines* foresee implementation of policy, which is based on the best practice of companies of the developed countries, in accordance with the activities outlined in the European Charter for Small Enterprises, simultaneously taking into account also the specifics of the SME development problems in Latvia.

For implementation of the *Basic Guidelines*, on May 25, 2004 the Cabinet of Ministers approved the **Programme on Development of Small and Medium-Sized Enterprises of Latvia in 2004-2006** in order to promote objectives of the SME development policy.

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 funding 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 territories with a relatively low index of socio-economic development. Implementation of these measures is planned in close connection with the plans of utilisation of financial resources from the EU Structural Funds.

For the majority of the entrepreneurial activity assistance measures envisaged in the *Programme*, attraction of co-financing of the EU Structural Funds is planned.

In the 2nd half of 2004, in the framework of the *Programme* and in co-operation with the Ministry of Economics, motivation seminars for businesses and seminars about application of the European Union legislation requirements to Latvian enterprises were organised, information booklets “How to start business?” were made for business beginners, and internet portal www.mazaisbizness.lv for business beginners and businessmen was created.

In 2005 it is planned to continue training businessmen and business beginners and informing them about their pressing issues by organising informative seminars, publishing informative educational materials and implementing businessmen’s training programmes. Studies will be done on the administrative procedure which hinders SME development and identification as well as identification of the tax burden, by indicating factors which impede development in this field, and comparative analysis of tax application in EU countries will be performed.

In co-operation with the World Bank, it is planned to do a business environment study, identifying potential activities for improvement of business environment; it is also planned to start operation of venture capital funds, thereby businessmen will get access to additional financial assistance instrument in cases where receiving other loans for improvement of their activity is difficult.

It is possible for Latvian businessmen to attract co-financing from the EU Structural Funds for development and improvement of their activity (see Section 6.2.1), by submitting 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 continued education.

More comprehensive information on state support programmes as well as on guidelines and methodical instructions for getting the support is available on the website www.liaa.gov.lv of the Latvian Investment and Development Agency.

The *Mortgage and Land Bank of Latvia* (hereinafter MLBL) plays an important role in the SME support system. Since 2000 MLBL helps to implement the **Programme of Crediting Latvian SME Development**. The insofar implementation of the programme has essentially 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 of 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 within the framework of the EU programmes is continued in the framework of the Programme of Crediting Latvian SME Development (second phase).

Until March 31, 2005 more than 1699 new jobs were created and 97 new enterprises were established within the framework of the Programme (second phase).

Total amount of loans granted within the framework of the second phase of the SME development crediting project is 24.3 million LVL. Approximately 40% of these loans are granted from state-guaranteed credit lines (14.8 million EUR from the European Investment Bank (EIB) credit line and 3.9 million LVL from the Kreditanstalt fuer Wiederaufbau (KfW) credit line).

Special assistance loans in the framework of special programmes were granted to 273 SME for the total amount of about 10 million LVL. The great part of special assistance loans were granted to SME in regions requiring special assistance (approximately 4.1 million LVL), followed by special

assistance loans to business beginners (about 2 million LVL), female enterprises (approximately 1.8 million LVL) and rapidly growing SME (about 2.1 million LVL).

Since June 2003 the **Latvian Guarantee Agency** (LGA) has started its work. 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. In 2004 the LGA has issued 20 guarantees for the total amount of 0.66 million LVL.

Since January 1, 2004 the LGA has raised the amount of support for one project up to 50 thousand LVL. The LGA Loan Guarantee Support Programme will be used as one of the instruments for utilisation of the EU Structural Funds. The EU funds attracted in the framework of the programme in the period till 2006 will allow to issue guarantees to entrepreneurs for the amount of approximately 25 million LVL.

In 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 practical implementation of the Charter, on December 20, 2000 the European Council accepted (by Decision No. 2000/819/EC) the **fourth Multiannual Programme for Enterprise and Entrepreneurship, and in particular for Small and Medium-Sized Enterprises (for 2001-2005)**. Actually, this Programme is an action plan with the following objectives:

- to enhance the growth and competitiveness of enterprises in a knowledge-based and internationalised economy;
- to promote entrepreneurship;
- to simplify and improve the administrative and regulatory framework for business so that research, innovation and business creation can flourish;
- to improve the financial environment business, especially SME;
- to give business easier access to Community support services, programmes and networks and to improve the co-ordination of these facilities.

In that way the Programme is directly focused on solution of the principal SME development problems – inaccessibility of start-up capital to launch small and medium-sized business, lack of financial resources to expand activity of already established enterprises, lack of information for the existing and potential entrepreneurs about the EU legislation in the field of business policy, insufficient knowledge of how to express opinion and efficiently influence EU legislative initiatives in this sphere, and existence of barriers hindering business activities.

Latvia joined the European Charter for Small Enterprises by signing the Maribor Declaration on April 23, 2002. In September 2002 Latvia joined also 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 range of integrated activities were performed in Latvia within the aforementioned three lines of action, thereby effectively overcoming obstacles to development of small and medium-sized business in Latvia.

Promotion of SME policy development of the Charter's member states through various so-called BEST (Business Environment Simplification Task) and horizontal projects is to be emphasised especially. The goal of these projects is to gain, as a result of active co-operation between the European

Commission and national governing institutions, a better insight into various issues concerning business in order to identify best practices and evaluate choice of policies. Also Latvian experts from governmental and non-governmental institutions participate in the working groups of BEST and horizontal projects; there are 23 projects in total, of which 9 are completed, 3 should be recognised as actually completed, 2 are just started, and the most of them (9) will be completed this year. As a result of these projects, specific problems involving business activities are being explored and potential solutions to these problems are being weighed by comparison of the diverse experience of countries participating in the Multiannual Programme. Thus recommendations of experts involved in the projects become a significant and vitally necessary condition for high-quality development of business policy planning documents and legislative acts affecting business, and this in turn results in improvement of business environment, making it more business-friendly and achieving essential progress in development of total business activities in the country.

The website of the Ministry of Economics includes information on the Multiannual Programme and the projects within its framework, a report on Latvian experts' participation in the working groups of the projects, as well as information on the legislative base for promotion of SME development and Latvian SME support activities.

6.8. Competition Policy

Competition policy in Latvia is being shaped in a way to governmentally ensure market economy processes, protecting effectively competitive business environment. Since accession to the EU, the scale of Latvian competition policy has widened, namely, the policy includes a task to prevent obstacles to functioning of the European single market. To implement single and harmonised competition policy, in 2004 the Latvian competition legislation was harmonised in compliance with requirements of EU competition norms. In case of cross-border jeopardy of competition or for prevention of potential competition deformations, the Latvian competition protection body – the Competition Council – has started active co-operation with the European Commission and competition protection institutions of EU member states.

In 2004 the Competition Council adopted 90 decisions in total, which is more than in the previous years. The increased number of investigations in the field of competition supervision and the increased number of market surveys testify about more active competition in different markets of goods and services, and among them also in monopolistic markets previously closed for competition. Final decision was adopted in 66 investigated cases, including 12 decisions where violations of the Competition Law were established and 7 decisions where violations of the Advertising Law were established; in 47 decisions of the Competition Council, violation was not established and case was dismissed. In 10 cases the Competition Council also imposed fines on market participants for established violations of the Competition Law. In several cases of violations of the Advertising Law, legal obligation was awarded to recall the advertising. Many examinations of cases started in 2004 are continued in 2005.

Number of final decisions adopted by the Competition Council in 2004 divides in the following way by groups of violations:

- abuse of dominant position – 11 decisions, in 3 of them violation is established;
- prohibited agreements – 15 decisions, in 4 of them violation is established;
- merger of enterprises – 9 decisions, in 1 of them violation is established (notification is not submitted before merger);
- unfair competition – 19 decisions, in 4 of them violation is established;
- possible violations of the Advertising Law – 12 decisions, in 7 of them violation is established.

8 self-initiated cases on possible violations of the Competition Law were completed by the Competition Council in 2004. The Competition Council keeps track of economic situation in different markets and can initiate a case if such facts appear or there is a sound cause to consider that such facts of violation should exist. On the Competition Council's initiative, a case on possible cartel between egg producers of Latvia was initiated in 2003. In the course of examination of the case the Competition

Council concluded that, as a result of mutual agreement between egg producers, level of prices was artificially distorted and market structure was weakened because self-regulation of the market was not allowed. In this way, consumers did not benefit from mutual competition between chicken egg producers (see Box 6.11).

Box 6.11

Competition Council establishes violation (prohibited cartel agreement) in chicken egg sales market

The Competition Council, after investigation of the case which lasted more than a year, found evidence and established that, in the period between July 2002 and April 2003, a cartel agreement existed between Latvian egg producers on determination of chicken egg prices and rules of price formation, and such agreement is prohibited by the Competition Law.

The Competition Council started inspection of the egg sales market in Latvia in May 2003 after information in the press that the egg producer JSC Balticovo had decided to raise chicken egg price by one santims (0.01 LVL) for ten eggs. To prevent possibility that customers stopped buying eggs produced by Balticovo and preferred cheaper eggs produced by other companies, the biggest egg producer Balticovo, which controls about 50% of Latvian egg market, advised all members of the Latvian Egg Producers Association to raise chicken egg prices and thereby influenced chicken egg producer companies in Latvia.

During examination of this case the Competition Council conducted checks in the Latvian Egg Producers Association and several egg production enterprises. The Competition Council found evidence that, at meetings of the Latvian Egg Producers Association held in the period from July 2002 till May 2003, the procedure of determination of egg sales price was co-ordinated and egg sales prices were discussed. Almost all egg producers participated in these meetings.

In addition, the Competition Council also analysed chicken egg turnover from January 2002 till April 2003 for all egg producers. Results of the analysis testified that, in summer of 2002, the supply of chicken eggs in Latvia exceeded the demand for them and surplus of eggs arose. The mentioned results indicate that the rise in chicken egg sales prices in summer of 2002 was not economically grounded, which also implies the possible agreement, namely, co-ordination of egg producers' actual action.

The Competition Council considers that an agreement exists if parties come to a consensus or a plan which restricts or tends to restrict their commercial freedom, by determining joint conditions for action of the parties, and that every company has to determine its commercial policy independently. The mentioned requirement does not deny companies the rights to assess and anticipate actions of competitors but it strictly does not allow direct or indirect contacts between companies whose goal or consequences are co-ordination and influence over competitors' action in the market.

In the particular case the egg producers, agreeing to the joint plan to determine egg sales prices, participated in general agreement scheme which was worked out at meetings of the Latvian Egg Producers Association. Egg producers jointly planned price rise for chicken eggs with a goal to prevent risk which would inevitably arise if every company separately raised egg prices. Taking into account the evidence in this case, the Competition Council concluded that egg producers have taken part in co-ordinated actions which were aimed at prevention, restriction or distortion of competition in the territory of Latvia.

The Competition Council established that LLC "Co Priedes" in the period from July 2002 till the end of August 2002 and JSC Balticovo, LLC "Daugavpils putni", JSC Madona, LLC "Mārupes lauksaimniecības centrs", LLC Nīckrasti, LLC "Ogres putni", LLC Palsa, farm "Sebri", LLC "Sidgunda 2" and LLC Vistako in the period from July 2002 till the end of August 2002 and in the period from March 2003 till the beginning of April 2003 have been involved in a violation – prohibited agreement on determination of prices and rules of price formation. The violation of the Competition Law manifested itself in a co-ordinated action of the mentioned market participants and in exchange of information between these companies, concerning prices and sales rules in the chicken egg sales market.

The Competition Council imposed fines on participants of the agreement in the total amount of 45 452 LVL, including the biggest fine of 26 729 LVL which was imposed on JSC Balticovo. The fines are to be transferred to the state budget.

The full text of the Decision No. 88 adopted by the Competition Council on December 20, 2004 is published on the Competition Council's website www.competition.lv.

In 2004 the Competition Council has provided its conclusion or opinion on 41 complaints or has forwarded submitted complaint to other competent institution. In 2004 the Competition Council also prepared several conclusions on mergers, not issuing a decision, because it was easy to establish that, as a result of the mergers, dominant position will not arise or strengthen and competition in the particular market will not be essentially decreased. The most substantial merger in the Latvian market was the constitution of the joint venture of "ICA Baltic AB" and "Kesko Food Ltd."; as a result of this merger, Latvian companies LLC "Rimi Latvija" and LLC "Kesko Food" which are owned by the aforementioned companies became a single participator in the market. As the constitution of the mentioned joint venture concerned several EU countries, a decision on this concentration was made by the European Commission.

The EU Council Regulation No. 1/2003 endows competition protection bodies of all member states with rights to examine cases and apply penalties for violations of Articles 81 and 82 of the Treaty establishing the European Community. Article 81 of the Treaty prescribes prohibition of agreements restricting competition and conditions on which these agreements would be exempted from the prohibition, while Article 82 prescribes prohibition of abuse of a dominant position. In 2004, two cases

on possible violations of EU competition law were initiated by the Competition Council. Although it is too early to judge the results of decentralised application of EU competition law, it is clear that application of EU competition law requires profound knowledge and understanding of EU competition law as well as constant keeping track of topicalities of the EU competition policy and law. It has to be noted that, in investigation of cases on violations of the EC Treaty, the national competition body has to apply procedural legislation of the respective member state. Fixation of penalties for violations also takes place on basis of the member state's national law. The European Commission takes over examination of cases if a violation spans more than three member states and in instances where examination of cases is related to new interpretation of EU competition law or where examination of case at the Commission's level may promote effectiveness of investigation of violations.

In 2004 specification of the body's internal and external normative acts took place in order to ensure clear and unambiguous procedures of investigative actions for implementation of rights envisaged in the Competition Law. Special attention is being paid to analysis of judicial practice in competition cases (see Box 6.12).

Box 6.12

The Senate of the Supreme Court acknowledges the Competition Council's decision, by which a fine was imposed on enterprise for violations of an abuse of dominant position, as well-founded

On March 22, 2005 the Senate of the Supreme Court kept in force a court verdict on Competition Council's decision, by which a fine was imposed on JSC Latfood for established violations of the Competition Law by restricting action of other traders in potato chip trade.

In 1999 after a claim of LLC Transko the Competition Council started investigation in chip market. In the course of this investigation it was established that JSC Latfood is in a dominant position in the potato chips sales market of Latvia.

Analysing contracts concluded by JSC Latfood with retailers and wholesalers, the Competition Council came to a conclusion that, in accordance with terms of these treaties, traders undertook to accept products for sales from a limited number of producers or suppliers as well as to ensure certain placing of JSC Latfood chips on store shelves. This placing was determined within 50 to 100% of space envisaged for chips in retail trade and within 20 to 100% of respective place in wholesale trade. JSC Latfood applied loyalty discounts to traders for observance of the mentioned rules. In this way JSC Latfood actually restricted opportunities of other market participants to sell their goods in commercial networks of Latvia and narrowed assortment of chip supply to customers' disadvantage.

The Competition Council acknowledged that JSC Latfood, by abusing its dominant position in the market, performed actions which created serious obstacles to fair competition. Stimulation of traders by granting loyalty discount decreased competition between trademarks of chips.

On November 14, 2001 the Competition Council fined JSC Latfood for abuse of a dominant position. The fine was set in amount of 0.1% of the enterprise's net turnover in 2000 – 3462.5 LVL.

JSC Latfood appealed against the decision but the court of final instance acknowledged that decision of the Competition Council is well-founded and is not reversible.

The decision of the Senate of the Supreme Court strengthens the practice of what conditions of a contract are considered restrictive in the sense of the Competition Law. Being in a dominant position imposes additional limitations and responsibility on enterprise in conclusion of contracts with traders, so that actions of this enterprise meet requirements set in the Competition Law and accordingly do not restrict and do not distort competition to consumer's disadvantage.

After liberalisation of telecommunications or electronic communications market was started in January 2003, domination of the historical monopolist LLC "Lattelekom SIA" in the market continues. Action of the LLC "Lattelekom SIA", by setting relatively high interconnection tariffs for its competitors in voice telephony services market in public fixed electronic communications network, is still an open issue. The Competition Council assessed claim of several operators and Telecommunications Association of Latvia on the mentioned tariffs but adopted decision to dismiss the case because the Council did not see its competence where the law prescribes competence of the Public Utilities Commission (see Section 6.9). The regulator's competence to determine the dispute settlement procedure, to interfere in disputes on interconnection tariffs and to set the upper limit of these tariffs if operator with significant influence cannot substantiate its proposed tariff is prescribed in the new Law on Electronic Communications which regulates the sector, and this competence indicates the decisive role of the Public Utilities Commission in solution of these issues.

Promotion of competition by liberalising markets of gas, electricity, railway and air transport sectors are activities of EU scale, and they fully concern Latvia as well. Energy sector, transport, communications, waste management, sales of food products and oil products, public procurements are risk sectors which are subjected and will be subjected to heightened supervision. In this regard, the necessity to get support from society for successful implementation of competition policy and to promote society's awareness of legal and economic aspects of competition has been explored.

Among the most important tasks in 2005 the Competition Council has determined the crackdown on the heaviest violations of competition law, which cause losses to wide circles of society, identification of risk sectors, and assessment of main economic indicators in sectors where possibilities of competition law violations exist, especially marking out markets with inflexible supply. Intensive surveillance of several particular markets will be performed, where threats related to the possible exchange of information concerning prices or sales conditions exist.

In parallel with surveillance of markets and investigation of cases, the Competition Council will continue to give opinions, in the context of competition protection and development, on draft normative acts which are forwarded to the Cabinet of Ministers and the Saeima for consideration. In order to not allow a possibility of competition distortion already on the level of normative acts development, active co-operation with the public sector will be carried out, analysing documents under development in state and local government institutions, support measures to be organised, and other activities.

In 2005 the regional and international co-operation with competition protection bodies of EU and CIS member states successfully started by the Competition Council will be developed, and participation in the Organisation of Economic Co-operation and Development (OECD) activities in competition policy sphere will be continued in order to form “good practice” in making use of various investigation techniques and implementation of legislative norms.

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. The first-tier regulator, the Public Utilities Commission (hereinafter the Commission), regulates public utilities at state level, while the second-tier regulatory institutions, 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 supply of heat (except combined heat and power). It has to be noted that the Commission does not supervise 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. Its task is to ensure to all users the possibility to receive uninterrupted and safe public utilities 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, only a court may declare decisions taken by the Commission substantively unlawful and repeal them. The activities of the Commission are financed from the duty paid by enterprises on the basis of the annual net turnover of regulated public utilities.

The Commission performs the following functions:

- protects the interests of users and promotes the development of providers of public utilities;
- promotes competition in regulated sectors;
- issues licenses, registers authorisations and supervises compliance with their conditions;
- supervises compliance of the public utilities with specified quality and environmental protection requirements, technical specifications, standards;
- determines tariff calculation methodologies;
- sets service tariffs;
- carries out extra-judicial dispute settlement.

The unified multi-sector public utilities regulation model has shown its advantages in Latvian situation, and such model has to be improved further in interests of both the users and providers of public utilities. For implementation of regulation unity principle, all regulation functions are to be included in unified regulation process, and the current fragmentation (even duplication) in implementation of regulation functions between ministries, regulators and other state institutions has to be eliminated.

Sufficiently high self-dependence and independence level of the unified regulator has to be strengthened in Latvian legal system.

The situation and policies in the regulated sectors

Energy sector

Since July 1, 2004 all electricity users, with the exception of households, have the opportunity to choose alternative suppliers of electricity. However, practically none eligible consumer has changed his supplier of electricity. To activate competition and promote alternative suppliers' entry into market, separation of electricity transmission networks and establishment of independent transmission operator is necessary. For attainment of these goals, the Commission works to prepare licence of independent transmission operator. At the same time, specialists of the Commission were involved in preparation of amendments to the Energy Law and development of the Electricity Market Law, in order to implement EU directives for embodiment of the electricity market.

In February 2005 the Commission approved the heat production tariff of LLC "Dobeles siltums" co-generation plant in amount of 8.06 LVL/MWh. The approved tariff is the lowest heat production tariff of co-generation plants at the moment. Assessing factors which influence heat production tariffs of co-generation plants and comparing situation in several towns, the specialists of the Commission noted that the load of co-generation equipment is essential. These load indicators in Dobeles are optimally chosen thereby obtaining low tariff for thermal energy. Indicators of co-generation plant in Saldus are similar. Yet in several towns heat production tariffs are even 70% higher. If a co-generation plant with excessive capacity is installed, the investment required for construction of the plant is included in the tariff, raising the price of heat. To protect consumer interests and encourage development of such co-generation plants which operate at optimal load and increase efficiency of fuel use, at the beginning of 2005 amendments were prepared in the "Tariff Calculation Methodology for Heat Energy Generated in Combined Heat and Power Plants (CHPs) and for Electricity Generated by CHPs with Capacity above 4 Megawatts".

In view of the rise in oil and oil product prices in the world, the natural gas price charged by suppliers has increased in Latvia. Thereby the JSC "Latvijas Gāze" has approached the Commission with the request to raise end-user tariffs for natural gas. In the 1st half of 2005 the Commission examines proposals for tariff changes in 2005-2007. The Commission assesses commensurability of these proposals, striving to balance interests of consumers and provider of public utility.

Electronic communications and post

The Electronic Communications Law was adopted by the Saeima on October 28, 2004 and came into force as of December 1, 2004. According to this law, the Commission has to work out almost 40 secondary normative acts (regulations, procedures, methodologies) by June 1, 2005. A public hearing is held on every significant draft regulation, and market participants actively seize the chance to participate in discussion of documents. In this way the quality of documents to be developed improves and market participants timely prepare for introduction of new requirements. In the first months of 2005 a great part of the normative acts to be worked out has already been discussed and approved, hereby it will be possible to meet the deadlines stipulated by the law for development of normative acts.

At the end of 2004 the Commission's board adopted a decision to set the upper limit on tariffs for interconnection services provided by LLC "Lattelekom" at 0.8 santims per minute. The set upper limit on tariffs for interconnection services would enable other operators to offer alternative services to customers of Lattelekom, and this would motivate Lattelekom to reduce its tariffs for end-consumers. Lattelekom regarded this decision of the Commission as an illegitimate one and asked the Administrative District Court to repeal this decision. On January 27, 2005 the Administrative District Court decided to suspend the decision of the Commission until retrial of the case on its merits and announcement of the final decision of the court.

In March 2005 the Commission published the summarised results of electronic communications quality tests performed in 2004. It was established that a great number of new market participants, which declare targets for quality of provided public utilities themselves, have not been able to ensure quality corresponding to the targets. This is attributed to overoptimistically set quality targets as well as technical limitations on reaching the planned connection times or meeting line instalment schedules. Analysis of measurements of Lattelekom service quality in administrative districts of Latvia shows that the quality of these services tends to equalise between districts. In several districts where service quality

indicators in the previous report year were low a rapid improvement of the quality is observed, which indicates the contribution of the company in the development of its network. However, in some administrative districts of Latvia the quality of payphone services is considerably lower than the average. Quality indicators of Lattelekom information operator service have slightly declined in comparison with the preceding report years, which is attributed to discrepancy between the number of jobs and the load. Full text of the quality report is available in the Commission's homepage www.sprk.gov.lv.

Due to rapid increase in number of users in public mobile electronic communications networks, the numbering resources allocated to mobile communications in the existing numbering plan are practically exhausted. Thereby a solution for further expansion or restructuring of numbering resources must be found in the nearest future so that the market development is not hindered. As introduction of a new numbering scheme implies additional expenses for businesses and public institutions, a decision on transition to the new numbering scheme has to be made by the Cabinet of Ministers. Efficiency of resource use can be promoted by charging a fee for resource use, which is envisaged in the Guidelines for Electronic Communications Sector of the Republic of Latvia for 2004-2008. At the same time, charging a fee for resource use is to be evaluated comprehensively and thoroughly because it must not cause rise in tariffs for service users or hinder starting new businesses and further development of the sector.

Railway

Due to the wish of the JSC "Pasazieru vilciens" to raise fares, in January 2005 the Commission prepared the assessment of the situation in domestic passenger transportation by railway. It was established that amendments to the Railway Law in the 1st half of 2004 and implementation of requirements of EU directives have led to increase in railway infrastructure costs for passenger carriers, lowering profitability of transportation. However, after these changes the usefulness of maintaining the existing network of routes has not been reassessed. Although the JSC "Pasazieru vilciens" receives subsidies from the state budget, the total amount of revenue is insufficient for improvement of quality of services and renewal of the rolling stock. As infrastructure costs rose, prices for fuel and other materials have gone up as well, while electricity tariffs for railway decreased in 2004 and as of January 1, 2005 a reduced VAT rate is applied to passenger transportation.

The Commission points out in its assessment that the fare increase planned by the JSC "Pasazieru vilciens" would be insufficient for solution of problems related to passenger transportation by railway. The Commission urged the responsible ministries to evaluate if it would be more useful to channel the existing subsidies to assistance for other types of transportation in order to improve the accessibility of public transport and quality of services without worsening the situation of passengers. Using the assessment made by the Commission and taking other considerations into account, the Minister of Transport and Communications cancelled the fare increase planned by the JSC "Pasazieru vilciens".

Due to amendments made to the Railway Law in 2004, the Commission has to determine the public railway infrastructure usage charge. The Commission developed methodology for calculation of infrastructure usage charge and in September 2004 accepted this methodology. In March 2005 the data required for calculation of the charge were received from the state JSC "Latvijas dzelzceļš", meetings with carriers and sector representatives were held and a public hearing took place. As a result, on April 1, 2005 the decision was made to set the charge for the state JSC "Latvijas dzelzceļš" public railway infrastructure usage for transportation for the train traffic schedule in 2005-2006.

6.10. Export Promotion

The main problems in export at present are the following:

- faster increase in export volumes is limited by lack of skilled labour force (technologists, engineers) in production; there is a lack of skilled marketing specialists in manufacturing enterprises; knowledge of foreign language is insufficient; information on significance of production in development of national economy is necessary in Latvia;

- Latvian enterprises are insufficiently informed on creation and development of innovative products and on opportunities of co-operation with scientific potential of Latvia;
- products of low added value form a large share in the total Latvian exports;
- Latvian enterprises lack experience and knowledge of how to create and sell their brand and product to end consumer;
- export-capable enterprises are already producing almost within the limits of their capacity but are not able to raise production volumes due to lack of current assets;
- Latvia as producing and export-capable country is still little recognisable outside the Baltic Sea region;
- the majority of Latvian enterprises are too small in the international market and therefore unable to apply for significant orders. Mutual co-operation of Latvian enterprises is weak because, while maintaining a wide assortment of goods, production volume has decreased and functions not being the basic activity of the enterprise (such as logistics) are performed. Supplies of manufacturing enterprises may be characterised in a similar way, as they are small by volume and fragmented;
- transport infrastructure and logistical services deteriorate with increase in distance to main ports of Latvia, thereby unbalanced regional development takes shape.

As the mentioned problems embrace wide range of issues and are closely connected with implementation of industrial and entrepreneurship policy and development of transport sector and infrastructure, they have to be solved in an integrated way in order to ensure the rise of competitiveness of Latvia on the whole and the achievement of goals defined in the Long-Term Economic Strategy of Latvia.

Objectives and main tasks of export promotion policy and the results to be achieved are determined by the **Latvian Export Promotion Programme (2005-2009) (LEPP)**.

Objective of LEPP is to actively promote international competitiveness of Latvian enterprises and to foster entry into new markets and consolidation in the existing ones. Achievement of this objective is planned, implementing the following main tasks of the programme:

- strengthen operation of export-promoting institutions both by legal and financial aspects as well as ensure harmonisation of their operation and co-operation with non-governmental organisations and enterprises;
- promote regional and global competitiveness of Latvian enterprises;
- provide enterprises with high-quality information and financial assistance for implementation of external marketing activities, market research and participation in international exhibitions and fairs as well as trade missions;
- actively and effectively use opportunities provided by international treaties of Latvia, promoting entry into new markets and diversification of exports;
- ensure training of specialists of Latvian enterprises in international trade practice, especially in development and implementation of external marketing strategy of an enterprise.

To supervise implementation of LEPP, the **Export Promotion Council** chaired by the Minister of Economics was established by the Cabinet of Ministers' Instruction No. 213 of April 6, 2005. The Council contains representatives of public institutions and sectoral associations as well as social partners. During the Council's meeting on April 28, 2005, work plan of LEPP for 2005 was approved and discussions were held on priorities and necessary measures for promotion of international competitiveness of Latvian enterprises and fostering of export. To provide assistance to Latvian enterprises in fostering of export, LEPP envisages several measures and the main lines of action are:

- development of institutional base for export promotion;
- promotion of international competitiveness of Latvian enterprises and development of export capability;
- support in export marketing and entry into new markets.

Tieback to **Development Concept of Foreign Economic Representative Offices of Latvia** is essential for LEPP; implementation of the Concept substantially contributes to strengthening of competitiveness of Latvian entrepreneurs in the global market, especially in the EU internal market. With establishment of network of foreign economic representative offices abroad and consolidation of LIDA as its support institution in Latvia, Latvian entrepreneurs are provided with help and services

similar to those received by their competitors and partners in EU member states. International trade, including export, is a significant part of the Lisbon strategy; without this state support infrastructure, Latvian entrepreneurs would not be able to implement goals and requirements defined in the Lisbon strategy.

At present, nine foreign economic representative offices of Latvia operate actively (in Germany, United Kingdom, Sweden, France, Russia, Kazakhstan, the Netherlands, Norway and Denmark). It is planned to open a representative office in the US in the second half of 2005.

Representative offices constitute an important instrument for export promotion and attraction of foreign investments, therefore it is essential to ensure expansion and development of the network of these offices. In 2005 it is envisaged to strengthen capacity of representative offices, ensuring 2 employees in the offices with the most intensive flow of investment/export demands and supplies and the biggest amount of work (United Kingdom, Germany, France, Russia, Sweden).

Operation of representative offices takes place in three main directions: identification and channelling of potential investment and export projects, services for Latvian enterprises, distribution of information to foreign companies on the economical situation and business environment of Latvia.

The Ministry of Economics and the Latvian Investment and Development Agency (LIDA) also plan to organise two forums for Latvian entrepreneurs with leaders of representative offices in this year; in the framework of these forums the enterprises will be acquainted with opportunities for co-operation with the respective countries, and individual meetings with leaders of representative offices will also take place. In the framework of the forum which took place in 2004, representatives of more than 170 enterprises participated in contact exchange.

External marketing is one of the main export promotion instruments. The Ministry of Economics in co-operation with LIDA and other institutions carries out several external marketing measures.

Box 6.13

Project “House” of the festival “Astonishing Latvia” in France on October 20-December 10, 2005

The festival “Astonishing Latvia” (“Etonnante Lettonie”) is an event initiated by the President of Latvia Vaira Vīķe-Freiberga and the President of France Jacques Chirac with a goal to boost the recognisability of the image of Latvia in France and to promote positive long-term co-operation in politics, economics and entrepreneurship, tourism, culture and other fields.

Concept “Speaking stones” of the project “House” implemented by the Ministry of Economics and LIDA is the most significant component of the festival. “Speaking stones”, made from 12 personified and interactive boulders, is a travelling object which will be placed in the central squares of four major cities of France (Paris, Strasbourg, Bordeaux, Lyons), ensuring a campaign of Latvia’s image and the economic promotion in the French market. The economic dimension of the project includes activities for promotion of economic co-operation on state, institutional and individual levels, attraction of interest of potential investors and entrepreneurs, exploration of France as an export target market for Latvia and advancement of Latvian entrepreneurs in this market, and attraction of potential tourists. Business seminars, sectoral presentations (woodworking, textile, information technologies, etc.), mutual meetings of Latvian and French entrepreneurs, and a tourism promotion campaign are planned during the implementation of this project.

Foreign visits of state officials with participation of Latvian business delegations are also an effective way of external marketing. Within such visits, high-quality business programmes of the highest level are prepared and provided for enterprises. In 2005, visits to the Netherlands, France, Switzerland, Norway, US, Sweden, Turkey, Germany, the United Kingdom, Italy, Uzbekistan and other countries are envisaged.

In parallel to the mentioned activities, the participation of Latvian enterprises at LIDA stands in several international exhibitions which play a leading role in the respective sector, as well as trade missions of Latvian enterprises abroad with individual business programme prepared for each entrepreneur within these missions are also planned this year. It is planned to expand the range of consultations given by LIDA to Latvian enterprises in 2005, ensuring selection of business partners from LIDA databases, search of business partners, information on external markets, and consultations in the external marketing.

To ensure information for foreign companies on Latvian sectors and the leading enterprises, it is foreseen to issue marketing brochures in such sectors as food industry, mechanical engineering, production of structures of horizontal beams, electronics, textile industry, chemistry and pharmacy.

6.11. Protection of Consumer Interests and Market Surveillance

The system of consumer rights protection in Latvia has gradually become stronger and more developed during the last years. Regular drafting and acceptance of normative documents regulating rights and duties as well as relations between consumers and producers, sellers, service providers and other stakeholders is an on-going process. Regulatory documents stipulating requirements for goods and services, and procedures of labelling are being developed. At the same time, a lot of efforts are focussed on the institutional capacity building to ensure adequate market surveillance and supervision of consumer rights protection.

In October 2004 the Cabinet of Ministers approved the Basic Guidelines of Consumer Rights Protection Policy, which define basic principles of consumer policy, goals and main courses of action to ensure high-level consumer rights protection.

The main basic principles of consumer rights protection policy in Latvia are:

- 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 participating 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 involving the society in solution of consumer rights protection issues.

It is envisaged to achieve this through attainment of the following sub-goals of consumer rights protection policy are:

- 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 consumers' and entrepreneurs' knowledge about consumer rights;
- to ensure effective solution of conflict situations concerning consumers;
- to increase the role of public organisations of consumer rights protection.

The Basic Guidelines have been developed according to the European Commission's Consumer Policy Strategy for 2003-2006. To implement these guidelines, draft regulations of the Cabinet of Ministers and draft Consumer Rights Protection Programme for 2005-2007 have been developed and submitted to the Cabinet of Ministers, and the programme will be developed also for 2008-2010.

The draft Consumer Rights Protection Programme for 2005-2007 envisages the following lines of action:

- improvement of normative base for consumer rights protection;
- creation of favourable business environment by carrying out adequate and efficient market surveillance and supervision of observance 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 September 2004 in Iceland, ministers of Nordic and Baltic states adopted declaration on co-operation in consumer rights protection. This declaration acknowledges the successful co-operation of the previous years in various consumer protection issues and announces the purpose to continue and develop this co-operation in the following issues:

- working out the normative acts (to exchange information in development and implementation of EU directives);

- supervision of compliance with the normative acts;
- activities and measures which take place in accordance with the European Commission's Consumer Programme;
- general policy issues and national action plans (consumer policy, co-operation with social partners, preparation of national action plans and other policy documents);
- link with other policies (role of competition law and policy in the consumer policy);
- examination of complaints (private and public institutions for extra-judicial solution of complaints, other facilitated mechanisms for solution of problems).

Normative base in the area of consumer rights protection in Latvia is established in conformity with requirements of the European Union and leading principles of the United Nations for consumer protection. As consumer rights protection directives of the European Union are mostly minimal harmonisation directives, consumer rights protection requirements prescribed in many spheres in Latvia ensure higher protection level than in several EU member countries.

At the end of 2004, the Cabinet of Ministers adopted Regulations on Distance Agreement on Provision of Financial Services, which determine additional conditions for consumer protection in conclusion of distance agreements on financial services – information to be included in the distance agreement and to be supplied to consumer before conclusion of the distance agreement on provision of financial services, term and procedure for fulfilment of rejection rights, and other conditions for implementation of distance agreement on provision of financial services.

To improve information for consumers about presence of such food products that contain allergenic substances and substances which can cause hyperaesthesia, and enable consumer to avoid acquisition and consumption of foodstuffs harmful to his health, at the end of 2004 the Cabinet of Ministers adopted Regulations Regarding Labelling of Food Products. This strengthens consumer confidence in food product safety and quality, which in turn favourably affects the business environment in Latvia.

After Latvia joined the European Union, the Ministry of Economics has engaged in drafting several EU laws and regulations in the area of consumer rights protection.

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). The 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 consumers' economic interests. Competent authorities of member states are provided with rights to demand that the competent authority of the member state where a violation of consumer rights may have been occurred percent 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 country has committed a violation in other country. The regulation will come fully into effect in 2006.

Draft directive of the European Parliament and the Council on unfair commercial practices against consumers in the internal market is being developed. The draft 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.

The **Consumer Rights Protection Centre** (hereinafter the Centre) under supervision of the Ministry of Economics is the main responsible co-ordinating institution that supervises observance of the consumer rights protection legislation. The Centre reviews applications and complaints of consumers about non-compliance of purchased goods or services with agreement terms, grants practical aid to consumers in the event of solving conflict situations, protects consumer rights in legal proceedings, represents interests of consumers in the process of drafting laws and regulations, 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. The Centre is actively engaged in providing information to consumers, preparing and disseminating reminders on consumer rights protection issues, delivering lectures to students of comprehensive schools and placing

publications in regional press on these issues. Information in the Centre's homepage www.ptac.lv is regularly updated as well as in the homepage www.pateretaja-celvedis.lv of non-governmental organisations of consumer protection. These homepages contain information on the effective consumer rights protection legislation, various goods and services, and opportunities to protect legal rights of a consumer.

To provide consumers an opportunity to get information on consumer rights issues and solution of problem situations in cases when a commodity or service is purchased in some EU member country, it is envisaged to establish European Consumer Information Centre at the Centre with goals to:

- provide information about legislation and legal practice of EU member countries;
- give adequate informative aid to start solving conflict situations between individuals;
- provide information about judicial procedures and possibilities to take legal proceedings;
- co-ordinate possibilities of settling consumer disputes out of court;
- create opportunity for consumers to settle cross-border disputes rapidly and effectively, especially in cases where practical problems arise, e.g., providing translation;
- follow assessment of consumer complaints so that the assessment is done in accordance with the established out-of-court procedures.

To ensure that only safe goods corresponding to 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 correspond to requirements of normative acts are available in the market;
- goods are marked and tested in accordance with established procedure;
- goods are accompanied by the necessary technical documentation.

At the same time the market surveillance includes also actions taken by a market surveillance authority against a producer, seller or importer in case where their goods do not comply with the set requirements, and certain measures to prevent presence of non-complying goods in the market.

In November 2004 the statute of the Market Surveillance Council was approved, which determines functions and rights of the council and procedure of convening and running the council's meetings. The statute endows the council with broad functions in market surveillance co-ordination in order to ensure exchange of information and opinions between market surveillance authorities and to promote uniform approach to market surveillance in all institutions.

In February 2005 the Cabinet of Ministers adopted regulations "Procedures by which Market Supervision Institutions Request and Receive Samples of Products, and Handle them after Performance of Laboratory or Other Types of Expert-Examination". These regulations prescribe the procedures by which market supervision institutions shall request and receive samples of products, as well as by which they shall handle them after performance of laboratory or other type of expert-examination.

In the nearest future the Market Surveillance Strategy will be developed in order to create safe environment for consumers and to promote fair competition between businesses by carrying out adequate market surveillance.

It is planned to develop Cabinet of Ministers regulations in accordance with the guidelines adopted by the European Commission on the procedure by which other market surveillance institutions inform the Consumer Rights Protection Centre about the performed measures which restrict or prohibit putting goods into circulation, and on the procedure by which the Consumer Rights Protection Centre sends the received information to the European Commission and handles information received from the European Commission, and Cabinet of Ministers regulations on the procedure by which a producer, distributor or service provider informs state supervision and control institutions about goods or services which create risk non-compliant with general safety requirements.

In 2004 the Centre carried out 4223 inspection visits to trade and service companies (sites), provided 3791 consultations to entrepreneurs and 20 192 consultations to consumers, reviewed 1636 cases of administrative offences in the area of consumer rights protection and 943 applications and complaints of consumers. During that period of time 1166 inquiries on potential experts for examination of goods and services were made. As a result of this review, consumers got refunds of money paid for goods or services that do not comply with the agreement; total refunded money amounted to 130 862 LVL.

In the framework of legal assistance to consumers 189 consultations were provided and 18 decisions to fulfil legitimate demands of consumers were taken. Carrying out the supervision of advertising, 8640 advertisements were assessed.

In the first 3 months of 2005 the Centre carried out 1005 inspection visits to trade and service companies (sites), provided 498 consultations to entrepreneurs and 4706 consultations to consumers, reviewed 262 cases of administrative offences in the area of consumer rights protection and 246 applications and complaints of consumers. During that period of time 348 inquiries on potential experts for examination of goods and services were made. As a result of this review, consumers got refunds of money paid for goods or services that do not comply with the agreement; total refunded money amounted to 26 431 LVL.

In the framework of legal assistance to consumers 33 consultations were provided and 9 decisions to fulfil legitimate demands of consumers were taken. Carrying out the supervision of advertising, 2680 advertisements were assessed.

International co-operation plays an important role in consumer rights protection. The Centre participates in the Rapid Information Exchange System (RAPEX) that operates between EU countries. From this system the Centre receives information on dangerous goods sold in other EU countries. On grounds of this information, strengthened control procedures are carried out, and this information is released to consumers by mass media.

PHARE 2002 project “Market surveillance in non-food area” of EU is being implemented in Latvia. This project is generally aimed at achieving free movement of goods in non-food area (except medical goods) in order to notably strengthen capacity of market surveillance authorities in all areas except ones related to food, pharmaceutical products and medical goods.

In the framework of the 3rd component “Supply contract” of the project, technical equipment for market surveillance institutions is being purchased.

As a result of the project, the market surveillance system will be strengthened on a whole and high consumer protection in the area of non-food products in Latvia will be ensured accordingly.

Box 6.14

PHARE 2002 project “Market surveillance in non-food area” of EU

The project consists of three components – twinning agreement, service contract and supply contract. The 1st component “Twinning agreement” was finished at the end of March 2005, and during implementation of this project a profound analysis of market surveillance system existing in Latvian institutions was done and the following suggestions were made:

- it is necessary to strengthen role of the market surveillance council;
- it is necessary to establish effective system of information exchange between market surveillance authorities (L-RAPEX);
- it is necessary to change the risk assessment system according to which the market surveillance is implemented;
- professional training in specific areas has to be ensured for employees of market surveillance authorities;
- more funds have to be allocated for sampling and testing of goods;
- closer co-operation with businesses and representatives of non-governmental organisations is necessary.

Implementation of the 2nd component “Service contract” was started in September 2004; within this implementation, fulfilment of the following tasks is envisaged:

- to create information exchange system between market surveillance authorities;
- to establish database system at the Consumer Rights Protection Centre and the State Sanitary Inspectorate;
- to set up a quality management system at the Consumer Rights Protection Centre;
- to inform consumers and entrepreneurs on issues related to market surveillance;
- to provide professional training for employees of market surveillance authorities on issues related to market surveillance.

6.12. Quality Assurance

6.12.1. Quality Structural Policy

The main task in the area of quality assurance includes promoting application of the requirements of legal acts in the regulated and non-regulated scope as well as improving the legislative basis, hence ensuring compliance of products and services in the market with national and EU requirements and encouraging increased competitiveness of entrepreneurs.

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 the regulations of the Cabinet of Ministers resulting from these laws.

The main directions of the policy are:

- The improvement of infrastructure of conformity assessment (including testing and calibration laboratories, inspection and certification institutions, environmental verifiers) in accordance with Latvian national economy needs in order to protect consumers and environment from low-quality products and services, to promote growth competitiveness of entrepreneurs and reliability of products and services provided by Latvian entrepreneurs;
- The improvement of informative and consultative base in order to inform inhabitants of Latvia on the newest national and EU the requirements of legal acts;
- The participation of national institutions of accreditation, standardisation and metrology in international organisations, ensuring their international recognition and compliance of Latvian quality assurance system with international requirements;
- The maintenance and international comparison of the national base of standards in order to ensure the necessary traceability of measurements and to protect the society from inaccurately conducted measurements;
- The promotion of 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 foreign markets;
- The improvement of market surveillance system in order to provide equal conditions for all market participators and to protect consumers from actions performed within unfair competition among entrepreneurs.

Taking into account that introduction and maintenance of quality management system in a company substantially improves its operation and thereby improves quality of the manufactured products or provided services, in the 1st quarter of 2005 the number of companies where quality management systems were introduced has grown rapidly from 466 companies on November 1, 2004 to 557 companies on April 1, 2005.

To foster development of Latvian national economy, the following activities have been carried out in the 1st quarter of 2005:

- regulations on 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”;
- regulations on national accreditation, standardisation and metrology councils have been drafted and approved by the Cabinet of Ministers in compliance with requirements of the State Administration Structure Law;
- publication of Latvian conformity assessment institutions in “Latvijas Vēstnesis” official gazette and their notification to the European Commission and EU member countries as well as publication of EU conformity assessment institutions in “Latvijas Vēstnesis” in accordance with requirements of the Law “On Conformity Assessment” were ensured;
- adaptation of standards regulating conformity assessment areas with a translation method in Latvian was ensured;
- supervision of measuring instruments offered in regulated sphere in the market in accordance with requirements set in normative acts was ensured;
- participation of national accreditation, standardisation and metrology institutions in working groups and conferences of international organisations was ensured in order to shape unified conformity assessment policy in all European Union, including protection of Latvian interests.

To improve legislative, informative and consultative base as well as infrastructure of conformity assessment system, it is planned to carry out the following activities in 2005:

- draft regulations in area of metrology in order to fully harmonise national requirements with EU requirements thereby aligning the judicial environment of entrepreneurship;

- work out a manual on establishment and maintenance of metrological systems for entrepreneurs about requirements for measuring instruments subject to state metrological control;
- inform the society on a regular basis about topicalities in area of quality assurance in order to deepen society's understanding of quality assurance issues;
- organise annual international quality conference and Latvian Quality Award 2005 in co-operation with Latvian Association for Quality in order to popularise quality assurance as a way for raising the business competitiveness.

6.11.2. Standardisation, Metrology, Accreditation

Standardisation. The national standardisation institution in Latvia is the limited liability company “Latvijas standarts” (LVS) with a task to manage and co-ordinate standardisation activities. This company provides Latvian national economy with information of standardisation.

The main functions of LVS are as follows:

- set up the national fund of standards by organising development of Latvian national standards and adaptation of international and regional standards at the status of national standards;
- issue and publish Latvian national standards, maintain the informative basis of standardisation documents and distribute information of standardisation;
- co-operate with international and European standardisation organisations ISO, IEC, CEN and CENELEC.

To develop national standards and adapt international and regional standards at the status of Latvian national standards, 42 technical committees of standardisation have been set up in various sectors of national economy. All parties concerned with standardisation take part in the working of these committees. Producers, users, organisations of protection of consumer interests, certification, testing, accreditation, control and supervision, and other parties related to use of standards are considered the concerned parties.

15 257 standards have been registered as national standards as on April 1, 2005. 628 European standards and 11 international standards were adapted during the first 3 months of 2005. Standardisation information services were provided to 2153 legal and private persons in the reported period.

Metrology. The limited liability company “Latvijas Nacionālais metroloģijas centrs” (LNMC) is the national metrology institution which ensures uniformity of measurements in Latvia and international traceability and recognition of measurements conducted in the country, in this way encouraging international trade and confidence in conformity assessment of goods carried out in Latvia and excluding necessity of repeated conformity assessment procedures.

The main objective of the company is to promote alignment of Latvian national metrology system in compliance with the practice established in the European Union and in keeping with needs of Latvian national economy.

The key tasks of the company are:

- to maintain national measurement standards at appropriate level;
- to provide metrological services corresponding to Latvian interests of national economy (calibration and verification of measuring instruments);
- to ensure mutual recognition of issued certificates.

On February 14, 2005 the compliance of the quality system of LNMC as Latvian national metrology institution with requirements of LVS EN ISO/IEC 17025 standard was presented at the EUROMET Quality System forum in Romania.

During the first 3 months of 2005 the measurement capacity of LNMC was increased in order to raise credibility of measurements and widen the range of services. Activities of laboratories to ensure international recognition of calibration and measuring capabilities (CMC) are continuing. The CMC of LNMC's Geometric Research Laboratory has been included in the BIPM database for the first time. Active participation in working groups of the European Co-operation in Legal Metrology (WELMEC) takes place in the area of legally regulated metrology.

117 204 measuring instruments were checked in the 1st quarter of 2005, including 112 543 instruments verified and 4661 calibrated.

The State metrological supervision. The state metrological supervision in Latvia is carried out by the State Metrological Inspection (SMI). It is a direct administration body under authority of the Ministry of Economics and operates according to the Regulations No. 174 “Statute of the State Metrological Inspection” adopted by the Cabinet of Ministers on March 8, 2005.

The aim of the Inspection is to ensure accuracy and credibility of measurements in scope affecting human life and health, environmental health and safety as well as consumer rights protection. As Latvia became a full-fledged member of the European Union, the control of pre-packed goods has become a pressing issue. Latvia as an EU member state has to guarantee that the actual content of the package of CE-marked goods produced in Latvia conforms to requirements of the respective EU directives and national normative acts related to these directives. Achievement of this goal requires periodic and effective control in enterprises producing pre-packed goods.

SMI controls and supervises compliance with requirements set in legal acts of measuring instruments offered on the market in the regulated sphere, performs state metrological supervision of measuring instruments handed over for use and metrological control of pre-packed goods in line with requirements of the Law “On Uniformity of Measurements”. SMI officials are authorised to draw up reports regarding administrative violations and impose administrative penalties for non-compliance with metrological requirements. Amendments to the Code of Administrative Violations of Latvia set up different sanctions for private and legal persons and envisages, that SMI can impose administrative fine up to 3000 LVL for offering and sale of measuring instruments subject to conformity assessment without conformity certifications or confirmations.

In the first 3 months of 2005 the State Metrological Inspection has carried out checks in 675 enterprises, subjecting 10.2 thousand measuring instruments to state metrological supervision. Control of pre-packed goods was performed in 9 enterprises.

SMI constantly co-operates with metrological supervision institutions of other countries and participates in WELMEC working groups WG4 “General Aspects of Legal Metrology” and WG5 “Metrological Supervision”.

Accreditation. The state agency Latvian National Accreditation Bureau (LATAK) is a the state institution under authority of the Ministry of Economics and performs its main functions determined by the Law “On Conformity Assessment”:

- to evaluate, accredit and supervise testing and calibration laboratories and the certification and inspection authorities in conformity with the prescribed requirements of Latvian national standards, regulatory enactments, and EU or international standards;
- to maintain and improve the Latvian national accreditation system in accordance with EU and international requirements.

In December 2004 the standard LVS EN ISO/IEC 17011: 2004 “Conformity assessment – General requirements for accreditation institutions which accredit conformity assessment institutions” was adapted at the Latvian national standard status. LATAK has started improving its quality management system in accordance with requirements of the mentioned standard.

In the first 3 months of 2004 the Bureau has accomplished the performance indicators set up by the Cabinet of Ministers:

- 36 accreditation and re-accreditation procedures (15 institutions newly accredited, 21 institutions repeatedly accredited);
- 122 supervision procedures of accredited institutions;
- 162 institutions accredited; of them, 148 results have been internationally recognised in the testing, calibration and certification area in accordance with the concluded Multilateral Recognition Agreement (MLA) of the European co-operation for Accreditation (EA);
- 35 proficiency testing programmes organised and co-ordinated;
- co-operation on agreement with Ukrainian accreditation bureau concluded.

6.13. Privatisation

Upon restoration of the independent state of Latvia, it became vital for the national economic interests to make the transition from a command economy to a market economy based on private property and private initiative. To achieve this goal, restitution of ownership rights (denationalisation) and mass privatisation of properties owned by the state and local governments created and fostered private entrepreneurship. Also, a land reform was started in rural areas and cities.

The mass privatisation carried out in Latvia has basically achieved its goal:

- firstly, one-third of Latvia's population has acquired properties that used to belong to the state or local governments, such as shares, apartments, land, and other property;
- secondly, 75% of gross domestic product is made up by the private sector which at the beginning of 2005 employed 74% of Latvia's economically active population.

According to the Declaration on the planned activities of the Cabinet of Ministers headed by Aigars Kalvītis, transition from privatisation to the procedure of divestment of the state property and completion of the land reform have been planned in 2005. During the final stage of the privatisation process, privatisation of state and local governments' statutory companies, capital shares and other property units, dwelling-houses and land already under way will be completed in accordance with the regulatory acts and the issue of privatisation certificates will be stopped.

For this purpose, a draft of the "Law on Completion of the State and Local Government Property Privatisation and Use of Privatisation Certificates" and the respective amendments to other laws related to the status of permanent user of the state land, procedure of redemption determined by land reform laws, procedure of privatisation and alienation of the state and local government property, and issue and use of privatisation certificates have been developed and are under consideration by the Saeima. It is envisaged to stipulate in the law that shares of such state joint stock companies as Latvenergo, "Latvijas pasts", "Starptautiskā lidosta "Rīga"", "Latvijas dzelzceļš", "Latvijas gaisa satiksme" and "Latvijas meži" must not be brought to privatisation or sold.

Privatisation of state-owned property units

Privatisation of state-owned property or land is being carried out by the state JSC "Privatizācijas aģentūra" (Privatisation Agency) under the Law on Privatisation of Property Units Owned by State and Local Governments.

A physical or legal person eligible to acquire a movable or immovable property in Latvia can be the subject in privatisation of state and local government property (companies, enterprises, real estate, capital shares, land). Payment for the property units has to be done in lats (LVL) and/or privatisation certificates.

From April 17, 1994 till May 1, 2005, privatisation rules have been approved in the statutory procedure for 2206 state property units (except land), including tax payment capitalisation (128 units), and 2070 units (95.3% of state property units to be privatised) have been sold (purchase agreements signed with new owners), organised into statutory companies or liquidated, including agreements on sale of shares created as a result of capitalisation (90 units). 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 in privatisation certificates. New owners took over obligations of privatised state companies (enterprises) for more than 259 million LVL, and the amount of the specified guaranteed investments reached 153 million LVL.

Since 1997 the Privatisation Agency carries out privatisation of state-owned land parcels. 3442 state-owned land parcels (78.5% of all land put up for privatisation) with total area of 5501.1 hectares have been privatised (purchase agreements signed) by May 1, 2005. Total sales price for the privatised state land parcels has reached 106.73 million LVL, including 20.05 million LVL (18.8%) in cash and 86.68 million LVL (81.2%) in property compensation certificates.

Privatisation of local government property

Privatisation of local government property units and land in the country is carried out by the property privatisation commission of the respective local government (rural municipality, town or city, district, *novads* i.e. amalgamated local government). According to provisions under the Law on

Privatisation of Property Units Owned by State and Local Governments, it is the responsibility of the Ministry of Economics to supervise work of these commissions (ascertain compliance of privatisation projects and rules with regulatory acts).

From February 17, 1994 till May 1, 2005 the Ministry of Economics has reviewed and accepted for information 2925 privatisation projects for the total relative price of 91.9 million LVL (including payments in certificates for the nominal value of 55.7 million LVL).

From January 1, 1997 till May 1, 2005 the Ministry of Economics has reviewed and accepted privatisation rules in respect of 1465 built-up and vacant local government land parcels with total value of 16.9 million LVL (of which 12.3 million LVL have to be paid in property compensation certificates).

Privatisation of apartment houses

Privatisation of apartment houses in Latvia began in 1995. By June 1, 2005 the Central Apartment Houses Privatisation Commission (renamed as the state agency “Mājokļu aģentūra” (Housing Agency) as of 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 27965 state and local government apartment houses with 491 309 apartments or 98.91% of the total number of apartments (496 707). 193 507 apartments have been handed over to private owners by a resolution preceding privatisation of the apartment house.

There are 400 481 state and local government apartments that have been privatised (purchase agreements signed) in Latvia by June 1, 2005, equalling to 80.63% of the total number of apartments. Apartment owners so far have taken over management of 8449 apartment houses, including 5209 local government apartment houses and 3240 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 the apartment house: they can either organise a co-operative society of apartment owners (CSAO) or sign an authorisation agreement for management of their residential house. As a result of this process, 311 CSAOs have been founded in Latvia, including 204 CSAOs in seven largest cities and 107 in various districts of Latvia. So far the biggest number of CSAOs have been founded in cities of Riga and Ventspils and in Kuldīga and Valmiera districts. Authorisation agreements for house management have been signed for 2527 dwelling-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 cognisable to the state for permanent use, and redemption of the allocated land. Land redemption and privatisation of land parcels is being carried out in relation with the rural and urban land reform under way in the country.

The reform of the rural and urban land cognisable to the state is close to completion. Basically all claims for the urban land have been reviewed and decisions made about granting ownership to land against pay but conclusion of purchase agreements is continuing (348 agreements in the 1st quarter of 2005). Allocation of rural land for use or change of user and transfer of ownership for pay is continuing. According to the land reform laws, JSC “Latvijas Hipotēku un zemes banka” (Mortgage and Land Bank of Latvia) has signed a total of 253 604 land purchase agreements (2898 in the 1st quarter of 2005) for sale of 1.409 million hectares of land (21 965 hectares in the 1st quarter of 2005).

As of January 1, 2004 free (unclaimed) state land area totalled 16.6 thousand hectares and 666 thousand hectares of land cognisable to the state were given to 117.0 thousand physical persons for permanent use.

Privatisation certificates

Privatisation certificates are being issued and used according to the Law on Privatisation Certificates. By April 1, 2005 a total of 103.9 million privatisation certificates have been issued to 2.45 million people for the time they have lived in Latvia, including 788.3 thousand certificates granted to 40.8 thousand politically repressed persons. 7.78 million property compensation certificates have been issued to 113.2 thousand former owners or their heirs, including 691.7 thousand certificates for property appropriated for the state needs at the privatised specialised state agricultural companies, 4744.2 thousand for land in rural areas, 945.0 thousand for house ownership, 773.5 thousand for urban land, 460.1 thousand for companies and other property units, 89.9 thousand for property taken away from the politically repressed persons, and 77.4 thousand for property alienated in illegal manner.

In the 1st quarter of 2005 a total of 24.9 thousand property compensation certificates have been granted to 0.4 thousand former owners or their heirs.

According to the Law on Privatisation of Land in Rural Areas, 11 063 decisions have been made by April 1, 2005 about payment of cash compensations for former land ownership in rural areas. Compensations totalling 17.4 million LVL have been paid to 8396 persons, cancelling 0.62 million property compensation certificates.

Table 6.7

Use of Privatisation Certificates

(as of April 1, 2005)

Type of property	Number	Number of privatisation certificates (million)	incl. property compensation certificates (thousand)
Apartment houses	420 thousand privatised housing units	34.78	582.1
Companies and other properties	accurate data not available	7.09	109.6
Capital shares (stocks)	accurate data not available	44.43	954.0
including:			
in a public offering	128.7 million shares	37.14	820.0
Land	258 thousand land parcels	14.87	4836.1
Total:		101.17	6481.8
% of total certificates issued		90.6%	83.3%

By April 1, 2005 cash compensations in the total amount of 4.3 million LVL were paid to 24.6 thousand politically repressed persons as payment for privatisation certificates.

101.17 million certificates or 90.6% of the total number of issued certificates have been used for privatisation of state and local government property units by April 1, 2005 (see Table 6.7).

As of April 1, 2005 a total of 4.02 million certificates or 3.6% of the total number of the certificates issued, including 0.36 million property compensation certificates, were on accounts of 460 thousand physical persons.

Accounts of legal persons held 4.32 million privatisation certificates, including 0.25 million property compensation certificates, as of April 1, 2005.

Holders of privatisation certificates in April 2005 could use services of 23 licensed intermediary companies to make transactions in the privatisation certificate market. Total monthly transactions with privatisation certificates (selling and buying from physical persons) carried out by intermediary companies in 2005 varied from 0.14 million certificates in January to 0.18 million in February.

6.14. Public Private Partnership

Public private partnership (PPP) is a co-operation between a state or local government institution and a private enterprise whereby a public service is being transferred over to a private enterprise for a certain period of time on the basis of agreement. Use of PPP mechanism is relatively complicated and the mechanism is not always applicable to all public investment projects. It is difficult to find standard solutions for PPP projects therefore several preconditions are to be observed so that the potential PPP project will be successful (see Box 6.15).

PPP is mostly used in cases when the state does not want to privatise services or objects un wishes to retain them under its control but their maintenance requires capital investments. With PPP it is possible to stimulate attraction of private capital and administration methods into national economy, improve quality of services and ensure a more rational use of state resources. PPP is characterised by:

- co-operation between a state or local government institution and a private enterprise;
- a detailed agreement that regulates PPP;
- certain time period of partnership;

- explicit terms of partnership, for example, quality of the service and its availability to the society;
- preservation of state control during the whole period of partnership;
- principle of “value for money”¹;
- improvement of quality and efficiency.

Box 6.15**Preconditions for successful PPP project**

To achieve successful implementation of PPP project and the desirable results, several preconditions have to be observed:

- the planned public investment project is relatively large and requires effective risk analysis and management;
- the private sector has adequate experience in the particular sphere to achieve value for money;
- it is possible to define not only the contributions but also the standard and desirable results for the particular public service where investment is planned, so that the private partner can use innovative solutions to reach efficiency in long term;
- it is possible to evaluate the service and related assets in long term, observing the principle of “full life cycle” costs;
- the planned volume of the project is sufficient so that the project preparation costs will be commensurate;
- in the sector of the planned project, the development of technologies is stable (does not develop very fast).

As PPP is a dynamic process and every specific case of partnership depends on various circumstances (for example, terms of agreement, schemes of financing flows, specific nature of the object or service), unified description of the various types of PPP is impossible. The PPP co-operation models used most often in the national economy are the projects of BOT² type which may be subdivided in: a) concession with user payment (e.g., toll road) and b) concession without user payment (public sector pays off to the private partner for provided service or for building and maintenance of fixed asset during the whole life cycle of the project – so called projects of DBFO³ type).

PPP is used in several sectors of the national economy. PPP traditionally is associated with infrastructure development and maintenance. The biggest financial resources are usually involved here, that is why heightened attention of the society is paid to these projects. Worldwide, PPP is also used in provision of public transport services, education (building and maintenance of educational establishments), construction and maintenance of municipal housing, water supply and waste water treatment, waste management, health care, IT, construction and maintenance of prisons, etc.

British experience shows that the use of PPP model during the whole life cycle of the project creates savings in the amount of 17% in comparison with implementation of this project in the traditional public capital procurement. 88% of PPP projects are completed at the right time in comparison with 27% of traditional public capital projects⁴. Thereby the information aggregated by the British Treasury demonstrates viability of PPP models in provision of efficient public services.

Preconditions for PPP have been established also in Latvia. Implementation of PPP projects is regulated by the Concessions Law adopted by the Saeima on January 20, 2000. In addition, the institutional system for implementation of PPP policy and PPP projects is created:

- in September 2003 the Concessions Division started its work at the Ministry of Economics (development of PPP policy);
- in May 2004 the Public Private Partnership Unit was established at LIDA (promotion of PPP projects).

PPP policy development

Starting development of PPP policy, the current situation was comprehensively assessed. The most substantial problems for successful use of PPP mechanism were identified as follows:

- 1) lack of co-ordination between institutions in the PPP sphere, which essentially hinders successful PPP policy on the whole and development of PPP mechanism use. Beside the Ministry of Economics and LIDA, other institutions exist with essential influence on PPP use possibilities;
- 2) PPP instrument is not associated with public investment plans and programmes (of local governments, state and EU). Although the most important reasons of PPP use are to ensure sufficient amount of investment and high-quality implementation of the required projects for

¹ “value for money” – value according to the contribution

² acronym from words “*build – operate – transfer*”

³ acronym from words “*design – build – finance – operate*”

⁴ HM Treasury, “PFI: meeting the investment challenge”, London, UK, 2003

- provision of public services and infrastructure, use of PPP mechanism is not allowed in any public investment plan or programme in Latvia. In this way, successful PPP development is hindered and the opportunities which may be provided by PPP have not been used;
- 3) lack of instruments supporting the PPP process. International experience indicates that several instruments supporting the PPP process are required, 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 to reduce administrative costs of preparation of the project, which sometimes make up 5 to 12% of the total costs of the project¹;
 - 4) lack of PPP projects conforming to the best international practice, which could be used as examples;
 - 5) lack of knowledge on PPP mechanism.

To prevent these problems, on March 22, 2005 the Cabinet of Ministers approved policy planning document “Basic Guidelines of Latvian Public Private Partnership” (hereinafter Guidelines) which envisages clear directions of activity for promotion of PPP projects.

Carrying out activities foreseen in the Guidelines, implementation of a bigger number of public investment projects important to the society which otherwise would not have been implemented at all or would have been implemented later is planned in the country. The main directions of activity to achieve the set goal and results are:

- improvement of the knowledge and understanding of PPP by preparing programmes of PPP training and informative seminars, establishing PPP communications strategy and starting active implementation of this strategy;
- analysis of national economy sectors from PPP aspect;
- alignment of legislative framework;
- ensuring co-ordinated activity of institutions and organisations involved in PPP process;
- provision of instruments promoting PPP process, by establishing a fund for preparation of PPP projects and preparing standard documents and guidelines for full PPP project cycle.

To implement tasks set up in the Guidelines, the working group for development of action plan for Basic Guidelines of Public Private Partnership Promotion in 2005-2009 has been established; the group has a task to work out the action plan and submit to the Cabinet of Ministers until June 2005.

The Ministry of Economics has started alignment of legislative framework; draft Law on Granting of Concessions has been worked out in order to harmonise Latvian legislation with the new EU Procurement Directives².

The draft Law on Granting of Concessions is aimed at ensuring transparency of concession granting procedure, free competition between applicants as well as equal and fair attitude to them, and efficient use of state or local government finances, reducing as much as possible the risk of customer or provider of public services.

The draft Law on Granting of Concessions prescribes a new definition of the term “concession”, distinguishing between “construction concession” and “service concession”. In addition, the draft law also prescribes that the decision to start procedure of concession granting is taken only when an institution empowered by the Cabinet of Ministers has approved economic and financial calculations done by customer or public services provider, thus maximally reducing the possibility that agreements unfavourable for the state could be concluded.

Promotion of PPP projects

LIDA continues to provide advisory support for PPP in three essential directions:

- 1) advising public institutions in PPP area. Advising has been done, assessments have been conducted and proposals submitted on concession terms, concession tender rules and concession agreement. LIDA has advised implementers of more than 20 potential PPP projects of state and local governments;

¹ Michael Klein (ed.): *Concessions for infrastructure. A guide to their design and award*, World Bank, www.worldbank.org.

² Directives of the European Parliament and of the Council – 2004/17/EC coordinating the procurement procedures of entities operating in the water, energy, transport and postal services sectors, and 2004/18/EC on the coordination of procedures for the award of public works contracts, public supply contracts and public service contracts

- 2) development of PPP methodology. Although a comprehensive development of PPP methodology is only at the planning stage, the methodology “Criteria and methodology for assessment of value for money” is already developed. This methodology has been prepared to determine if implementation of the potential investment project in a traditional way is more advantageous for the state than its implementation according to basic principles of PPP;
- 3) improving knowledge on PPP. Regular meetings with representatives of state and local government institutions are held in order to discuss issues related to PPP. Besides, LIDA participates and organises seminars where representatives of national and local governments are being informed on PPP aspects. The seminar “Opportunities of financing the public sector development projects” organised on April 21, 2005 was among the most important of these seminars; approximately 100 representatives of state and local government institutions took part in this seminar.

6.15. Advisory Councils of the Ministry of Economics

National Economy Council of the Ministry of Economics (hereinafter NEC) was established in 1999 and operates as an advisory institution of the ministry.

Founders of the NEC are the Ministry of Economics, Latvian Chamber of Commerce and Industry, Latvian Employers’ Confederation, Latvian Industry Confederation, Latvian Free Trade Union Confederation, and Union of Local and Regional Governments of Latvia.

NEC consists of the Minister of Economics and 22 experts designated by founders of the NEC, including representatives of entrepreneurs, public institutions and other organisations. Representatives of the Ministry of Economics’ Council of the Small and Medium Sized Enterprises and Crafts and of the Foreign Investors Council in Latvia participate at the status of observers.

NEC reviews and monitors settlement of issues important for the development of Latvian economy (drafts of regulatory documents, concepts of development of the national economy, state budget and other documents). It prepares proposals and adopts recommending decisions on these issues, carries out a dialogue between businesses and the Ministry of Economics, the Single Economic Strategy and Development Council, and other public institutions and non-governmental organisations.

NEC meetings are held once a month and are chaired by the Chairman elected by the NEC Steering Committee. NEC invites the branch associations as observers to participate in the meetings.

In between the 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 Council is organised through the Secretariat of the NEC.

A representative of the NEC attends the Meetings of the State Secretaries (SSM) with adviser rights and, according to the Roll of Procedures of the Cabinet of Ministers, the NEC is empowered to pass opinions on the draft regulatory documents approved by the SSM.

NEC also is co-operating with the Saeima, ministries and other public institutions in order to incorporate NEC’s proposals into normative acts aimed at improvement of business environment.

To ensure that interests of industries are represented professionally in efficient dialogue between the Ministry of Economics, the NEC, other business organisations and public institutions, a model of co-operation has been set up by the Ministry of Economics, whereby a protocol of agreement on co-operation has been signed with the councils of experts of particular industries and the industry associations, which correspond most of all to functions of the Ministry of Economics and account for the biggest part of Latvian GDP.

The Ministry of Economics and the NEC signed such protocol with the following councils of experts (CE) of industries: CE of Machine Building and Metal Treatment 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 Industry.

On signing the protocol of agreement, the parties agreed to pool their resources for development of programmatic documents, to 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, aimed to discuss implementation of the co-operation mechanism and status of problem issues.

Box 6.16

Action Plan of the National Economy Council

From January until June 2005, the NEC has gone through the following issues of importance:

- price changes in 2004, their influence on the national economy and forecasts for 2005;
- plan of business environment improvement measures for 2005;
- Action Plan of the Ministry of Economics for 2005;
- informative draft report developed by the Ministry of Finance on opportunities to cancel use of invoices/bills for numbered goods acquired from the state;
- basic principles of the National Development Plan for 2007-2013 and the course of its development;
- report of 2005 on the process of implementation of the Single Strategy of National Economy;
- vision of development of the Latvian state;
- concept of development of the vocational (including higher) education;
- improvement of the tax policy for business environment improvement.

Key issues the NEC plans to deal with during the coming months:

- Action Plan of public private partnership policy for 2005-2009;
- measures for implementation of Latvian national programme for tourism development;
- national strategy for promotion of quality;
- development of Latvian transport infrastructure.

Participating organisations of the NEC in their daily work have identified several provisions governing the corporate income tax and the personal income tax, seen as a hindrance to business development in Latvia and boosting the tax intake. Experts of the NEC are working actively with the task force of the Ministry of Finance, dealing with assessment of the national taxation policy in order to reduce the tax burden on businesses and to enhance business development in Latvia.

NEC has unambiguously voiced a position that, in order to successfully master the EU Structural Funds, procedures as simple as possible should be created so that maximum number of projects submitted by Latvian small and medium sized commercial companies are implemented.

To promote creation of environment favourable to innovative business in Latvia, the NEC is taking active involvement in the EU 5th framework programme's project "Strategies for Development of Knowledge-Based Business in Latvia". As part of the project implementation, studies have been conducted in the following four spheres: analyses of the needs of enterprises in relation to innovations; capacity of innovations at research institutions of Latvia; institutions supporting innovations; and accessibility of resources for financing the innovations. NEC supports technology commercialisation and business activity motivation programmes, developed as part of the RIS Latvia project, and recommends to increase financing for the implementation of new innovation promotion and support programme as part of the National Innovation Programme's action plan for 2005-2006.

The Council of the Small and Medium-Sized Enterprises and Crafts (hereinafter CSMEC) at the Ministry of Economics unites representatives delegated by 28 non-governmental organisations representing small and medium-sized enterprises (SME) and business people (organisations of various sectors of economy and regional organisations of SME). The Ministry of Economics participates in the status of observer.

The composition and statute of the CSMEC were approved by the Order No 49 of February 16, 2004 of the Ministry of Economics.

The activity of the CSMEC is aimed to involve public organisations of SME and branch associations into development and implementation of favourable SME business environment policy.

The key functions of the CSMEC are: to review and follow settlement of issues (drafts of regulatory 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 SME, as well as prepare proposals and make recommending decisions on these issues; to carry out dialogue between entrepreneurs and the Ministry of Economics, other public institutions and non-governmental organisations as well as international organisations, influencing operations and development of SME.

The CSMEC convenes for meetings once a month on average.

The work of the CSMEC is chaired by a chairman and a deputy chairman which are elected by the council.

In between the meetings of the council, the recommending decisions are taken by the CSMEC Steering Committee which 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 operations the CSMEC has launched a positive and efficient dialogue with institutions representing businesses, the Ministry of Economics and public institutions responsible for improvement of business environment in Latvia. It is important that, through co-operative efforts with the Ministry of Economics, businesses are invited on a regular basis to assess SME development issues and the draft programme documents shaping SME development policy before they are adopted by the Cabinet of Ministers.

On initiative of the CSMEC, an internet portal www.mazaisbizness.lv has been set up for SME, that is made as a manual and provides practical information for people willing to launch business activity as well as information necessary for SME regarding legislative acts, various legal and financial issues and latest developments. The portal provides a chance for economic operators to get free advice of specialists on how to launch and develop commercial activity.

In their daily work, participating organisations of the CSMEC have identified several provisions governing the corporate income tax and personal income tax, seen as a hindrance to business development in Latvia. The council actively participated in search of solutions to issues related to improvement of tax policy.

Highly important for businesses is the work performed by the CSMEC participating organisations in the working group of the Ministry of Economics and the Latvian Investment and Development Agency (LIDA), developing documents related to preparation of project applications by businesses and receiving financing from the EU Structural Funds (SF), namely, the guidelines of grant schemes for receiving aid from the EU SF (ERDF), administrative and specific criteria for the state support programmes for receiving the EU SF, on procuring supplies and services, as well as contract between the LIDA, which is handling the grants scheme, and recipient of the financing.

For more detailed acquaintance with business environment in Latvian regions, the CSMEC organises visiting sessions on a regular basis; during these sessions, meetings with municipal leaders and specialists as well as businesses of the respective region are held, problems and needs of businesses are found out and solutions to them are searched in common. In the surveyed period, four visiting sessions of the council have taken place – in Jelgava, Kuldīga, Daugavpils and Liepāja.

In the visiting sessions, the main topics of discussion are business environment and development opportunities in the respective region, municipal support for businesses, and factors hindering opportunities of businesses to use financing from the EU Structural Funds.

To strengthen the role of the CSMEC in improvement of business environment and to ensure that the non-governmental sector is competently represented in mastering the EU Structural Funds and aid programmes, the CSMEC members and representatives of its participating organisations are delegated for participation in the following councils and committees:

- EU Structural Funds Supervision Committee at the Ministry of Finance;
- Task force of the EU Structural Funds Steering Committee at the Ministry of Finance;
- National Information Society Council;
- Export Promotion Council at the Ministry of Economics;
- Advisory Council of the Latvian Investment and Development Agency;
- Task force for national tax policy assessment at the Ministry of Finance;
- European Economic and Social Committee (EESC) in Brussels.

Representatives of the council take part in the Multiannual Programme for Enterprise and Entrepreneurship of the European Commission, in particular for SME in 2001-2005, in the project work groups:

- Consultation of Stakeholders in the Shaping of Small Business Policy at National/Regional level (Best);
- Obstacles to Growth: Recruiting the first Employee;
- Second Career – overcoming the obstacles to self-employment.

Box 6.17

Action Plan of the Council of the Small and Medium-Sized Enterprises and Crafts at the Ministry of Economics

From January till June 2005, the CSMEC has dealt with the following important issues at its sessions:

- measures implemented in 2004 in the framework of SME development programme, planned measures for promotion of SME development in 2005;
- informative draft report developed by the Ministry of Finance on opportunities to cancel use of invoices/bills for numbered goods acquired from the state;
- problems of fictional business activity and their potential solutions;
- alternative options of entrepreneurship risk state fees and satisfaction of employee claims;
- operation of the Food and Veterinary Service, performed controls and promotion of co-operation with non-governmental organisations;
- possible changes in taxation policy, aimed at promotion of SME development;
- setting a fixed corporate income tax rate for small enterprises;
- opportunities of simplified accounting in small enterprises;
- process of mastering the EU Structural Funds, identified problems and their solutions, planned changes in state aid programmes;
- copyright issues regarding commercial activity;
- activity of Latvian experts regarding projects implemented in the framework of the Multiannual Programme for Enterprise and Entrepreneurship;
- draft Cabinet of Ministers regulations “Professional Qualification Requirements for Persons Employed in Food Turnover” developed by the Ministry of Agriculture.

7. Recommendations

The economic policy of Latvia is aimed at reaching a population welfare level compliant with the EU average standard in 20-30 years. To achieve this, annual GDP growth by 8% has to be ensured every year until 2010.

Since 2000, Latvian GDP has increased annually by 7.6% on average, and in 2004 the increase even amounted to 8.5%. To keep such growth rate also in future years, it is necessary to maintain stable macroeconomic environment and continue implementing structural reforms in order to ensure productivity and growth of economic activity and to improve business environment, infrastructure, labour force and education.

Analysis of economic situation shows that the growth in future years may be hindered by slow development of several economic policy areas.

Stability of macroeconomic environment in Latvia may be threatened by the high inflation rate and imbalance of the foreign sector. Rapid increase in prices negatively affects business environment, diminishing competitiveness of national economy, besides, the high inflation rate may be an obstacle to introduction of the euro in 2008.

To maintain stable macroeconomic environment, the following objectives have to be fulfilled:

- **To carry out Latvia's accession to the European Economic and Monetary Union** in line with the strategy worked out by the Bank of Latvia and the government;
- **To observe permissible volume of total budget deficit and ensure efficiency of budget use** in implementation of fiscal policy;
- **To gradually plan changes of public utility tariffs** 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 formed, which would allow to forecast the potential impact of measures for raising all administratively regulated prices, including public utilities prices regulated at local government level, on total inflation in certain time period;
- **To strengthen competition supervision and encourage competition development** 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 competition law violations, such as abuse of dominant position and cartel agreements, introducing more effective investigation instruments and motivating sanctions policy.

Conditions favourable to business activities and functioning of economy have to be created. Although business environment improves, which is indicated by increased number of enterprises and steadily high level of investment, it is necessary to continue improvement of normative acts and their administration in all those areas that constitute the set of conditions which determine how an enterprise starts its business, what opportunities it has for expansion of production, restructuring and modernisation, and how normal and natural is its liquidation process. There is no considerable progress in improvement of the national road network. Poor funding for programmes in areas that are not priorities of the common EU structural policy has to be noted as a general shortcoming.

The most important and immediate tasks in creation of conditions favourable to functioning of economy are:

- In improvement of business environment, it is necessary to foresee improvement of tax administration, lifting compulsory invoices for goods, reduction of entrepreneurial risk state fee (so-called "cheat" fee), simplification of accounting forms and bookkeeping, and simplification of processes related to construction. **Unification of corporate income tax for all entrepreneurs** is one of the most essential tasks;
- **To continue assessment of national normative acts and their drafts**, in order to identify and prevent potential violations of competition law already during the drafting process, technical barriers to trade, and discriminating conditions (legal and administrative barriers) in the area of free circulation of goods and services and business law. *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 develop favourable co-operation between public administration bodies and entrepreneurs**, carrying out an effective and fair market surveillance in order to ensure honest competition and observance of consumer rights;
 - **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. Transparency of procurement procedures has to be ensured, publishing announcements about start of procurement and taken decision, as well as following changes in EU normative acts and implementing preconditions for electrification of procurement process. Opportunities to prevent money laundering, which are prescribed in normative acts, have to be used more effectively. It is essential to ensure availability of information about public administration functions delegated to commercial companies, their implementation and legal control. This should promote more efficient use of funds and lessen opportunities of corruption;
 - Transposing EU requirements on further opening of energy sector, electronic communications and postal markets, **it is essential to encourage real competition and ensure that the changes done will be in consumer interests.** To improve safety and continuity of supply and to increase choice opportunities for consumers, connection of economically based infrastructure networks with other EU member states' networks should be promoted. This will result in smaller opportunities of historically dominant companies to influence price formation and hence will give place to more complete application of market principles;
 - To consolidate budget resources and effectively channel them to alignment and provision of infrastructure with national importance, **investment from the state budget are to be planned purposefully and systematically**, respecting financial opportunities of the state budget. It is necessary to create stable funding system for those programmes which are not priorities of the common EU structural policy. Implementation of Public Investment Programme should successfully ensure such approach;
 - to use and get maximum benefit from EU funding, **the management process of EU structural instruments has to be improved**, focusing in particular on establishment of effective system for EU funds absorption and supervision. **Special training programmes for Latvian officials and users of these funds have to be created**;
 - **To promote introduction of the public private partnership mechanism**, especially as regards 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, recommendations have to be made for preparation and administration of the public private partnership.

There is no pronounced progress in **creation of efficient and competitive sectoral structure**; share of high technology sectors in the national economy increases at a slower pace than set up in target indicators of the Single Strategy of National Economy, and also the share of high technology products in exports does not grow at the rate determined by the target indicator achievement dynamics. Essential shortcomings hindering structural changes are: non-compliance of educational structure with long-term labour market requirements, low investments of public and private sectors in research and development, low availability of internet, electronic signature is still not introduced.

To promote creation of efficient and competitive sectoral structure, the following actions have to be implemented:

- **To improve efficiency, capacity and quality of the educational and training system and its compliance with the long-term labour market demands.** Although Latvia in terms of the number of university students per 10 thousand inhabitants occupies one of first places in Europe, the current educational structure is one-sided as only about one-fifth of students acquires knowledge in technical and natural sciences. If priorities in educational policy do not change, lack of specialists in technical sciences and overabundance of specialists in social

- sciences are expected in future. Introducing changes in the educational system, the principle of education accessibility must be observed with the purpose to ensure this in the context of life-long learning. Development of human resources has to be promoted by improving the level of academic and vocational education according to the market demands, aligning the educational system, making it accessible to all groups of population, promoting wider use of distance learning methods, creating opportunities for labour force to change their qualification in accordance with needs of employers, and increasing funding to both applied research and fundamental science;
- **To increase public sector investment in research and development (R&D) and to promote private sector investment in R&D.** Measures have to be developed and carried out to promote co-operation between educational, research and industry sectors, ensuring transfer of knowledge and technologies. National research programmes and principles for distribution of grants need to be improved. State support must be provided to innovative enterprises and infrastructure for development of research and knowledge centres, technological centres, business incubators, knowledge-based technology businesses;
 - **ensure implementation of the National Programme on Venture Capital**, thus carrying out creation and functioning of effective instruments co-funded by public sector, which would promote availability of venture capital and encourage commercial activity in Latvia;
 - **To raise availability of internet.** Rapid increase in number of internet users both in cities and the countryside henceforth is impossible without considerable funding and additional measures;
 - **To introduce electronic signature**, which is a precondition to ensure development of e-government;
 - **To improve the existing state support programmes**, making them an effective instrument to strengthen long-term competitiveness of Latvian entrepreneurs. The state support granting system must be improved, focussing the state support on projects which will give the biggest value in future. The influence of existing state support programmes on competitiveness of Latvia has to be assessed and state support programme priorities for the next planning period must be defined, changes in support granting conditions have to be done in order to channel resources to activities where state support is needed the most for strengthening of long-term competitiveness of Latvian entrepreneurs;
 - **To develop and carry out export promotion policy** in line with the new foreign trade priorities in order to actively promote international competitiveness of Latvian companies, foster expansion into new markets and consolidation in the existing ones. It is essential to ensure institutional base of export promotion, availability of financial instruments and support to companies in export marketing;
 - **To promote improvement and introduction of the quality assurance and conformity assessment system.** To support and foster introduction of quality systems such as environmental management systems, work safety and professional health systems, food quality assurance systems and other comprehensive quality management systems in order to promote upgrading of companies and growth of competitiveness. To raise awareness in society of requirements of conformity assessment system, promote compliance with them and improve normative acts in accordance with EU requirements;
 - **To provide efficient management of state-owned properties** by promoting divestment of state-owned real estate 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 improvements must be made to management of state-owned corporate enterprises and the mechanism for adjustment to national interests in the state-controlled corporate and other enterprises;
 - **To improve legal norms related to protection of investor interests and rights**, investing in shares issued by a joint stock company without acquiring decisive influence in the respective company.

No progress is reached in **lessening the socio-economic disproportion and risks**, as regional stratification increases and inequality in distribution of income rises. Due to the high unemployment and low social benefits a big part of population is subject to poverty risk. Formation of *novads* (amalgamated local governments) is a too slow process, therefore a big number of economically and administratively

weak local governments exist in Latvia for a long time, which are not able to ensure performance of all local government functions and do not stimulate economic activities in *novads*.

To promote lessening of the mentioned disproportion, the most important urgent tasks are:

- **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 measures, including measures for promotion of self-employment and launching business activity, strengthening competitiveness of the unemployed from problem groups and job seekers, especially long-term unemployed, persons with a low education, persons after childcare holidays, disabled persons with various functional disorders, and other problem groups, taking into account the specific situation of unemployment in regions;
- **To solve structural problems of employment** by supporting efforts to get adequate and higher qualification in accordance with labour market demands and facilitating labour mobility, especially by improving transport infrastructure;
- **To accelerate the process of *novads* (amalgamated local governments) formation. To pay special attention to incentives for development of less developed regions.** To create real levers and instruments in order to stimulate entrepreneurs to invest into depressive regions;
- **To revise the system of taxes and allowances so that there would be more financial benefit in working**, to increase efficiency of social expenditures and to raise the non-taxable minimum.

To achieve strategic goals of Latvia, it is essential to continue improving **co-ordination of economic policy** in the country:

- **To develop a good-quality National Development Plan (NDP) and documents related to absorption of EU funds envisaged for 2007-2013**; development of the Plan and documents has just begun. The NDP as a medium-term strategic document has to specify the state model envisaged by the *Single Strategy of National Economy* and to define public investment priorities for medium-term period;
- **To introduce medium-term budget planning** more consistently in order to ensure purposeful, far-sighted, co-ordinated, lucid and result-oriented use of available resources, and a link of the *Single Strategy of National Economy*, the NDP and strategic plans of ministries with the budget.

The insufficient administrative capacity is a substantial obstacle to preparation of good-quality legislation and normative acts and hence to formation and implementation of the structural policy. The markedly high labour turnover of public agencies frequently does not allow formation of a successive and weighted structural policy. Therefore the **reform of public administration has to be continued** by introducing, among other things, a uniform system of wages and strengthening the existing public administration bodies.

Successful implementation of structural reforms will ensure stable economic growth and will promote the convergence process and deeper integration into the European and global economy. Success in development and economic growth of Latvia will depend not only on the work of public institutions but also on everyone's personal initiative in any location of Latvia in conditions of mutual understanding and dialogue within the society.