

**Ministry of Economics
Republic of Latvia**

**ECONOMIC
DEVELOPMENT
OF LATVIA**

REPORT

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Dear reader,

We offer for your attention the 23rd **Report on the Economic Development of Latvia** prepared by specialists of the Ministry of Economics. The first Report was published in September 1994 and the following ones since 1995 were published traditionally twice a year in June and December. The present Report, just like the previous ones, evaluates economic situation in Latvia and progress of reforms as well as offers economic development forecasts.

It is to be noted with satisfaction that the rates of economic growth in Latvia have been very fast in recent years. Since 2000 Latvian GDP has increased annually by 7.7% on average. Such indicators of development are among the highest in the European Union.

Also 2005 was a successful and dynamic year in the economic development of Latvia, as GDP volume in 9 months of the year increased by 10.1% in comparison with the respective period of the preceding year, and export volumes in 11 months of the year grew by 34% in comparison with 11 months of the previous year; number of foreign travellers visiting Latvia in the 1st half of 2005 went up by 31% in comparison with the respective period of the preceding year. Several national economy sectors, such as wood industry, metalworking and machine building, construction, tourism and others, also developed rapidly.

Stability and predictability of business environment is also indicated by number of newly founded enterprises and commercial companies, that reached 1046 in November 2004 (record number of the last 10 years). 9970 newly founded companies were registered in 11 months of this year, which is 8.6% more than in the same period of the previous year.

Looking back at achievements of the Ministry of Economics in 2005, the most essential of them is the laid foundations to transition of Latvian economy from labour-intensive economy to economy based on knowledge and innovation, which will foster growth of our national economy in the future. The developed National Lisbon Programme of Latvia for 2005-2008 clearly defines how reorientation of this economy will take place, meaning production of increasingly higher value-added products and promotion of company competitiveness.

The priority for operation of the Ministry of Economics will remain unchanged in 2006, namely, promotion of knowledge-based commercial activity and competitiveness. To raise competitiveness of Latvian economy, not only competitiveness of companies should be promoted in the domestic market but also their entry and consolidation in foreign markets should be fostered. Export promotion measures will be carried out. At present, introduction of corporate income tax rate of 15% for all businesses, formation of e-government, simplification of legislation and procedures, strengthening of dialogue between government and NGOs are taking place. To promote formation and development of innovative companies, resources of the EU Structural Funds are available and the fund of risk capital funds is being established.

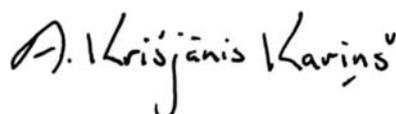
I am convinced that successful implementation of structural reforms will ensure stable growth also in the next years.

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

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

I hope that the Report will be useful to economists, businesses and everyone interested in problems of Latvian economic development and will encourage exchange of opinions between public bodies, various organisations and interest groups, economists and other stakeholders.

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



Artūrs Krišjānis Kariņš,
Minister of Economics

December 2005

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Abbreviations

Abbreviations

APS	Atomic power station
CEE	Central and Eastern Europe
CEES	Common European Economic Space
CIS	Commonwealth of Independent States
CM	Cabinet of Ministers
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
ERDF	European Regional Development Fund
ERM II	European currency rate mechanism
ESA	European System of National Accounts
ESF	European Social Fund
ETA	European Technical Approval
EU	European Union
EU-10	New European Union Member States
EU-15	European Union before enlargement on May 1, 2004
EU-25	European Union after enlargement on May 1, 2004
FCMC	Financial and Capital Market Commission
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
FICIL	Foreign Investors Council in Latvia
FTA	Free Trade Agreement
GDP	Gross domestic product
GVA	Gross value added
HPS	Hydroelectric power station
ICT	Information and communication technologies
IMF	International Monetary Fund
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
IUVI	Import unit value index
JSC	Joint stock company
KfW	Kreditanstalt für Wiederaufbau
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
LLC	Limited liability company
LNAB	Latvian National Accreditation Bureau
LNMC	Latvian National Metrology Centre
LVS	Latvijas Standarts
ME	Ministry of Economics of Latvia
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-governmental organisation
NIB	Nordic Investment Bank
NPFT	National Programme of Foreign Trade
OECD	Organisation for Economic Co-operation and Development
PHARE	The Economic assistance programme of European Union for countries of Central and Eastern Europe
PIP	Public Investment Programme
PPI	Producer price index
PPP	Public and private partnership
R&D	Research and Development
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
SEA	State Employment Agency
SME	Small and medium-sized enterprises
SOLVIT	Efficient Solving of Internal Market Problems
TPS	Thermal power station
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, single currency of the EMU
GBP	British pound
LVL	Latvian lats (national currency of Latvia)
SDR	Special drawing rights, IMF approved currency
USD	US dollar

Conventional designations

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

1. Economic Situation: Brief Overview

Reforms accomplished in Latvia and integration in the European Union have left a positive impact on economic development of the country. **Latvia has shown the highest economic growth rates in the EU.** Since 2000 the average annual growth of gross domestic product (GDP) in Latvia was 7.7%, in 2004 GDP increased even faster by 8.5%. The high growth rates are achieved due to the stable dynamics of domestic demand and increase in exports.

Rapid economic growth of Latvia continues in 2005 as well. GDP in the first 9 months of 2005 increased by 10.1% in comparison with the respective period of 2004. Especially fast growth was observed in the 2nd and 3rd quarters of 2005 (growth in both quarters was by 11.4% higher in comparison with the respective periods of the preceding year). These quarterly growth rates were the fastest in Latvia since the restoration of independence.

Economic activity increases in all major sectors of the national economy. Manufacturing contributes essentially to the growth. In the period from 2001 to 2004, output in manufacturing has grown by 9% 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 the first 9 months of 2005, manufacturing output grew at a slightly slower pace (by 5.4%), mainly due to the negative impact of January storm on the biggest export sector – production of timber and wood articles. 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 4.5% in 2004 and 4.3% in the first 9 months of 2005. 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 on the external demand. Latvia's accession to the EU ensures more equal competition opportunities for farmers in the EU internal market, while support from the EU funds facilitates modernisation of agriculture and diversification of agricultural activities.

Rapid rise in investment has a favourable influence on development of construction. The construction sector grew by 13% in 2004 and by 15.8% in the first 9 months of 2005. Construction of residential and commercial buildings, hotels, streets and roads, industrial and other objects is growing fast. The construction sector is expected to maintain high development rates also in the future due to development of mortgage lending, increased economic activity and investment as well as implementation of projects financed from the EU funds.

Increased domestic demand promotes development of services, especially those concerning wholesale and retail trade (this sector grew by 10.1% in 2004 and by 17.3% in the first 9 months of 2005). It must be noted that growth of the trade sector is mostly determined by the domestic demand, but slightly more than one-tenth is also linked to trade intermediary services, which are provided to non-residents. This share increases every year.

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

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

On the whole, the transport and communications sector grew by 12.9% in 2004 and by 16.3% in the first 9 months of 2005. After accession to the EU, cargo transportation increased especially fast and passenger transport services grow, including air transport services.

The Ministry of Economics forecasts that the growth of the **GDP in Latvia will exceed 10% in 2005**.

The economic growth in Latvia is achieved in conditions of stable macroeconomic environment. The Bank of Latvia implements *de facto* policy of fixed national currency exchange rate. This reduces uncertainty, eliminates exposure to currency risk and gives entrepreneurs a stable base for planning and price determination. As of January 1, 2005 the national currency lat (LVL) is re-pegged from the SDR currency basket to the euro at the rate 1 EUR = 0.702804 LVL. Change of the LVL peg was determined by Latvia's plans to join the European Exchange Rate Mechanism II (ERM II) and, after fulfilment of required criteria, to join the Economic and Monetary Union (EMU).

Since May 2, 2005 Latvia has joined ERM II with already existing exchange rate of lat against the euro, namely, 1 EUR = 0.702804 LVL. Latvia will have to participate in ERM II at least for two years, fulfilling the Maastricht criterion on exchange rate stability. When the EU Council decides that Latvia is ready to take part in the EMU, the Latvian national currency will be substituted by the euro and the Bank of Latvia will discontinue implementing an independent monetary policy. Timetable for introduction of the euro that is approved by the Cabinet of Ministers envisages Latvia's joining the EMU on January 1, 2008.

Table 1.1

Latvia: Key Indicators of Economic Development

	2002	2003	2004	2005	2006 f
	(growth against the preceding year, %)				
Gross domestic product	6.5	7.2	8.5	10.3 f	8.5
Private consumption	7.4	8.2	9.3	9.0 f	9.0
Public consumption	2.2	1.9	2.1	2.3 f	2.5
Gross fixed capital formation	13.0	12.3	23.8	22.0 f	15.0
Exports	5.4	5.2	9.4	20.9 f	9.6
Imports	4.7	13.1	16.6	12.2 f	7.8
Consumer prices	1.9	2.9	6.2	6.7	5.5
	(in % of GDP, unless indicated otherwise)				
Central government budget fiscal balance	-2.3	-1.6	-1.1	-1.0 f	-1.5
Central government debt	13.1	13.2	13.2	10.5 f	10.5
Current account balance	-6.6	-8.1	-12.9	-11.5 f	-9.8
Foreign direct investments (flows)	2.7	2.6	5.1	5.0 f	5.0
Unemployment rate (15-74 years)	12.0	10.6	10.4	9.3 f	8.8

f – forecast

Relatively high inflation rate was observed in the last two years. Faster growth of inflation in 2004 was mainly due to a combination of several one-time factors (rise of administratively regulated prices, harmonisation of indirect tax rates, inflation expectations related to Latvia's accession to the EU, and high world oil prices). High rate of inflation remains in 2005 mostly due to increased world fuel prices and second-round inflation (spiral). According to forecasts, inflation will decrease gradually in the coming years due to diminishing impact of the mentioned factors, which are raising prices.

In view of growing domestic demand and to hold down credit growth rate, the Bank of Latvia raised the refinancing rate by 0.5 percentage points to 4% in March and November of 2004 and increased the reserve requirement from 3% to 4% in July 2004 and to 8% in December 2005. 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. In order to unify conditions of mutual bank competition and to slow down the rapidly growing borrowing by Latvian banks from foreign banks, the Bank of Latvia included bank commitments to foreign banks

and central banks of foreign countries with a fixed term or warning term for withdrawal over 2 years in the base of compulsory reserves as from January 24, 2005.

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 criteria, 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.

The Saeima approved the state budget for 2005 with a fiscal deficit in the amount of 1.68% of GDP. However, provisional data of budget execution show that 2005 was concluded with a considerably lower deficit than planned, i.e., in the amount of 91.6 million LVL or approximately 1% of GDP. The Saeima approved the state budget for 2006 with a deficit in the amount of 145.2 million LVL or 1.5% of GDP.

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. At the end of November 2005 the central government debt was 908.1 million LVL.

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

In 2004 the current account deficit amounted to 12.9% of GDP and was by 4.8 percentage points higher than in 2003. It was caused by worsened trade balance (by 2.5 percentage points) and decrease in positive balance of services (by 0.8 percentage points). Worsening of the revenue balance by 1.9 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 starts decreasing. Trade balance and revenue balance have substantially improved in the first 9 months of 2005 in comparison with the respective period of the preceding year. In January–September 2005 the current account deficit made 11.4% of GDP (in January–September 2004 it was 14.1% of GDP).

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

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

EU is the main trading partner of Latvia. Trade with EU member states has been constantly expanding since restoration of Latvia's independence, and currently more than 70% of Latvian exports and imports are linked to the EU, including also the new EU member states. In the 11 months of 2005 most of Latvia's foreign trade turnover was made up by trade with Germany (13% of the total), Lithuania (13%), Estonia (9%), Russia (8%), Sweden (6%) and Poland (6%).

The exports of Latvian goods in current prices grew by 11-12% annually during 2000-2002, by 17% in 2003, by 29% in 2004, and by 34% in January–November 2005. In 2004 and 2005 the exports of goods were favourably affected by the rapid increase in export unit value, which rose by 11% in the 11 months of 2005 in comparison with the respective period of the preceding year. Exports increase to all sales markets for Latvian goods – to EU member states, CIS countries and other countries of the world. In the 11 months of 2005 the fastest growth rates were observed in exports of mineral products, foodstuffs, means of transport and machine building products. Also imports in the first 9 months of 2005 considerably exceeded the volume of the previous year (by 27% in current prices).

With the economic growth, income of the population is also growing. The real income of employees in the period from 2000 till 2004 has increased by 24%. It continued increasing in 2005 and in the first 3 quarters of this year went up by 9–10% against the respective quarters of the preceding year.

It should be noted 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 2003.

The employment and unemployment indicators are gradually improving. However, it should be noted that the growth has been mainly reached at the expense of productivity and less due to 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 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.

The economic activity of the population (participation in the labour market) in Latvia is close to the EU average, while the economic activity of women has already exceeded the average indicators in the EU. In the period from 2000 till 2004 the employment rate in Latvia has increased by 4.8 percentage points. In 2004 it reached 62.3%, only slightly falling behind the EU average. The employment rate continued increasing in 2005 and reached 63.1% (in the first 3 quarters of the year), which is by 0.8 percentage points higher than in the respective period of 2004.

According to the data of the Labour Force Survey done by CSB, the unemployment rate has gone down from 14.4% in 2000 to 10.4% in 2004, while in the first 3 quarters of 2005 it decreased to 9.3%. 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, which is twice as low as the average in Latvia.

The economic growth potential is best characterised by the growth of investments. In the period from 2000 till 2004 the total fixed capital formation has increased by 1.7 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, among them stable macroeconomic environment, inflow of foreign investments, reduction of interest rates on loans and strengthening of the banking sector, increase of general economic activities and formation of positive future expectations, etc.

In 2005 high investment level was retained in the national economy. Investments in the fixed assets increased by 21.5% in the 9 months of 2005. Investment process was favourably affected by the improvement of accessibility of finances and high growth rates.

At the end of 2004 foreign direct investments accumulated in Latvia amounted to 2360.8 million LVL or about 31.8% of annual GDP volume. The volume of incoming foreign direct investments in 2004 by 2.3 times exceeded the volume of 2003 and equalled to 377.6 million LVL (5.1% of GDP). In the nine months of 2005 the volume of incoming foreign direct investments in Latvia exceeded by 11.8% the volume of the respective period of 2004. This covered almost one-fifth of investment in fixed assets.

Interest of investors from the EU countries in Latvia has increased after Latvia's accession to the EU. 85% of incoming foreign direct investments in 2004 were related to investors from the EU countries, but in the nine months of 2005 the investments from the EU countries have increased by 22.5%.

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

2. Development of World Economy¹

Growth of world economy in 2004 was among the fastest during the last years. In 2004 the economic activities increased considerably in almost all regions of the world, especially in the biggest oil producing countries. However, a small decrease of growth rates was observed at the end of the year. In the 1st quarter of 2005 the growth slightly increased but already in the 2nd quarter of 2005 it was slowed down by the rapid rise of oil prices. Therefore the total annual growth for 2005 is forecasted at slightly slower pace than in the previous year (see Table 2.1).

Table 2.1

GDP Growth
(percentage against the preceding year)

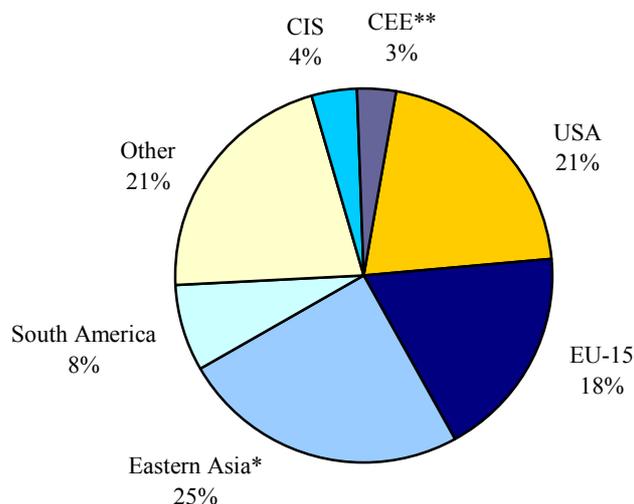
	1996-2001 (annual average)	2003	2004	2005 f	2006 f
World	3.6	4.0	5.1	4.3	4.3
USA	3.1	2.7	4.2	3.5	3.3
Japan	1.2	1.4	2.7	2.0	2.0
EU	2.7	1.3	2.5	1.6	2.1
CIS	2.3	7.9	8.4	6.0	5.7

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

In September 2005 just as a half-year before IMF forecasted that world economy will grow by 4.3% in 2005.

Figure 2.1

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



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

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

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

At the beginning of 2005 like in 2004, the economic growth of the **United States** continued at a rapid pace. It was stimulated by the income growth, improvements in the labour market conditions,

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.

supportive financial market conditions and rising house prices. The disastrous hurricane *Katrina* that killed many people and destroyed a big number of properties is mentioned as the main factor hindering development in the short-term. Therefore it is justifiably considered the most expensive natural disaster in recent years.

Taking into account the above-mentioned, GDP growth in the US in 2005 would be 3.5% that is slightly less than was forecasted at the beginning of the year. Likewise, growth forecast for 2006 is reduced to 3.3 per cent.

Economy of **Japan** continued growing at a rather fast pace in the 1st half of 2005, mainly due to increased household demand. The growth was also promoted by increased exports, mostly to China and other Asian countries.

For 2005 and 2006, the increased exports related to risen demand for information technology products in the world is mentioned as the main factor that could favourably affect “recovery” of Japan’s growth. According to that, growth rate of Japanese GDP in comparison with April 2005 is increased by 1.2 percentage points and amount to 2% like in 2006. Unfavourable oil price fluctuations and the high yen exchange rate are still considered the main risk to growth.

Table 2.2

Main Macroeconomic Indicators of the Developed Countries
(percentage)

	GDP growth			Consumer price changes			Investment (% of GDP)			Current account deficit (% of GDP)			Budget deficit (% of GDP)		
	USA	EU	Japan	USA	EU	Japan	USA	EU	Japan	USA	EU	Japan	USA	EU	Japan
2003	2.7	1.3	1.4	2.3	2.0	-0.2	18.5	19.3	23.9	-4.7	0.1	3.2	-4.6	-3.0	-7.8
2004	4.2	2.5	2.7	2.7	2.2	0.0	19.6	19.7	23.9	-5.7	0.1	3.7	-4.0	-2.8	-7.2
2005 f	3.5	1.6	2.0	3.1	2.1	-0.4	19.8	19.9	24.3	-6.1	-0.1	3.3	-3.7	-3.1	-6.7
2006 f	3.3	2.1	2.0	2.8	1.9	-0.1	19.8	20.0	24.5	-6.1	-0.2	3.0	-3.9	-3.2	-6.2

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

Economic growth in the **old EU member states** in the 2nd half of 2004 reached slightly higher rate than earlier forecast but already at the beginning of 2005 the rate decreased again mainly due to the weak internal demand in spite of the increased exports which promoted growth. Unfavourable growth was also affected by the low confidence indicators due to rejection of the EU constitution and problems with approval of the EU budget in several old EU member states.

After stagnation during the previous three quarters, GDP in **Germany** grew by 1% in the 1st quarter of 2005. The increase in exports, which raised the positive current account balance of Germany’s balance of payments, is mainly mentioned as a cause for this growth. Domestic demand slightly fell because the private consumption and investment decreased.

For 2005 on the whole, IMF forecasted growth of German GDP by 0.8%; for 2006 the growth is forecasted in the amount of 1.2% which is by 0.7 percentage points less than forecasted in April 2005.

Economic growth in **France** for 2005 and 2006 is forecasted several percentage point tenths faster than in Germany due to increasing domestic demand. Private consumption was promoted by decrease in provisions while the growth of housing prices encouraged development of the construction sector.

For 2005 and 2006 on the whole, the growth in France is forecasted by 1.5% and 1.8% respectively. Like in other big EU-15 member states, it is more pessimistic than forecasted in April 2005.

The growth in the **United Kingdom** was weaker than forecasted (likewise in Germany and France) although British GDP growth in 2004 was considerably faster than in the latter countries. Pace of private consumption remarkably fell in the 1st quarter of 2005 due to the rising interest rates, high

fuel prices and stagnation in the housing market. Growth of exports is considered to be the main factor, which fostered development.

Growth forecasts for 2005 and 2006 in the United Kingdom are 1.9% and 2.2% respectively.

Although growth rates in the **new EU member states and candidate countries** have slightly decreased, they still are at very high level in comparison with the EU-15 member states. The slow growth in the EU-15 member states reduced export opportunities of the new EU member states and candidate countries. Exports were negatively affected by fluctuations of national currency exchange rates as well, and the internal demand has also slightly decreased. Hence, the low confidence indicators in the EU-15 member states and the rising oil prices are mentioned as the main factors hindering growth in these countries.

Amount of issued loans still continues growing, contributing to rapid increase in property prices. One should also mention the high inflation in particular countries but the inflation tends to decrease in the last months.

According to IMF calculations, the growth in 2005 on the whole will be slightly more moderate than in 2004 and will reach 4.3%. The growth in 2006 is forecasted in the amount of 4.6%.

Table 2.3

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

	GDP growth				Consumer prices				Current account deficit (% of GDP)			
	2003	2004	2005 f	2006 f	2003	2004	2005 f	2006 f	2003	2004	2005 f	2006 f
Total	4.6	6.6	4.3	4.6	9.5	6.7	4.9	4.4	-4.3	-4.9	-4.8	-4.9
Estonia	6.7	7.8	7.0	6.0	1.3	3.0	3.9	2.8	-12.1	-12.7	-10.9	-9.9
Latvia	7.5	8.5	7.8	6.8	2.9	6.3	6.3	5.1	-8.2	-12.3	-10.5	-9.4
Lithuania	9.7	6.7	6.8	6.5	-1.2	1.2	2.7	2.5	-7.0	-7.1	-8.1	-7.9
Czech Republic	3.2	4.4	4.1	3.9	0.1	2.8	2.0	2.5	-6.1	-5.2	-3.5	-3.2
Hungary	2.9	4.2	3.4	3.6	4.7	6.8	4.0	3.6	-8.8	-8.8	-8.5	-8.0
Poland	3.8	5.4	3.0	4.0	0.8	3.5	2.2	2.5	-2.2	-1.5	-1.0	-2.5
Slovakia	4.5	5.5	5.0	5.4	8.5	7.5	2.7	2.7	-0.9	-3.5	-6.3	-6.4
Slovenia	2.5	4.6	3.9	4.0	5.6	3.6	2.6	2.5	-0.4	-0.9	-1.6	-0.8
Cyprus	1.9	3.7	3.8	4.0	4.1	2.3	2.5	2.5	-3.4	-5.8	-4.0	-3.2
Malta	-1.9	1.0	1.5	1.8	1.9	2.7	2.4	1.9	-5.8	-10.4	-10.5	-8.6
Turkey	5.8	8.9	5.0	5.0	25.2	10.3	8.4	6.9	-3.3	-5.1	-5.6	-5.3
Bulgaria	4.3	5.6	5.5	5.5	2.3	6.1	4.4	3.5	-9.2	-7.5	-9.0	-8.5
Romania	5.2	8.3	5.0	5.0	15.3	11.9	8.8	6.9	-6.8	-7.5	-7.9	-7.8

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

The highest growth rates among EU member states are still maintained in the Baltic states, which is mostly stimulated by high domestic demand. The rapidly rising crediting promotes increase in private consumption while the low interest rates and availability of EU funds foster investment. This certainly creates big pressure on inflation, especially in Latvia. For the same reason, levels of current account deficit of the balance of payments are still very high in the Baltic states. The total economic growth in **Lithuania** and **Estonia** in 2005 is forecasted in the amount of 6.8% and 7% respectively, while in 2006 the growth will slightly diminish to 6% and 6.5% respectively.

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 risks to growth of Baltic states like in the previous year.

It is expected that growth in the group of **Commonwealth of Independent States (CIS)** will slightly decrease in 2005 in comparison with the rapid growth in 2003 and 2004, responding to stagnation in the oil product sector (diminishing investment and growth rates and the *Yukos* affair in Russia). In the region on the whole, private consumption continues growing, wages increase and crediting volumes go up accordingly.

In 2005 on the whole, the growth in the region is forecasted in the amount of 6% (slightly lower than in April 2005 forecast), mentioning such risks as the fluctuating prices for oil and other consumer goods and stagnation in markets of other regions (e.g., Asian countries). In 2006 the growth in the region may decrease even more to 5.7%, which is greatly affected by diminishing growth rate of Russia.

Table 2.4

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

	2003	2004	2005 f	2006 f
GDP growth	7.9	8.4	6.0	5.7
of which in Russia	7.3	7.2	5.5	5.3
Consumer prices	12.0	10.3	12.6	10.5
of which in Russia	13.7	10.9	12.8	10.7
Current account balance (% of GDP)	6.3	8.3	10.6	10.3
of which in Russia	8.2	10.3	13.2	13.0

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

Despite several natural disasters in 2005 (e.g., hurricane Katrina) and growing oil prices, the global growth in 2005–2006 is still projected rather positively in the amount of 4.3% (5.1% in 2004). Development of world financial markets, especially decrease of long-term interest rates, is mentioned as conducive to growth.

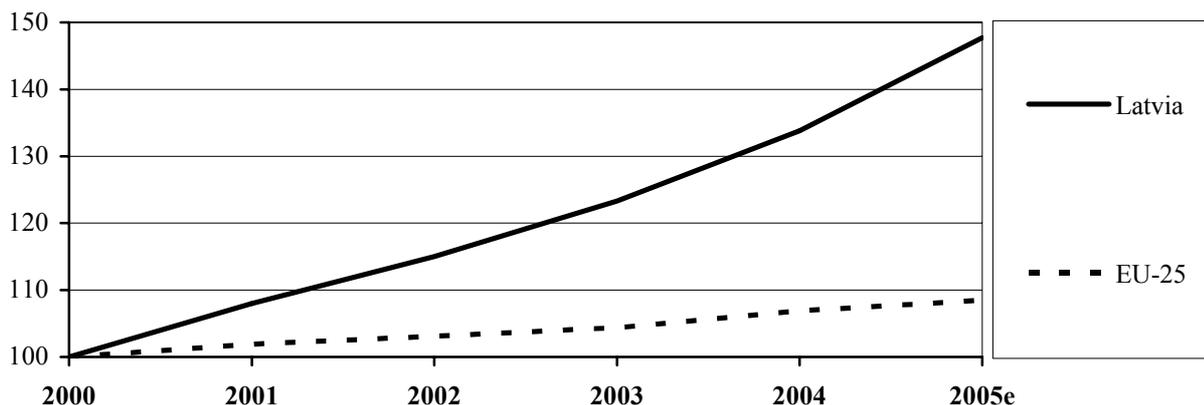
3. Growth and Productivity

3.1. GDP Dynamics and Productivity

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

Figure 3.1

GDP Growth in Latvia and EU-25
(2000 = 100%)



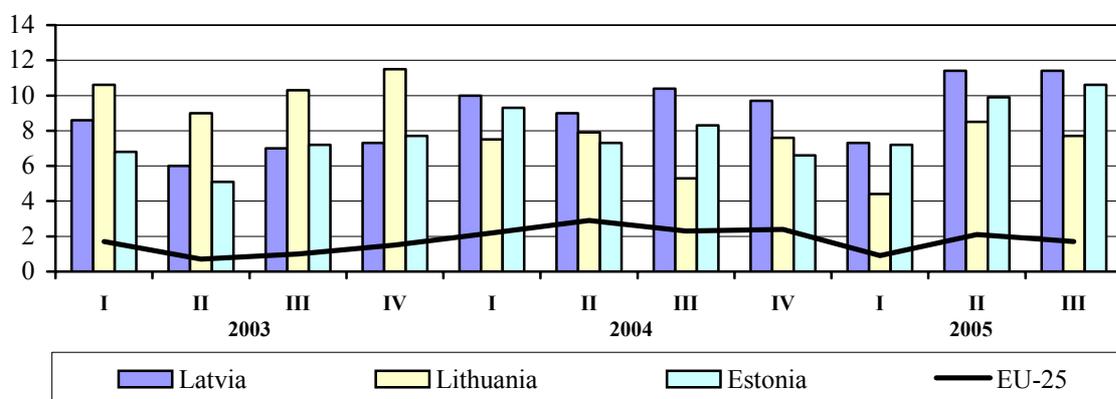
e – estimation of the Eurostat
Source: Eurostat

Growth was especially fast in 2005, when GDP in the first three quarters increased by 10.1% in comparison with the respective period of 2004. The steady growth is ensured by stable dynamics of domestic demand and ability to expand export markets.

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

Figure 3.2

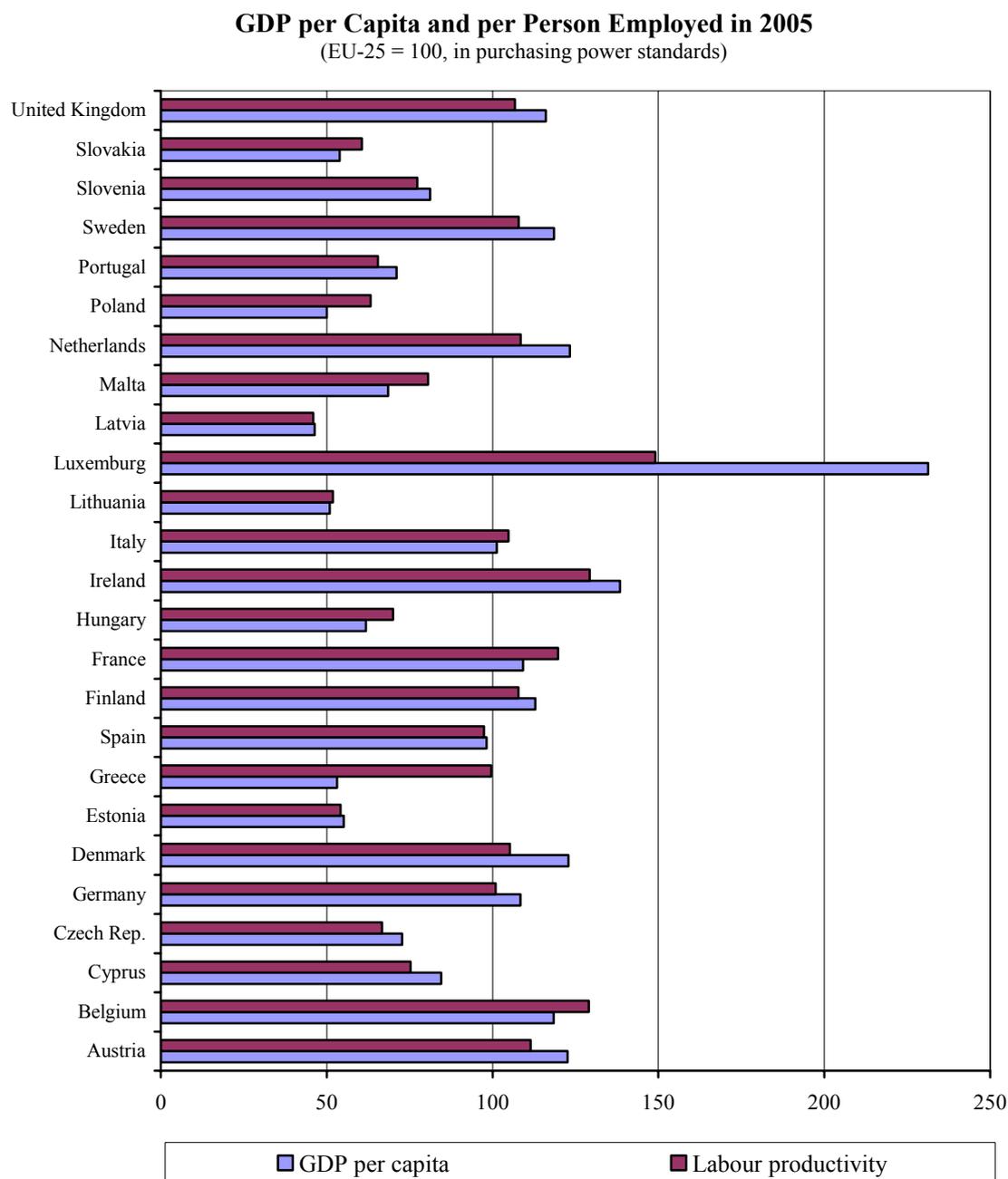
GDP Growth in Latvia, Lithuania, Estonia and EU-25, Quarterly Profile
(percentage change against the corresponding quarter of the preceding year)



Source: Eurostat

In 2005, Latvian GDP per capita in purchasing power standards was 46.4% of the EU-25 average (according to the estimation of the Eurostat). In comparison with 2000, the backwardness from the average EU level was reduced by 11.4 percentage points.

Figure 3.3



Source: estimation of the *Eurostat*

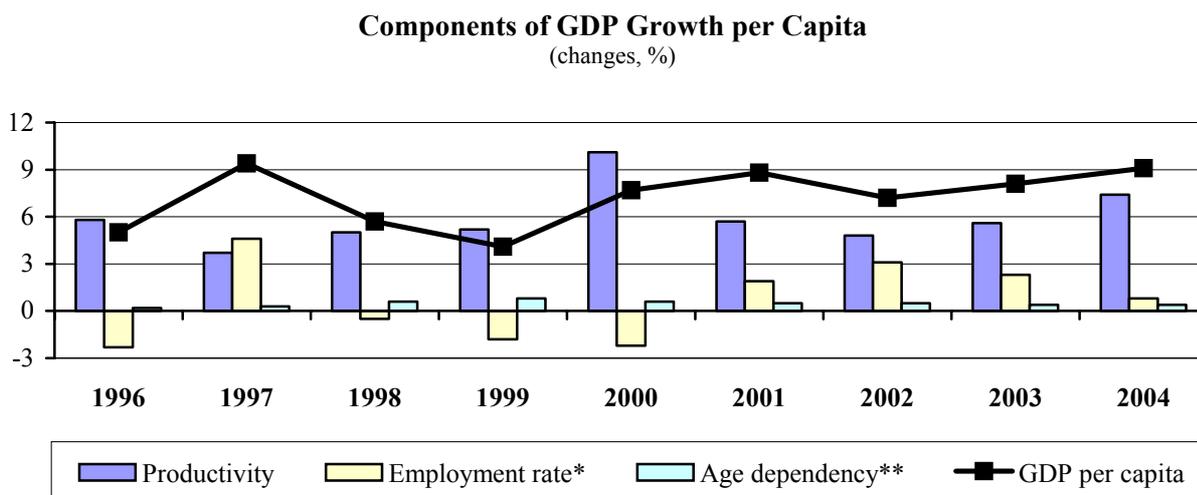
In this period, the real volume of GDP per capita has increased by 1.5 times in Latvia and by 8.5% on average in EU-25.

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

Increase of the Latvian GDP per capita was mainly fostered by productivity growth and, to a smaller extent, by employment growth and demographic changes (see Figure 3.4). In 2005, the volume of GDP per person employed in Latvia compared to the EU-25 average was almost at the same level as GDP per capita.

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

Figure 3.4



* for persons aged 15-64 years

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

Since 2000 along with the productivity growth the employment rate increases as well, and this reflects in faster GDP per capita growth. The positive impact of the age dependency decrease on GDP per capita should be also noted. Age dependency decreased due to the rapid decline of the population aged less than 14 years, and not so rapid increase of the population aged over 65 years.

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

Table 3.1

Productivity by Sectors of Economy –Value Added per Person Employed

	Annual average changes during the period of 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 economy	5.9	6509

* Public administration with health care and education

Productivity is increasing faster in manufacturing and agriculture. However, its level in these sectors still lags behind the 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 economy on average.

3.2. GDP Expenditure

3.2.1. Aggregate Demand

The stable growth in the last years was greatly ensured by the growing domestic demand. Private consumption has increased. Private consumption in favourably influenced not only by the annual increase of wages, but also by the opportunity for individuals to get consumer 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

Expenditure of GDP
(percentage)

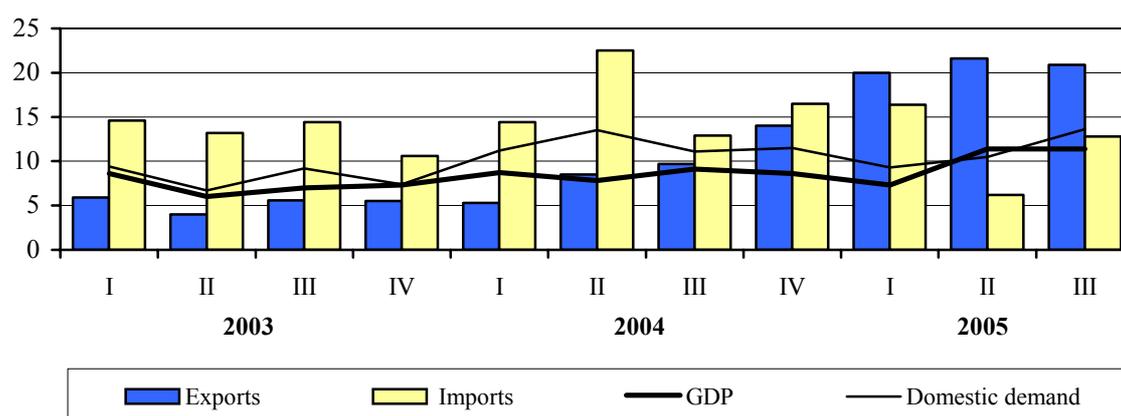
	2003			2004			2005e		
	Structure	Growth rates	Contribution to growth	Structure	Growth rates	Contribution to growth	Structure	Growth rates	Contribution to growth
Gross domestic product	100	7.2	7.2	100	8.5	8.5	100	10.3	10.3
Private consumption	62.4	8.2	5.1	62.4	9.3	5.9	60.9	9.0	5.7
Public consumption	21.4	1.9	0.4	20.0	2.1	0.4	19.8	3.0	0.5
Gross fixed capital formation	24.4	12.3	3.3	27.5	23.8	6.6	30.7	22.0	7.0
Changes in inventories	4.3	-	2.9	5.8	-	0.7	2.1	-	-4.4
Exports	42.1	5.2	2.1	44.1	9.4	3.8	48.7	18.5	8.5
Imports	-54.6	13.1	-6.6	-59.7	16.6	-8.9	-62.2	12.2	-7.0

e – estimation of the Ministry of Economics

High growth indicators are also in 2005. Similarly as in the previous year, the growth was largely stimulated by the domestic demand but the expansion of export opportunities had even bigger role (see Figure 3.5).

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 60% of GDP on average, but the final consumption expenditures are close to 62%, therefore the net savings are negative and comprise 2% of GDP.

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.

Table 3.3

Disposable Income and Final Consumption Expenditures of Households, Net Savings

	2002	2003	2004e	2005e
Disposable income of households (changes in % against the preceding year)	7.6	13.7	16.6	16.4
Final consumption expenditures of households (changes in % against the preceding year)	9.7	11.5	16.0	16.4
Net savings in % of disposable income	-5.5	-3.5	-2.9	-2.9
Net savings in % of GDP	-3.2	-2.1	-1.8	-1.7

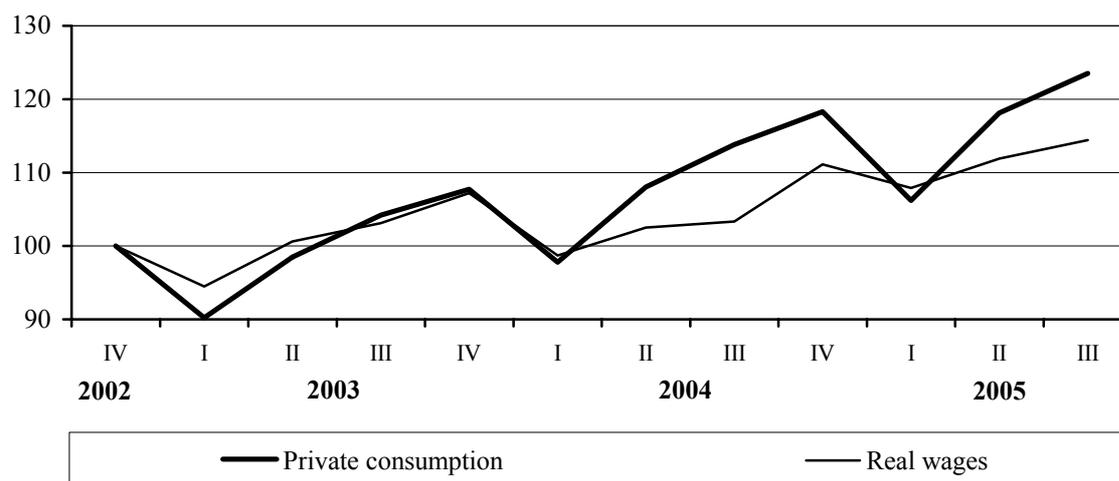
e – estimation of the Ministry of Economics

Dynamics of the disposable income and the final consumption (private consumption) expenditures of households are different. The private consumption increased faster than income until 2004, but in 2004 and 2005 it grew slightly slower. Hence the negative savings (debt) of households against GDP decreased to 1.7% in 2005 contrary to 3.2% in 2002. Real wages grow slightly slower than the private consumption while the share of pay for work in the total income of households slightly increases due to employment rise.

Figure 3.6

Growth of Real Wages and Private Consumption, Quarterly Profile

(4th quarter of 2002 = 100)



In 2004 the disposable monthly income of households per household member increased by 17% on average in comparison with 2003 and reached 101.23 LVL¹. Growth of the consumer price index in this period was lower (6.2%), thereby the purchasing power of the population rose by 9.7% on average. Higher nominal growth of the disposable income was in the countryside (12.4%) while the disposable income in cities grew by 11.4%.

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

Although the assessed real volume of public consumption grows at considerably slower pace, its actual 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 the GDP growth rates both in current and constant prices. Investment is the part of GDP expenditure with the most rapid growth rate.

¹ According to the data of household budget survey

3.2.3. Investment

Stable macroeconomic and financial environment, as well as positive evaluation of Latvian investment environment by international organisations, underly the high investment growth in Latvia, which continues for several years. In 2004 fixed investments were by 1.7 times bigger than in 2000, i.e., the investment in this period has annually increased by 15% on average. Latvia has the leading positions in the investment dynamics among the EU member states.

As indicated by the *Eurostat* data, investment growth in the new EU member states has slightly slowed down in the last four years compared to the previous five years, but still exceeds the EU-15 average growth rate, which equalled to mere 0.4 per cent from 2001 to 2004.

It should be noted that the investment dynamics in the Baltic States, including Latvia, have become more stable compared to the fluctuating volumes in 1998 and 1999.

The share of investment in GDP increased annually as well, along with the fast investment growth rates, which exceeded the GDP growth. In the last four years the share of investment in GDP (gross fixed capital formation against GDP) constitutes 25.3% on average or almost by 4 percentage points more than the EU-15 average level. So nearly a quarter of the national income is annually used for the gross fixed capital formation, which is one and a half times more than in the first 10 years on average after restoration of Latvia's independence. Rapid investment dynamics continued in 2005 as well. In 9 months of 2005 the investment went up by 21.5% in comparison with 9 months of the preceding year and comprised 28.2% of GDP.

Table 3.4

Gross Capital Formation			
	2001-2004 (average per year)	2004	9 months of 2005
Real growth			
GDP	7.6	8.5	10.1
Gross capital formation	19.9	23.0	5.6
– gross fixed capital formation	15.1	23.8	21.5
% of GDP			
Gross capital formation	29.2	33.3	30.7
– gross fixed capital formation	25.3	27.5	28.2
– changes in inventories	3.9	5.8	2.5

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% annually) while the investment in the public sector¹ has increased by 32% in 4 years (on average by 7.7% annually).

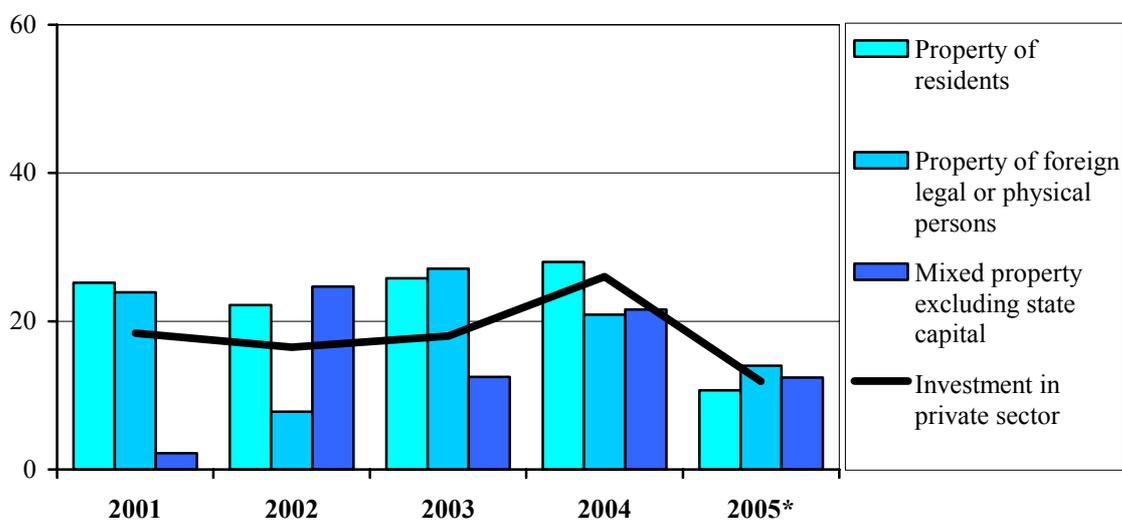
In 9 months of 2005, investment in the public sector went down by 3% compared to the respective period of 2004, while investment in the private sector increased by 22% and made 71% of all investment in Latvian economy.

Investments in companies owned by residents and in companies owned by non-residents increased at different paces (see Figure 3.7). Since 2001 the investment in companies owned by residents increased on average by 25.3% per annum and made up 42% of investment in the private sector or 27.7% of total investment. Investment in companies owned by non-residents reached 17% of investment in the private sector, growing annually by 19.7% on average. In 2005 faster growth of investment was observed in the companies owned by non-residents.

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

Figure 3.7

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



* estimated using the quarterly data

Sectoral structure of investment¹. Certain changes have also been observed in the sectoral structure of investment. In the last four years (2001 to 2004) investment dynamics in production sectors was more than one and a half times faster than in services. In this period, investment in production sectors grew by 106.2% (annually by 19.8% on average), while investment in services sectors increased by 61.1% (annually by 12.7% on average). Also in 2005 investment in production sectors grew much faster than in services sectors. In 9 months of 2005, investment in production sectors was 26% higher than in the respective period of the preceding year, while investment in services sectors grew by mere 6%. Positive investment dynamics is observed in all economy sectors. Investment in the hotels-and-restaurants sector almost doubled (increase by 94%), and investment also grew especially fast in agriculture (by 51%), mining industry (70%), manufacturing (37%), construction (69%) (see Table 3.5).

Table 3.5

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

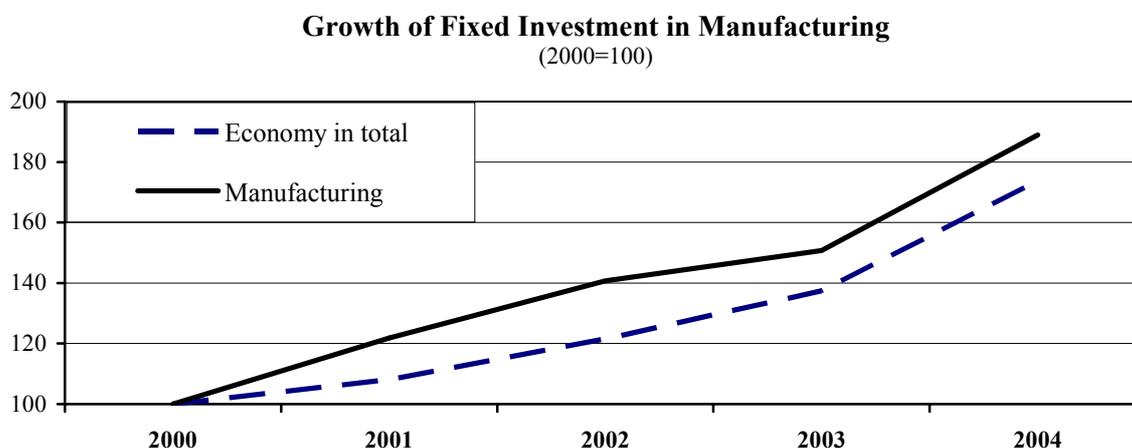
	Growth			Structure		
	Average 2001-2004	2004	9 months of 2005	Average 2001-2004	2004	9 months of 2005
Primary sectors	33.6	26.3	48.1	3.9	4.6	5.0
Manufacturing	17.3	25.4	37.0	15.8	15.5	20.3
Electricity, gas and water supply	19.0	31.2	-6.0	9.1	9.6	10.8
Construction	20.3	43.2	69.0	3.1	3.6	5.4
Trade	12.4	27.0	19.8	16.0	15.7	16.0
Transport and communications	1.8	3.0	2.0	19.0	14.4	16.4
Other commercial services	22.2	27.1	3.4	19.3	20.9	16.6
Public services	15.8	48.5	-9.0	13.9	15.7	9.6
Total	14.8	24.5	14.0	100.0	100.0	100.0

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

Due to faster dynamics of investment, the share of production sectors in the investment structure increases every year from 28% in 2001 to 33.2% in 2004. In 9 months of 2005 the investment in production sectors constituted 41.9% of total investment in Latvian economy.

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

Figure 3.8



In 2004 the investment in manufacturing constituted 15.3% or by 1.1 percentage points more than in 2000. In 9 months of 2005, the investment in manufacturing increased by 37% in comparison with 9 months of 2004.

Table 3.6

Dynamics and Structure of Investment in Manufacturing
(%)

	Growth rates			Structure		
	Average 2001-2004	2004	9 months of 2005	Average 2001-2004	2004	9 months of 2005
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

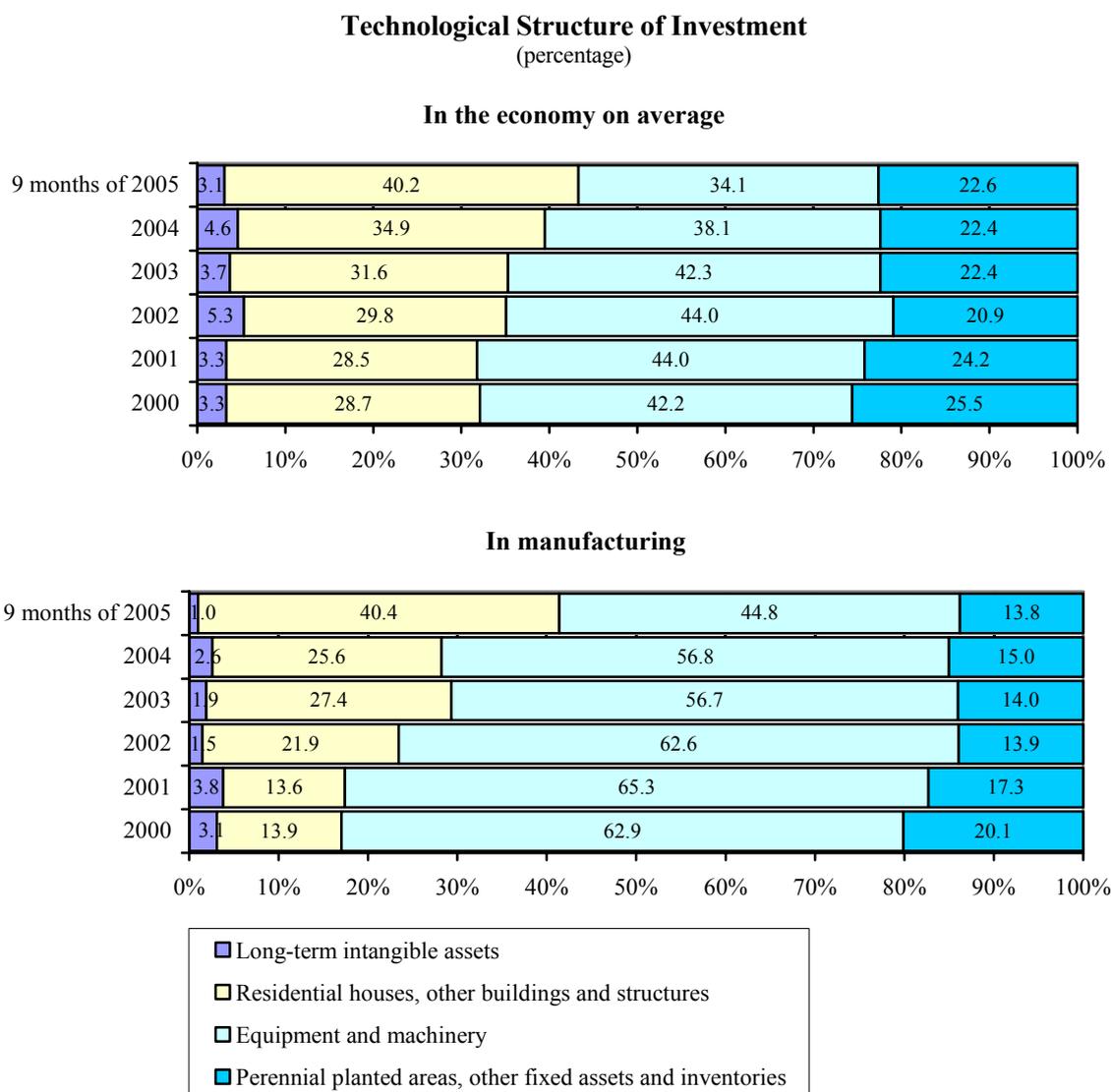
In 2004 the investment in manufacturing increased by 25.4%. These investments were mostly made in food industry and wood processing. Structure of investment in manufacturing gradually changes every year. In the period from 2001 to 2003 the share of these two sectors in investment made into manufacturing amounted to 57.4%, but decreased to 45% in 2004. This was mostly affected by decreased investment in wood processing. In 9 months of 2005 the investment in food industry and wood processing constituted 54% of all investment in manufacturing or 11% of total investment in Latvian economy.

Evaluating the **technological structure** of investment, it must be noted that in the last two years the share of residential houses, other buildings and structures in the total investment increased especially fast,

which was greatly influenced by the development of mortgage crediting in Latvia. The share of the long-term intangible assets in investment is still small.

The share of technological machinery and equipment in the total investment amounts to 43% on average in the last four years, and almost one-fourth of these investments are allocated for acquisition of transport vehicles and are not directly linked with the production process. One-third of the investments are channelled to construction and renovation of buildings.

Figure 3.9



Technological structure of investment is greatly influenced by production specifics and the structure of the existing fixed assets. The average share of equipment and machinery in the manufacturing is by 15 percentage points higher than in the economy on average, while the average share of investment into houses, buildings in the manufacturing investment structure during 2000-2004 was by 15 percentage points lower than in the economy on average. In the recent years, entrepreneurs in manufacturing invest increasingly more in buildings. New premises are being built and old premises renovated for production needs. This was greatly determined by improved access to funds and is indicative of a new development phase in manufacturing.

As it has been already mentioned, the share of the long-term intangible assets in investment is very small in Latvia with a poorly pronounced trend to grow gradually.

Table 3.7

Long-Term Intangible Assets
(% of fixed investment)

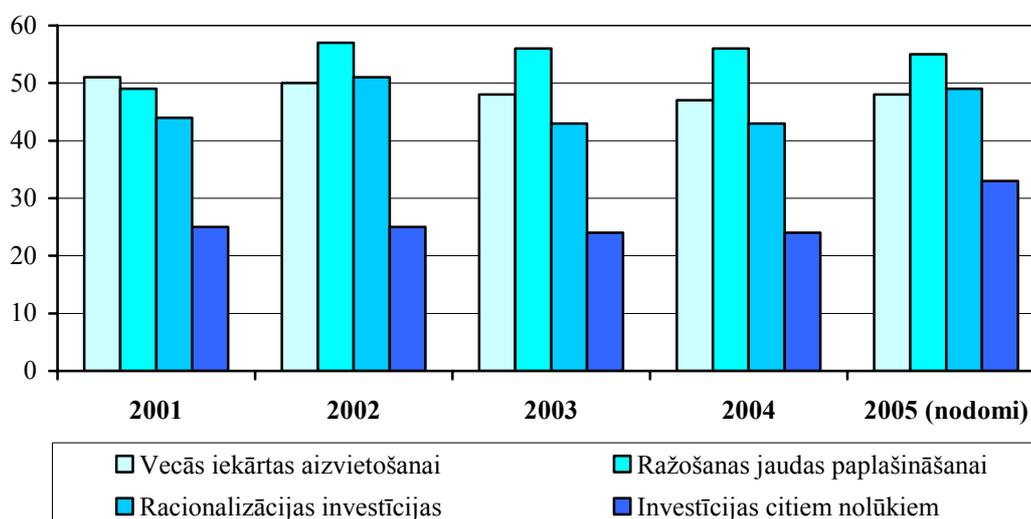
	2000	2001	2002	2003	2004	9 months of 2005
Primary sectors	0.73	0.39	0.87	0.65	1.21	1.76
Manufacturing	3.12	3.76	1.53	1.87	2.57	1.00
Electricity, gas and water supply	1.64	2.74	2.42	5.55	2.40	1.03
Construction	1.53	1.14	3.02	5.52	1.59	1.27
Trade	1.78	2.19	1.61	1.55	2.38	2.48
Transport and communications	3.13	3.61	8.33	2.67	6.65	2.33
Other commercial services	5.64	2.74	9.26	5.95	7.11	7.16
Public services	4.16	6.18	6.78	7.06	7.08	8.21
Total	3.28	3.35	5.28	3.72	4.48	3.13

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

The rapid growth of investment in the current years was mainly determined by such factors as wider access to financial resources, increased utilization rate, and the necessity to renew the current capacities for maintaining and increasing the competition.

Figure 3.10

Types of Fixed Investment in Manufacturing Enterprises
(percentage of number of enterprises)



Reduction of the tax burden and increased sales of products due to the growing demand positively affected the financial position of enterprises, thereby increasing opportunities to invest own means. Surely, the most essential financial incentive to investment in the last years is the 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%. Although in 2004 the average weighted annual rates for the long-term loans equalled to 9.2%, i.e., exceeded the level of 2003 by almost 2 percentage points, taking into account higher inflation, the real interest rates on loans are lower than in 2003. In 2005 the average weighted annual rates on long-term loans issued in LVL to domestic companies remained at the level of the previous year.

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

Most enterprises annually invest in replacement of old equipment. Such trend is also in 2005. Investments for replacement of old equipment are planned by 50% of the surveyed industrial companies.

Since 2002, investments in manufacturing are mostly made for expansion of the utilization rate. Also in 2005 such investments are planned by 55% of the surveyed companies. In 2003 and 2004 investments in production were made more for expansion of its capacities than for mechanisation and automatisation. In 2005, rationalisation investment is planned in bigger amount than in the previous years. The number of companies that plan to make investments for increase in labour safety and environmental protection is growing, and this fact should be evaluated positively. In 2004 such investments were made by 24% of companies but in 2005 such investments are planned by 33% of companies.

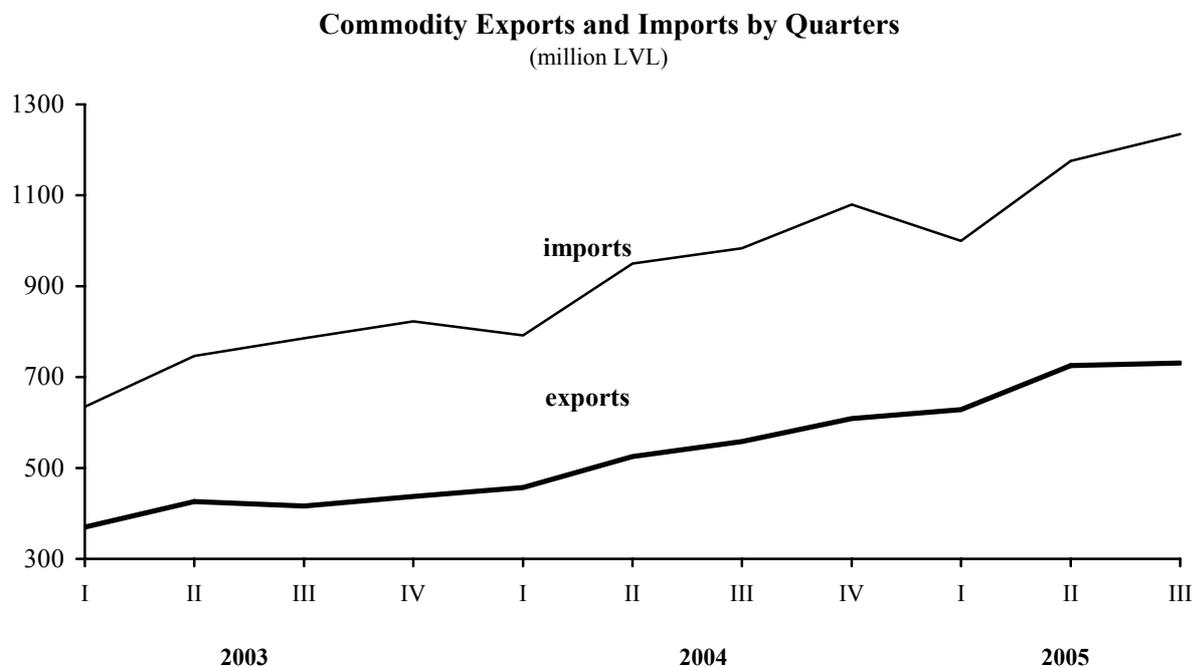
The utilization rate is also an important factor in the growth of investment. Results of business surveys indicate that the utilization rate in Latvian enterprises is increasing gradually. In 2004 the rate of utilization (as percentage of full capacity) in industry equalled to 71% on average, exceeding the average level of 2000 by 11 percentage points. In July 2005 the rate of utilization reached 79% and was the highest since 1993. The growing domestic and external demand in conditions of high rate of utilization can create additional stimuli for investment also in the future.

3.2.4. Exports and Imports

Exports and imports of commodities

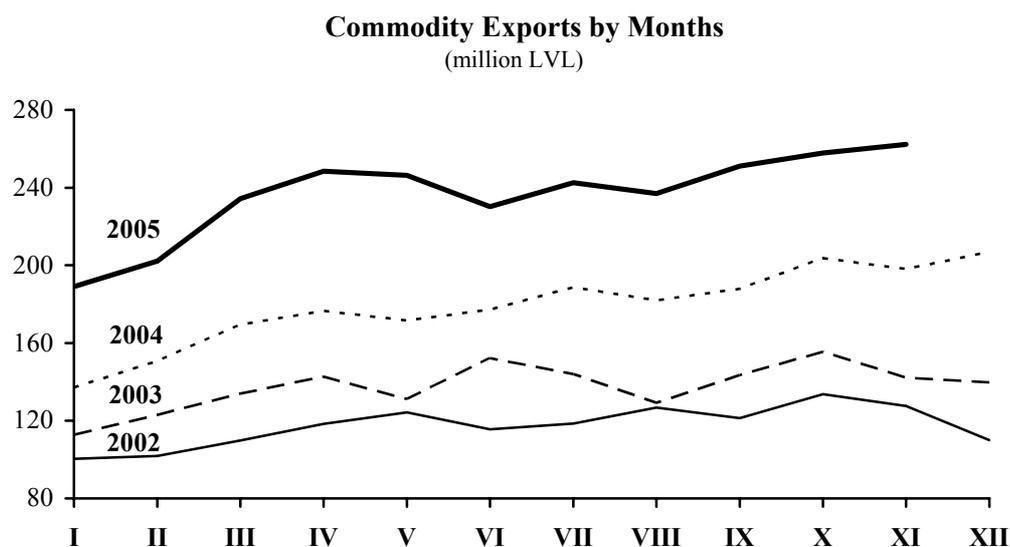
Exports of Latvian commodities in January-November 2005 were by 34% bigger than in the respective period of the preceding year. Imports increased by 27%, especially in the 2nd quarter (see Figure 3.11).

Figure 3.11



At the beginning of 2005 the **commodity exports** were favourably influenced by the fast rise of the export unit value, which grew by 14% in the 1st quarter in comparison with the respective period of the preceding year. In 3 quarters of 2005 the rise of export unit value was 11%. The main reason of the rise is the favourable changes of currency exchange rates.

Figure 3.12



Commodity exports in 11 months of 2005 went up in all groups of goods, especially mineral products and food products, which accounted for respective 26% and 17% of the total growth of exports (see Table 3.8).

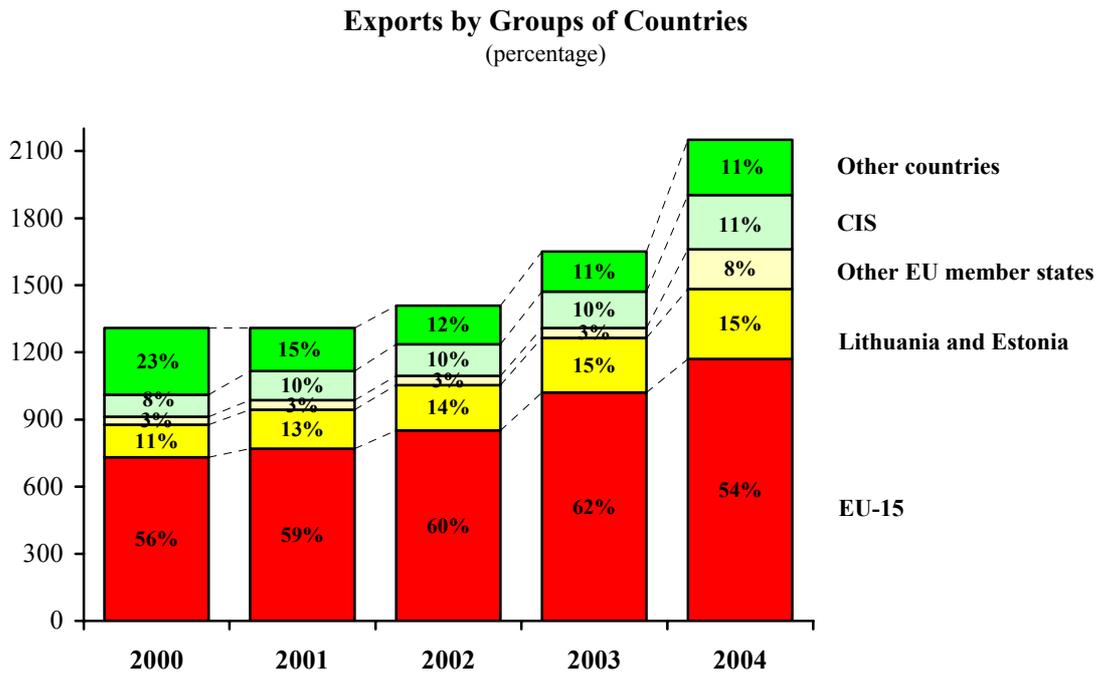
Table 3.8

Exports by Main Groups of Commodities
(FOB prices)

	2004			11 months of 2005		
	million LVL	structure (%)	increase against 2003 (current prices, %)	million LVL	structure (%)	increase against 11 months of 2004 (current prices, %)
Total	2150.0	100	30.3	2604.7	100	34.0
including:						
wood and wood products (IX)	655.3	30.5	12.6	656.7	25.2	8.9
metals and metal products (XV)	303.3	14.1	46.2	345.0	13.2	27.4
light industry products (VIII; XI-XII)	244.6	11.4	8.5	247.4	9.5	11.5
agricultural and food products (I-IV)	209.3	9.7	40.9	309.0	11.9	64.8
products of chemical industry and allied industries, plastics (VI-VII)	169.8	7.9	33.7	207.4	8.0	34.2
machinery (XVI)	169.1	7.9	44.8	235.0	9.0	57.2
mineral products (V)	114.1	5.3	331.9	244.2	9.4	152.6
transport vehicles (XVII)	54.4	2.5	58.9	100.7	3.9	104.7
other commodities (X; XIII-XIV; XVIII-XXII)	230.1	10.7	25.7	259.4	10.0	23.5

Exports to **EU member states** in 11 months of 2005 were by 32.2% bigger than in the previous year. Exports increased in all groups of commodities, and the biggest contributions to the growth and to the total exports were made by exports of mineral products and food products (29% and 18% respectively of the total growth of exports to the EU-25). Unusual but more moderate growth rates were observed in the export groups of machinery and metal products, which accounted for 25% of the total exports to the EU-25.

Figure 3.13



Exports to **CIS countries** in 11 months of 2005 increased at especially rapid pace by 45.4% in comparison with 11 months of 2004. The biggest contributions to this growth were made by increased exports of chemical industry products and machinery (25% and 23% respectively of the total growth of exports to CIS countries). Exports of wood and wood products decreased considerably (by 60%), although this group accounts for less than 2% of the total exports to CIS countries.

Commodity imports in 11 months of 2005 increased by 26.6% in comparison with 11 months of 2004 (see Figure 3.14 and Table 3.9). Imports increased in all groups of commodities. The biggest growth was observed in the group of mineral products, which accounted for 25% of the total increase of imports, and in the group of machinery (23%).

Figure 3.14

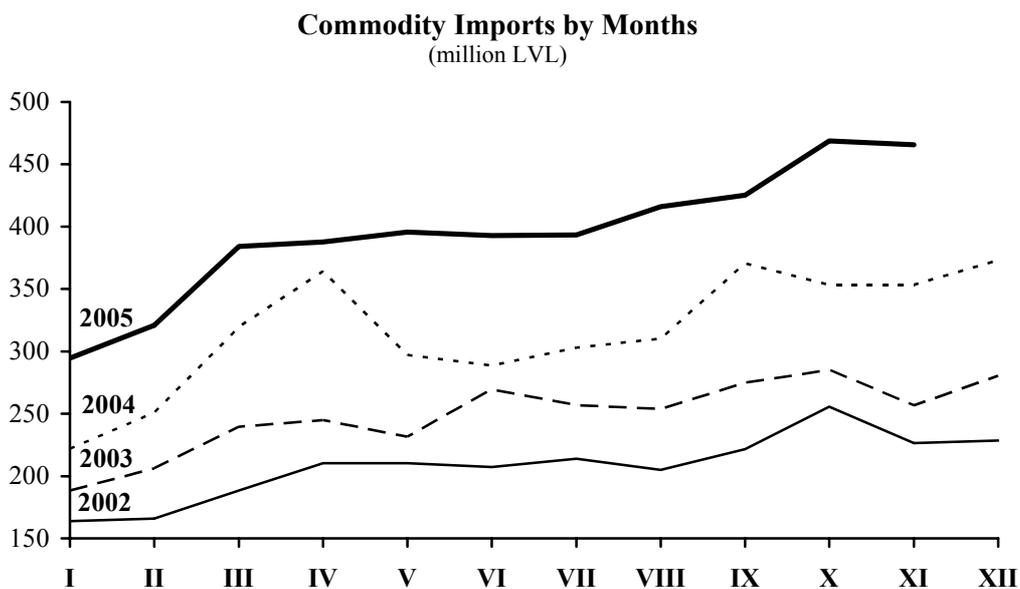


Table 3.9

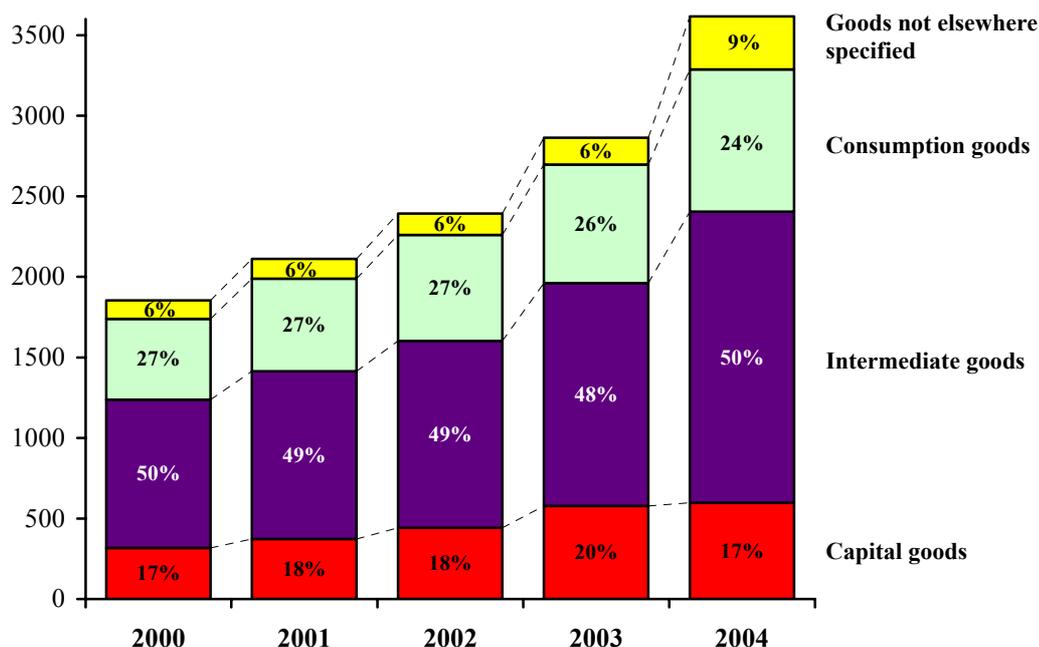
Imports by Main Groups of Commodities
(CIF prices)

	2004			11 months of 2005		
	million LVL	structure (%)	Increase against 2003 (current prices, %)	million LVL	structure (%)	increase against 11 months of 2004 (current prices, %)
Total	3805.3	100	27.3	4344.8	100	26.6
including:						
wood and wood products (IX)	114.8	3.0	63.4	130.5	3.0	24.5
metals and metal products (XV)	388.4	10.2	40.0	404.5	9.3	14.9
light industry products (VIII; XI-XII)	261.5	6.9	12.7	271.0	6.2	11.7
agricultural and food products (I-IV)	445.3	11.7	23.3	507.9	11.7	29.0
products of chemical industry and allied industries, plastics (VI-VII)	540.2	14.2	19.0	589.3	13.6	19.5
machinery (XVI)	755.4	19.9	20.0	847.1	19.5	25.0
mineral products (V)	481.7	12.7	62.2	675.9	15.6	57.5
transport vehicles (XVII)	413.7	10.9	31.9	465.5	10.7	24.3
other commodities (X; XIII-XIV; XVIII-XXII)	230.1	10.6	14.0	453.0	10.4	24.2

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.

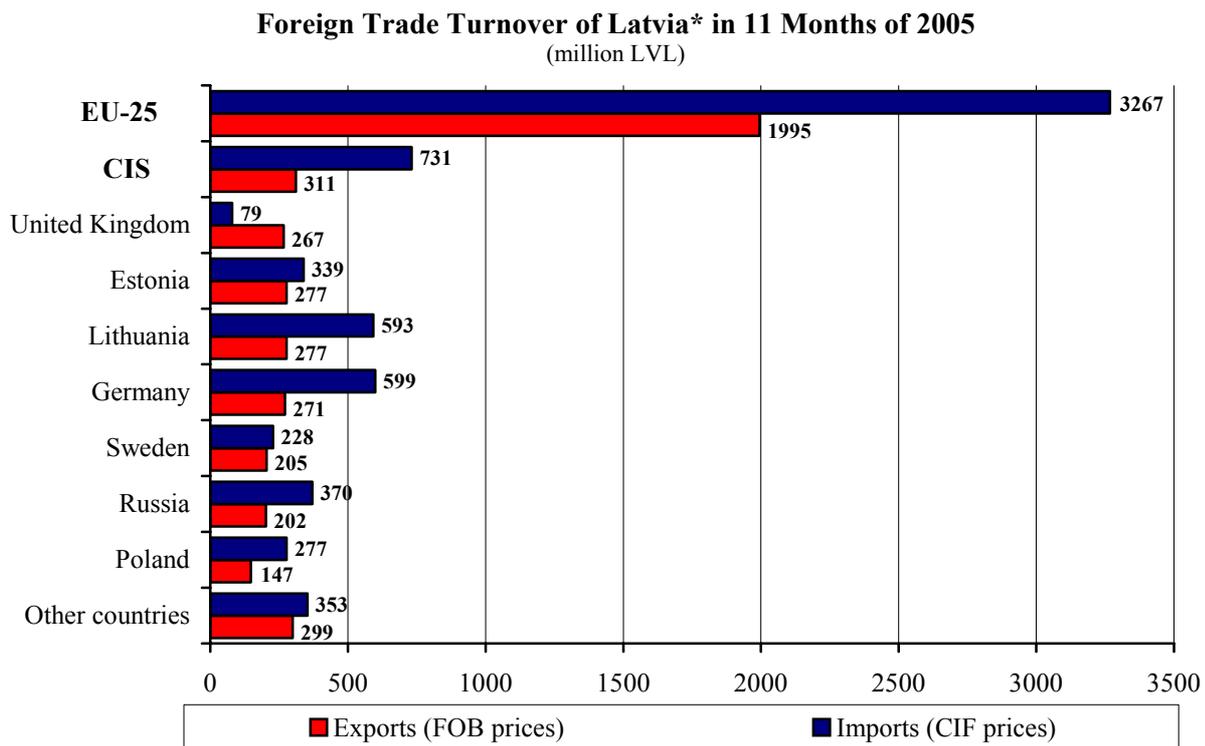
Figure 3.15

Imports by Classification of Broad Economic Categories
(in connection with basic indices of national accounts, in current FOB prices, million LVL)



The biggest **trading partners** of Latvia in 11 months of 2005 were Germany (13% of the total foreign trade turnover), Lithuania (13%), Estonia (9%), Russia (8%), Sweden (6%) and Poland (6%).

Figure 3.16



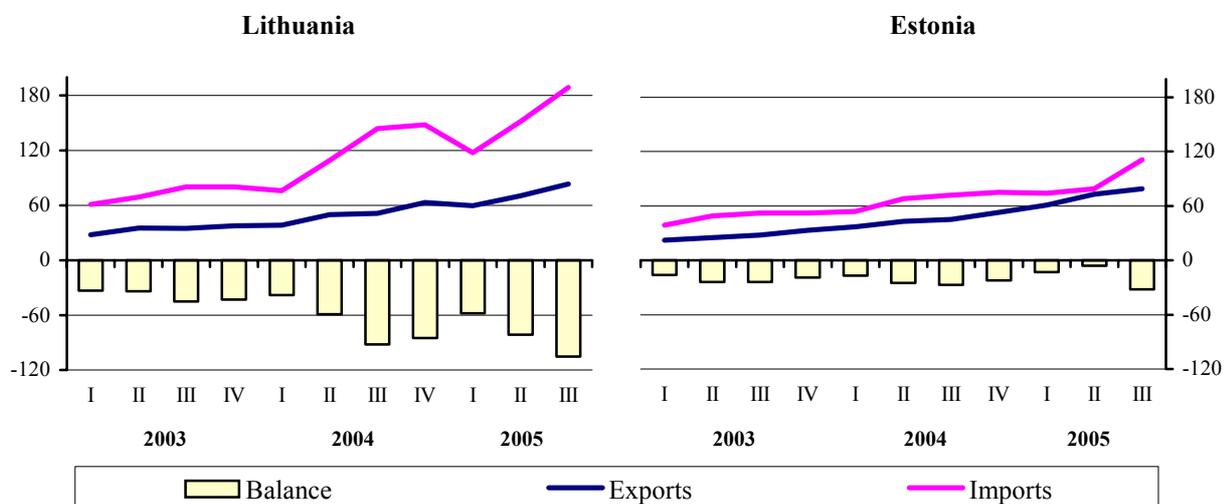
* with countries, where foreign trade turnover with Latvia is not less than 5%.

After accession to the EU, foreign trade of Latvia with **Lithuania** and **Estonia** is increasing very rapidly. Comparing with the period before accession to the EU, Latvian foreign trade with other Baltic states has increased more than twice during two years after accession. Unfortunately, a considerable negative balance still remains in trade with these countries, although the share of the negative balance slightly diminishes taking into account the rapid increases of trade volumes (see Figure 3.17).

As the figure shows, the negative balance of foreign trade with Lithuania (116% in comparison with exports) is bigger than with Estonia (23%). The main groups of commodities exported to Estonia and Lithuania are food products, chemical industry products, metals and metal products, while the main imported commodities are mineral products, transport vehicles and food products.

Figure 3.17

Latvian Foreign Trade Turnover with Lithuania and Estonia by Quarters (million LVL)



Exports and imports of services

The clearly negative balance of commodity trade of Latvia is partly covered by the positive balance of services (see Table 3.10). According to the data of the balance of payments, the balance of services in 3 quarters of 2005 has deteriorated in comparison with the respective period of the preceding year, as exports of services went up by 25%, but imports increased faster by 41%.

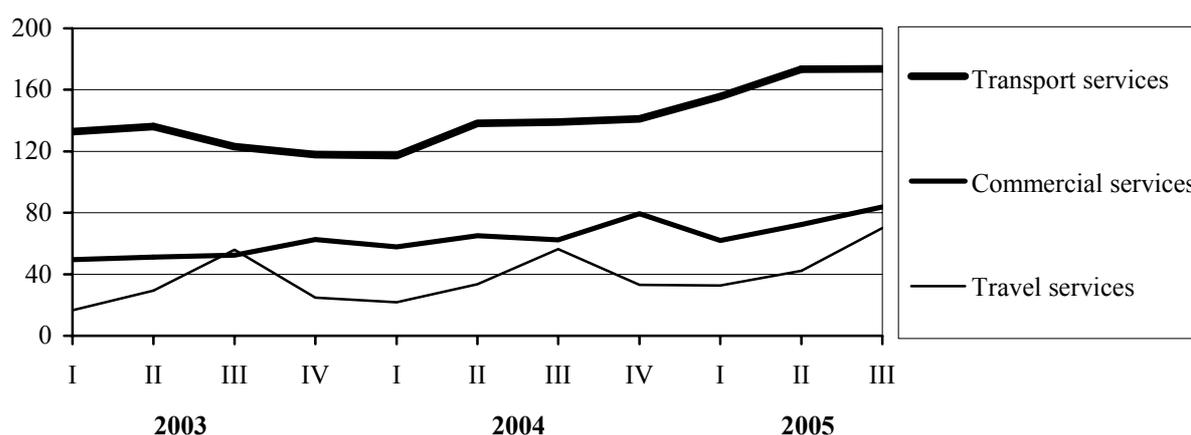
Table 3.10

Exports and Imports of Services in Three Quarters of 2005

	Million LVL			Structure (%)		Changes against 3 quarters of 2004 (%)	
	exports	imports	balance	exports	imports	exports	imports
Services – total	878.9	632.6	264.4	100.0	100.0	24.9	41.4
including:							
Transport services	502.7	208.4	294.2	57.2	33.0	27.4	30.3
– sea transport	214.1	47.7	166.4	24.4	7.5	26.2	14.7
– air transport	57.1	72.1	-15.1	6.5	11.4	41.0	50.2
– other transport	231.5	88.6	142.9	26.3	14.0	25.5	26.0
Travel	144.7	241.0	-96.3	16.5	38.1	30.0	70.2
Commercial services	218.1	170.9	42.7	24.8	27.0	17.8	26.9
Other services	13.5	12.2	1.3	1.5	1.9	8.5	9.7

More than half of the exports of services are made by revenues from transit haulage. 3 quarters of 2005 were slightly better for the transit business than 3 quarters of the preceding year. Increase of revenues from commercial services and incoming tourists is significant. Latvian travellers still, as usual, have spent more money abroad than incoming tourists in Latvia.

Figure 3.18

Exports of Services by Quarters
(million LVL)**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 71.8% (by value added) in 2000 to 73.3% in 2004, because trade has developed faster than other sectors of economy.

Table 3.11

Structure of Economy
(%)

	By value added		By number of employees	
	2000	2004	2000	2003
Primary sectors	4.8	4.4	14.5	12.9
Manufacturing	13.7	13.4	17.9	15.9
Electricity, gas and water supply	3.6	3.1	1.9	2.0
Construction	6.1	5.8	5.9	8.2
Trade, hotels and restaurants	17.9	19.8	17.7	17.3
Transport and communications	14.0	15.6	8.3	9.2
Other commercial services	23.0	22.2	12.3	13.4
Public services	16.9	15.7	21.5	21.1
Total	100.0	100.0	100.0	100.0

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

Rapid economic growth in recent years has been ensured by both increased domestic demand and wider export opportunities. Increase of domestic demand had a direct effect on the growth of services while 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 by 3 percentage points lower. 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 the domestic demand, but a little over one-tenth is related to the trade mediation services provided to non-residents. This share is growing every year.

Table 3.12

GDP Growth
(%)

	Growth rates				Contribution to growth			
	2002	2003	2004	2002-2004 average	2002	2003	2004	2002-2004 total
Primary sectors	5.1	-1.0	4.7	2.9	0.2	0.0	0.2	0.4
Manufacturing	8.9	16.0	7.9	7.6	1.2	0.9	1.1	3.2
Electricity, gas and water supply	4.2	4.5	4.9	4.5	0.1	0.2	0.2	0.5
Construction	10.8	13.7	13.0	12.5	0.7	0.9	0.9	2.5
Trade, hotels and restaurants	11.9	10.9	10.3	11.0	2.2	2.1	2.0	6.3
Transport and communications	3.4	8.9	12.9	8.4	0.5	1.2	1.8	3.5
Other commercial services	5.4	5.7	7.7	6.3	1.3	1.3	1.8	4.4
Public services	2.4	3.8	3.9	3.4	0.4	0.6	0.6	1.6
Total	6.6	7.2	8.5	7.4	6.6	7.2	8.5	22.2

Total demand of the transport and communications at least by two-thirds is determined by the 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, operation of 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 the growth of cargo turnover in other ports of Latvia, 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. Contributions by railway transport and port services to the growth of the sector were smaller.

Passenger transport services increased substantially, especially in air transport.

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

Table 3.13

GDP Growth in Three Quarters of 2005
(% against the respective quarter of the preceding year)

	Growth rates				Contribution to growth			
	1st quart.	2 nd quart.	3rd quart.	Total in 3 quarters	1st quart.	2nd quart.	3rd quart.	Total in 3 quarters
Primary sectors	1.0	1.1	1.1	1.0	0.0	0.3	0.3	0.2
Manufacturing	-0.1	7.8	8.9	5.4	0.0	1.1	1.2	0.8
Electricity, gas and water supply	-0.2	7.0	0.9	2.3	0.0	0.2	0.0	0.1
Construction	16.2	15.8	15.6	15.8	0.8	1.1	1.3	1.1
Trade, hotels and restaurants	1.2	1.2	1.2	17.0	3.2	3.6	3.5	3.4
Transport and communications	11.1	18.8	18.4	16.3	1.5	2.9	2.8	2.4
Other commercial services	5.4	8.2	9.9	7.8	1.3	1.9	2.1	1.8
Public services	2.7	4.0	1.5	2.7	0.4	0.6	0.2	0.4
Total	7.3	11.6	11.5	10.1	7.3	11.6	11.5	10.1

In 3 quarters of 2005 high growth rates remained, and the biggest contribution was made by fast growth of service sectors. High growth rates are in almost all sectors of economy, especially in construction, transport and communications, and trade services. Growth is slower in manufacturing. However, one has to note a gradual increase of manufacturing's growth rate, which in the 3rd quarter of the year already exceeds the average of previous three years.

High growth rates in 9 months of the year allow to forecast that the average growth in 2005 may exceed 10%, which is much faster rate than forecasted at the beginning of the year.

3.3.2. Manufacturing

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

Table 3.14

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

	Structure (by value added)	Growth	Share of exports in sector's sales
Manufacturing – total	100	6.2	52.2
Food industry	25.2	6.5	21.8
Light industry	7.7	-0.4	79.1
Wood processing	19.3	5.9	68.2
Manufacture of paper and publishing	7.8	2.2	20.0
Manufacture of chemicals, rubber and plastics	5.5	19.8	51.9
Manufacture of other non-metallic mineral products	4.8	12.5	35.0
Manufacture of fabricated metals	12.2	6.9	76.4
Manufacture of machinery and equipment	11.2	5.9	69.3
Other industries	6.3	10.4	68.1

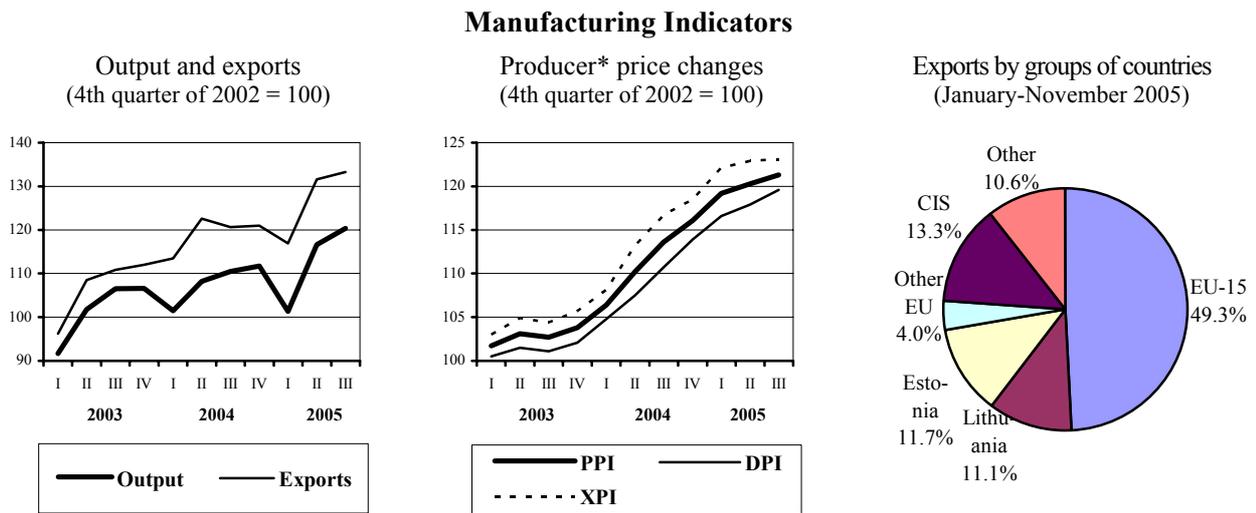
* according to operational data

In majority of sectors most of the output is being exported therefore their growth largely depends on expansion of export opportunities. Since 2002, producer prices have increased every year, especially for the products meant for export.

Immediately after Latvia's accession to the EU the growth rate of manufacturing decreased, mostly due to the narrowed exports of products of two manufacturing sectors – wood processing and textile industry. Considerable growth only resumed in May 2005.

In 2005 (according to the results of 10 months) growth was faster in sectors, where sales markets are relatively less linked to export, with the exception of food industry. For example, manufacturing of construction materials grew by almost 25%, printing and publishing industry – by 11%, and chemical industry – by 14%. Manufacturing outputs have increased by 6% on average in this period, as considerably more moderate growth (by 1.7%) was observed in wood processing, which is one of the principal Latvian export sectors.

Figure 3.19



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

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

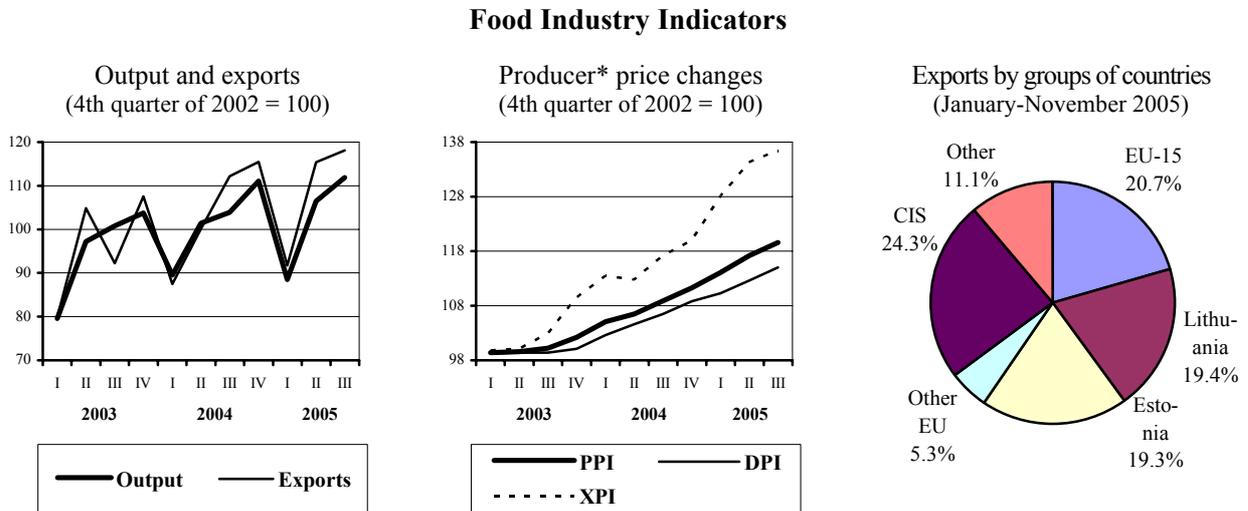
In manufacturing industry of Latvia, level of productivity is the highest in manufacturing of fabricated metals, but it is relatively low in majority of machinery and equipment sectors. Only textile industry has lower productivity.

Figure 3.20



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

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

Approximately 80% of the total food industry output is consumed in the domestic market. The rest is exported mostly to Estonia, Lithuania and Russia. In 2004 demand for Latvian foodstuffs increased in all trade directions – both to Russia and other CIS countries and to the EU, and exports to the EU member states increased more than 1.5 times mostly due to the increased demand in Estonia and Lithuania. Exports of food products to Lithuania and Estonia constitute almost two-thirds of the total exports of Latvian food products to the EU member states.

Growth of food industry in 2005 was slightly more moderate than in the previous year (by 4.5% in 10 months of the year), because the increase in exports was slightly lower. Exports of food products mainly expanded to Lithuania and Estonia.

Export prices grew very rapidly in 2004, while prices for products sold in the domestic market increased more moderately. This trend continues also in 2005. Export prices in the 3rd quarter of 2005 were by 16% higher than in the 3rd quarter of the preceding year, while producer prices for products sold in the domestic market exceeded the level of the previous year by 8%.

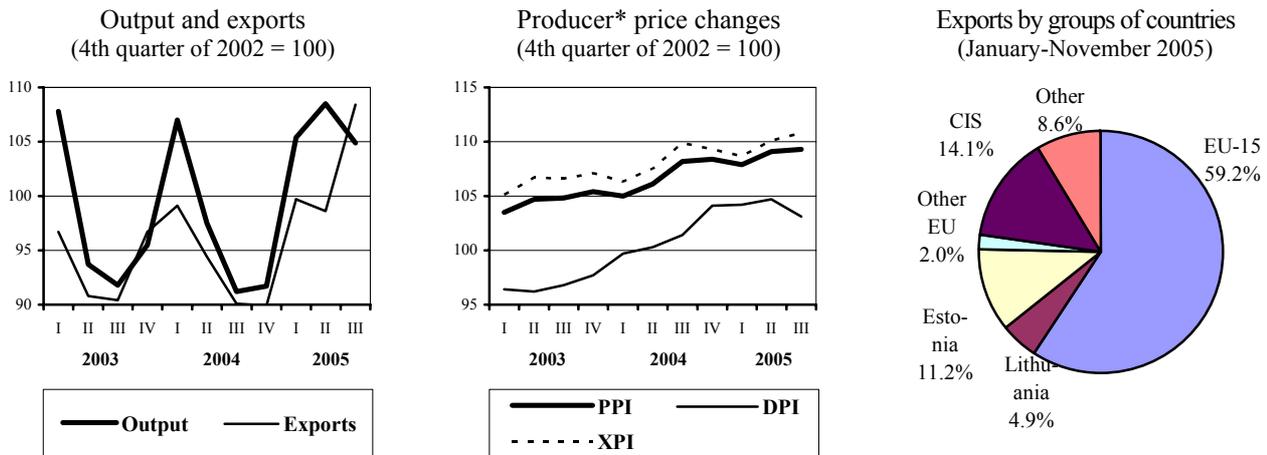
Light industry (production of textile and leather products) makes up less than 8% of the total value added of manufacturing. Only about one-fifth of the light industry output remains in Latvia. Most of the output (three-fourths of exports) is being exported to the EU member states.

The outputs and exports of the *textile industry* have not increased in the recent years, and in production of clothing they even decreased. The main sales markets for Latvian textile industry are in the EU member states. Due to the weak demand in EU member states and high competition in the sector, Latvian producers have not been able to expand production outputs despite the rapid rise of prices in the recent years. Narrowing of exports to the EU was partly compensated by the growth of exports to CIS countries.

Growth is observed in 2005. Output in January-October exceeds the output level of the same period in the preceding year by 8.2%, mainly due to the increased exports to CIS countries, Lithuania and Estonia. Exports to the old EU member states did not increase in this period.

Figure 3.22

Textile Industry and Production of Clothing



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

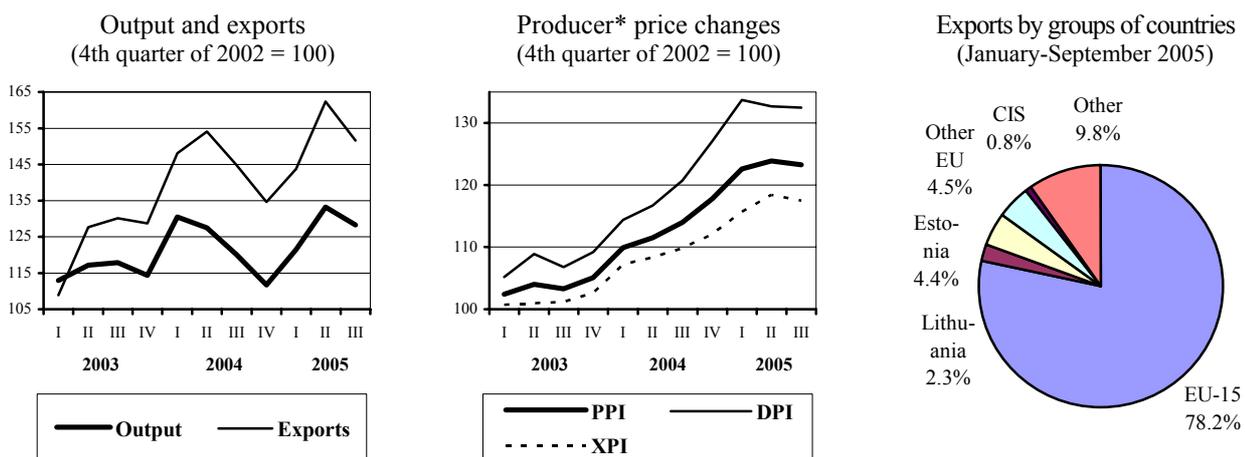
Wood processing is the second biggest sector (almost one-fifth of the total value added of manufacturing). This sector has shown the fastest growth since restoration of Latvia’s independence, nearly tripling its output in this period. The rapid growth was observed also in the last three years (2002-2004), growing by 9.1% on average annually. High share of exported products (almost 70% of the production output) is characteristic for the wood processing sector.

Production output went up very rapidly in 2003 (by 16.5%). Producer prices grew significantly during the year due to the high euro exchange rate, as 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 the weak external demand.

Production outputs in 2005 little exceeded the level of 2004 (by 1.7% in 10 months of the year). Decreased exports of wood processing products to the EU-15 member states were slightly compensated by the rapid growth of exports to Estonia and Lithuania as well as to the other new EU member states.

Figure 3.23

Wood Processing Indicators



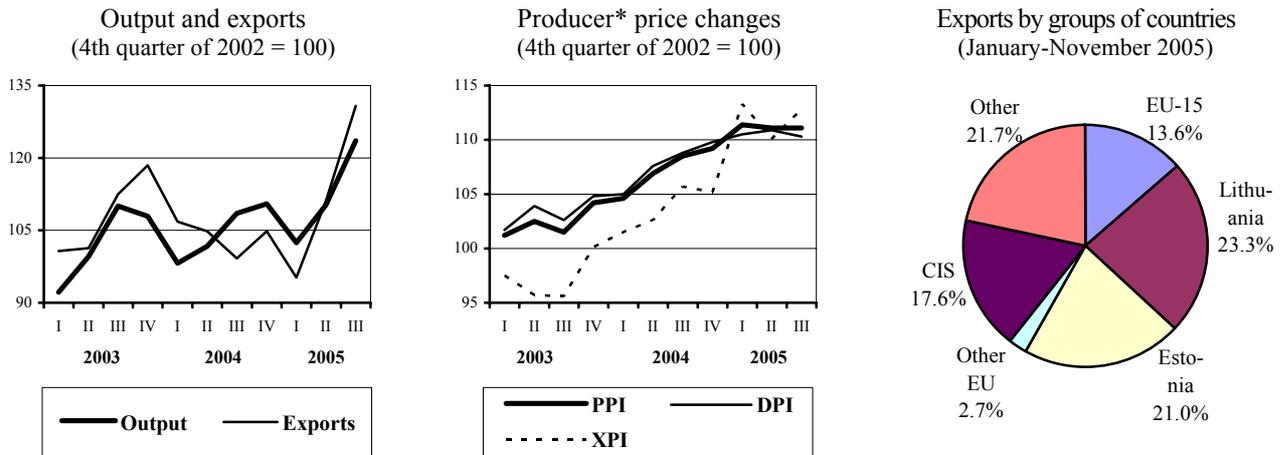
* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

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

Manufacture of paper and publishing has grown slowly in the last years (by 2% on average annually during the last 3 years). The sector has a relatively small share of exported products. Competitiveness of the sector in the domestic market is also decreasing.

Figure 3.24

Manufacture of Paper and Publishing



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

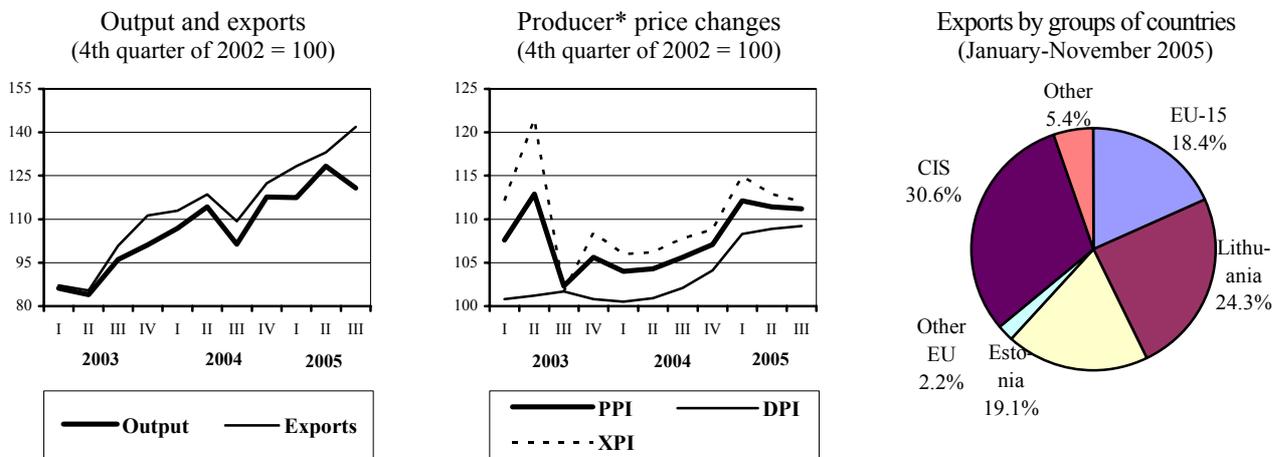
However, faster growth was observed in this sector in 2005. In the first 10 months of 2005 the output exceeded the level of the respective period in the preceding year by 10.6% due to the increased exports and rapid growth of export prices.

Main sales markets for exported products of this sector are Lithuania and Estonia, whereas opportunities to expand into markets of other EU member states are weak. Till 2005 the growth of export prices was much slower than the average price growth, as a relatively big share of exports is connected with CIS countries and other countries outside the EU, and trade conditions with these countries worsen due to the low exchange rate of the US dollar, which is one of the main currencies of account in these directions of trade. The situation improved in 2005 with increased US dollar exchange rate.

Chemical industry in Latvia has stable traditions, highly skilled specialists, long history of producing a wide range of products both for final and intermediary consumption, and a good base for research. Chemical industry accounts for approximately 6% of the total value added of manufacturing. Exports of chemical industry products go in almost equal shares to all major export partners of Latvia, but this mostly indicates weak competitiveness of the sector in markets of developed countries. Exports to Lithuania and Estonia make up about two-thirds of exports to the EU member states.

Figure 3.25

Manufacture of Chemicals, Rubber and Plastics



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

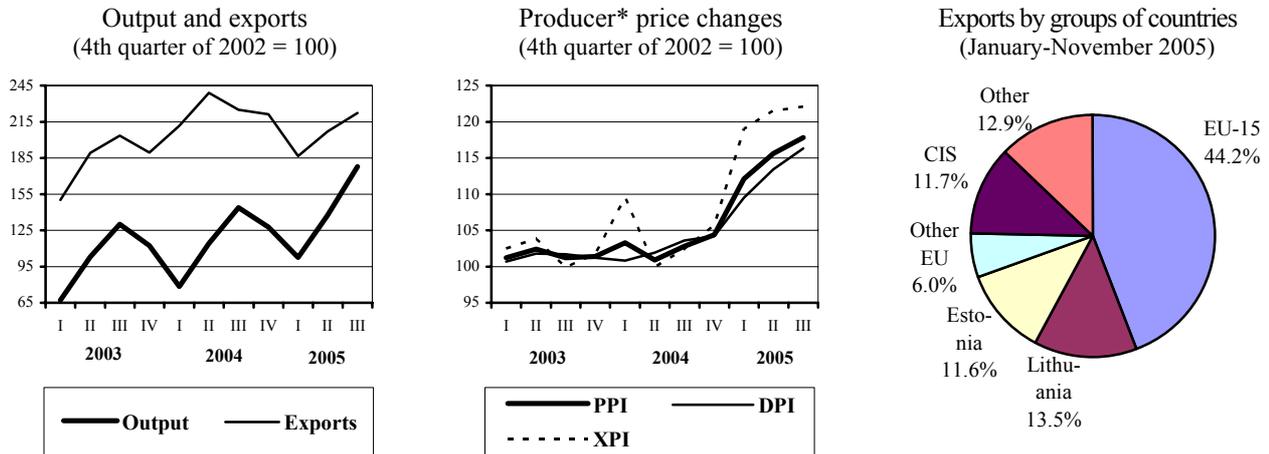
Growth of the sector has not been stable in the recent years. There have been periods of decline, for example, in 2003 after considerable growth of output in 2002. Rapid growth by almost 20% took place in

2004, mostly due to the increased demand in CIS countries. Growth rate was also high in 2005 (by 14% in 10 months of the year), mainly due to the expanded exports to CIS countries.

Manufacture of other non-metallic mineral products (mostly construction materials) has very unstable growth rates. After steep growth by 15.3% in 2002 the growth rate was more moderate in 2003 (by 5.4%), but was rather fast again in 2004 and 2005 (by 12.5% in 2004 and 24.9% in January-October 2005).

Figure 3.26

Other Non-Metallic Mineral Products



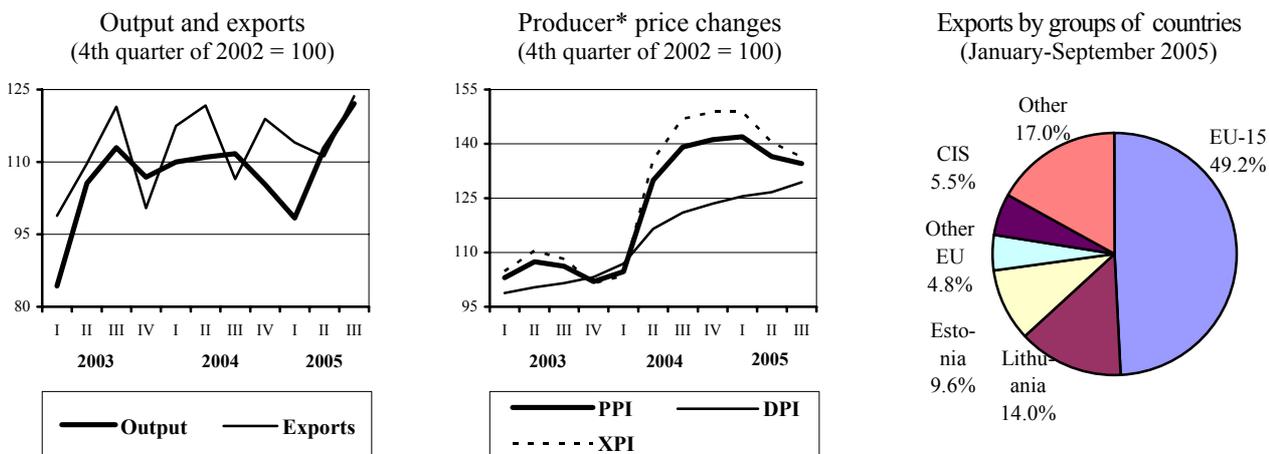
* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

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

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

Figure 3.27

Fabricated Metals



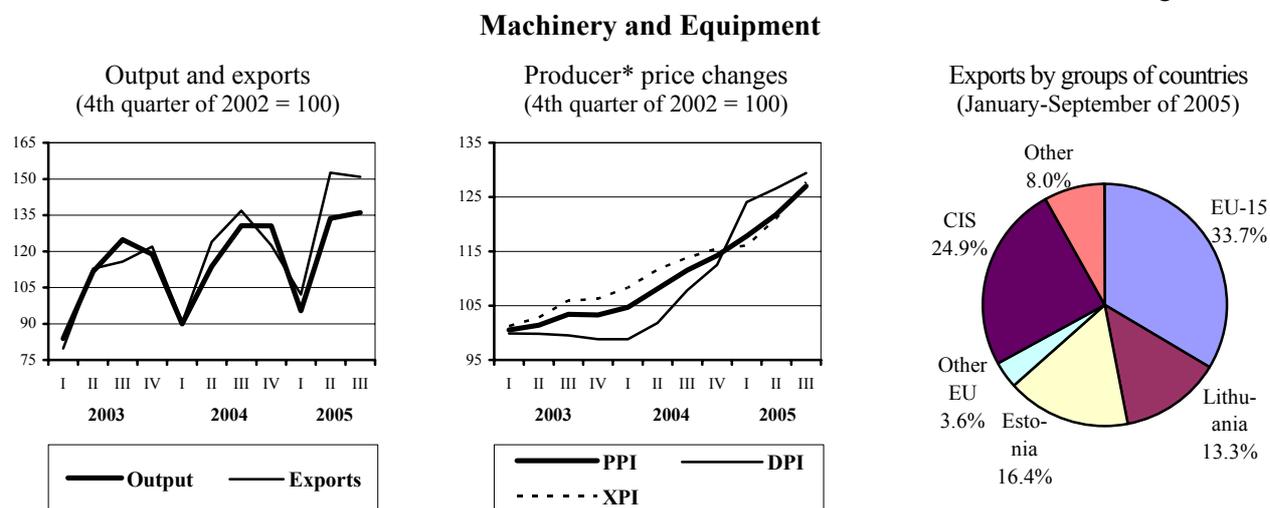
* PPI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

Average growth in the sector reached almost 7.7% in 2002-2003. 2004 was unfavourable year for the sector with decreased production output, and growth only resumed in the 2nd quarter of 2005. Production output in the 3rd quarter of 2005 exceeded the level of the 3rd quarter of 2004 by 9%.

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 the exported products.

Manufacture of machinery and equipment sectors constitute nearly one-tenth of the total value added of manufacturing, and the share is growing every year. Exports make up 70% of the total output of these sectors.

Figure 3.28



* 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 of the sector with these indicators falling in the 1st quarter of every year, yet the sector shows significant growth in general. In 2002-2004 the average growth rate exceeded 12.9%, and growth was especially fast in 2003.

Growth in the first 10 months of 2005 reached 7.4%, and it was ensured by increased exports, especially to the EU-15 member states and Estonia.

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 (natural gas and heavy oil) and local fuels (wood) are used in heat generation.

Table 3.13

Consumption of Energy Resources in Latvia¹
(thousand tons of conditional fuel – ktce²)

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

¹ Source: CSB and Ministry of Economics.

² 1 ktce = 0,02931 PJ.

In 2004 the total energy consumption of Latvia was 199 PJ; 64.9% of the consumption was ensured by imports of energy resources mostly from Russia (natural gas comprising 31.2%, heavy oil –

1.9%, other oil products – 26.6%, coal – 1.3%). Among local energy resources, wood has the biggest amount of usage (firewood, remainders of woodworking, wood chip) comprising 29.4% of the total energy consumption. Share of electricity generated by Latvian HPPs and wind power stations in the total energy consumption was 5.7%.

The Ministry of Economics forecasts essential decrease of heavy oil share in energy balance during the following years due to implementation of the EU Directive 1999/32/EC, which prescribes that the sulphur content in heavy oil must not exceed 1% (mass percentage).

Volume of *electricity* generation directly depends on the 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 the state JSC “Latvenergo” generated 63% of the required electricity, 31% was supplied by other countries and 6% was purchased from small power plants. In comparison with the preceding year, the electricity consumption has increased by approximately 3.9%. 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”

According to the forecasts, the sales of electricity in 2005 will grow by 3-4% in comparison with 2004.

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

- Ministry of Economics has started working out guidelines of energy sector development in Latvia in co-operation with representatives of energy companies, scientists, economists and representatives of associations. The guidelines will include governmental policy, development targets and priorities in energy sector both in medium-term and long-term;
- in the period after 2009 the excess capacity generated by energy systems of the neighbouring countries will become smaller and Latvia’s opportunities to ensure import of electricity will decrease;
- the current development of the situation in the Baltic energy supply indicates that an optimal future solution for basic capacities of electricity supply is represented by construction of a new nuclear power plant unit in Lithuania, using the existing infrastructure of the Ignalina nuclear power plant. If a positive decision to implement such project will be taken in Lithuania, it would be in Latvia’s interests to support the project and for the Ministry of Economics as a shareholder of the state JSC „Latvenergo” to suggest that the energy company assesses opportunities of participation in this project;
- Riga CHP-1 is a positive gain both for the state and Riga city. The State has new basic capacities of 144 MW and the centralised heat supply system of the right bank of the Daugava river in Riga has a new safe source of heat energy;

- recently conducted studies on the security of Latvia's electricity supply indicate that co-generation plant projects that are already completed, under implementation or to be started (the new Riga CHP-1; construction of Imanta CHP; reconstruction of Riga CHP-2) or participation in construction of a nuclear power plant in longer term are not sufficient for safe electricity supply of the country. There is a clear necessity of one more new basic power plant in Latvia. Taking into account the evident necessity to diversify energy supply structure of Latvia, this plant would use solid fuel (obviously, coal), admixing biofuel in it;
- transit electric lines between Lithuania and Kaliningrad region are unburdened after starting the new 1st energy unit of Kaliningrad CHP-2, thereby heightened voltage levels (especially in Liepāja and Klaipeda units) create problems for transmission system operators (TSOs) of Latvia and Lithuania. Transmission network links in Belarus and Russia are being unburdened, creating bigger opportunities for Latvia to import electricity from Russia. However, incomes of Latvian and Lithuanian TSOs for maintenance of electricity network and compensation of electricity losses from Russian electricity transit to Kaliningrad region will decrease;
- transmission network will be able to ensure necessary electricity flows in normal (standard) regimes if its renovation will take place in the current amounts.

Consumption structure of *centralised heat supply* has not changed in the recent years, with central heating comprising 65-70% and hot water supply making 30-35%. 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 CHPs 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 at all in Latgale region, with the exception of Daugavpils and Rēzekne cities and Preiļi district. In Kurzeme region, gas consumption is the biggest in Liepāja – 11% (by JSC "Liepājas siltums" and JSC "Liepājas metalurģs"), while in Zemgale region it amounts to 4% (in Jelgava city and Bauska district).

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

Oil products have an important place in the Latvian market of energy resources. Their market share is about 30%, including heavy fuel with about 6%. The biggest consumers of heavy oil are heat supply (53%) and industry (35%). Complying with requirements of the abovementioned EU Directive 1999/32/EC, on March 2, 2004 the Cabinet of Ministers adopted Regulation No. 125 "Regulation on the Limitation of Sulphur Content in 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.

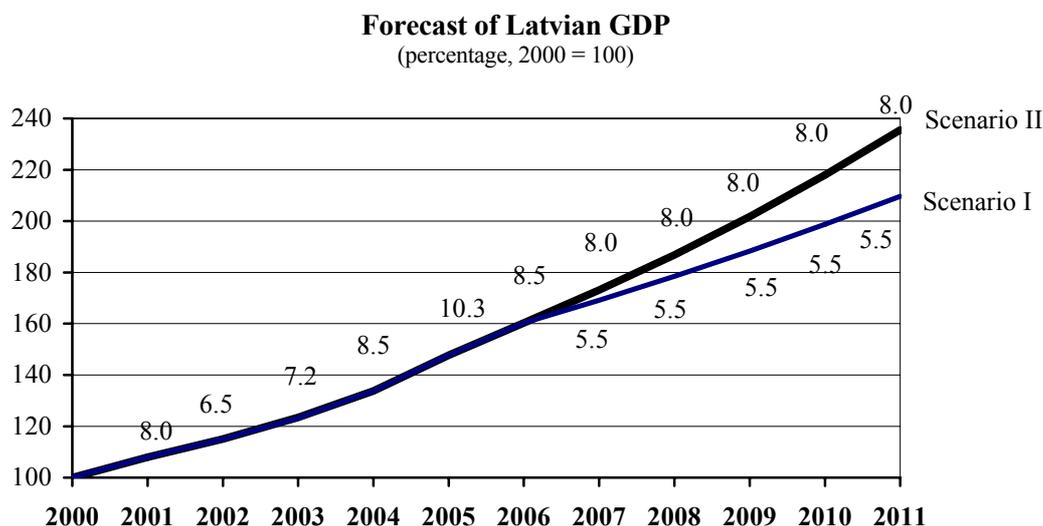
Latvia has started to create its oil product stock. According to the Treaty of Accession to the European Union, Latvia should create oil product reserves for 30 days and this should be done by July 1, 2004. Formation of the oil product stock should be completed by December 31, 2009. The total amount 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. Creation of the stock, its storage and inventory is a difficult process both financially and technically. On this account, Regulation No. 853 of the Cabinet of Ministers regulating procedure of creation and storage of oil product reserves was developed in co-operation with Latvian fuel traders and adopted on November 8, 2005.

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 29-30%. 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 keeps decreasing.

3.4. Forecasts

The Ministry of Economics has developed two scenarios of economy development for the medium-term period (until 2011): the slow growth scenario (Scenario I) and the dynamic scenario (Scenario II). The development scenario forecasts are based on the possible fluctuations of external and domestic demand, depending on several factors.

Figure 3.29



Development prospects in 2006

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

According to the forecasts, the private consumption and GDP will increase at the same rate. This will be ensured by the growing incomes of the 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 expectations of entrepreneurs as well as the good crediting conditions. Investment growth will also be stimulated by the opportunities to use EU funds, which will increase both the public and private sector investments.

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

Growth of *industry* is closely linked with possibilities to increase 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 EU markets is to be associated not only with the growth of demand for imports of these countries (as forecasted by the most economists for 2006), but also to a great extent with the ability of Latvian businesses to expand their market by using the economic advantages of offering cheaper products with appropriate quality.

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

Expansion of export possibilities to Russia in the next few years may be fostered by agreements between the EU and Russia on mutual trade conditions as well as good growth prospects of Russia in the

nearest years in connection with the high prices of oil products. There are rather good prospects to increase exports to other CIS countries, such as Belarus, Ukraine and countries of Central Asia.

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

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 Rīga ports keep their good growth potential.

Table 3.17

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

	2005	2006	2007-2011 * (annual average)
Gross domestic product	10.3	8.5	5.5 / 8.0
Primary sectors	4.4	5.0	3.4 / 5.0
Manufacturing	6.5	10.0	6.0 / 10.0
Electricity, gas and water supply	2.1	5.0	2.0 / 3.0
Construction	15.7	15.0	8.8 / 14.8
Trade, hotels and restaurants	17.0	10.0	6.0 / 7.3
Transport and communications	16.7	10.0	6.0 / 9.0
Other commercial services	8.3	8.0	5.8 / 8.0
Public services	2.5	2.0	2.0 / 2.5

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

Development prospects in 2007-2011

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.

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

Table 3.18

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

	2005		2006		2007-2011 * (annual average)	
	structure	growth rate	structure	growth rate	structure (in 2011)	growth rate
Gross domestic product	100	10.3	100	8.5	100	5.5 / 8.0
Private consumption	60.9	9.0	61.4	9.0	59.3 / 63.7	4.6 / 8.5
Public consumption	20.7	3.0	20.5	2.5	19.3 / 18.8	2.5 / 2.5
Gross fixed capital formation	30.7	22.0	31.6	15.0	30.7 / 32.0	7.0 / 12.0
Changes in inventories	2.3	–	-1.2	–	2.1 / 2	–
Exports	47.7	18.5	47.9	9.6	45.1 / 48.0	5.3 / 9.0
Imports	-62.2	12.2	60.2	7.8	-56.6 / -56.4	6.1 / 8.4
Export-import balance	-14.6	–	-12.3	–	-11.4 / -8.5	–

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

The main problems during this period should be associated with the potential rise of wages and thereby with the decrease of competitiveness of Latvian so-called *cheap sectors* in the world markets. Such sectors are textile and food industries and, partly, manufacture of fabricated metals and some sectors of machinery and equipment. The share of these sectors in Latvian economy is very high. Therefore their replacement with manufacturing of other sectors' products can not be achieved 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 growth rate of Latvia.

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

4. Macroeconomic Stability

4.1. Public Finances

4.1.1. Fiscal Policy and Public Debt

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

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

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

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

Since 2000 the fiscal deficit of the general government consolidated budget in Latvia has been lower than the level defined in the Maastricht criteria (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

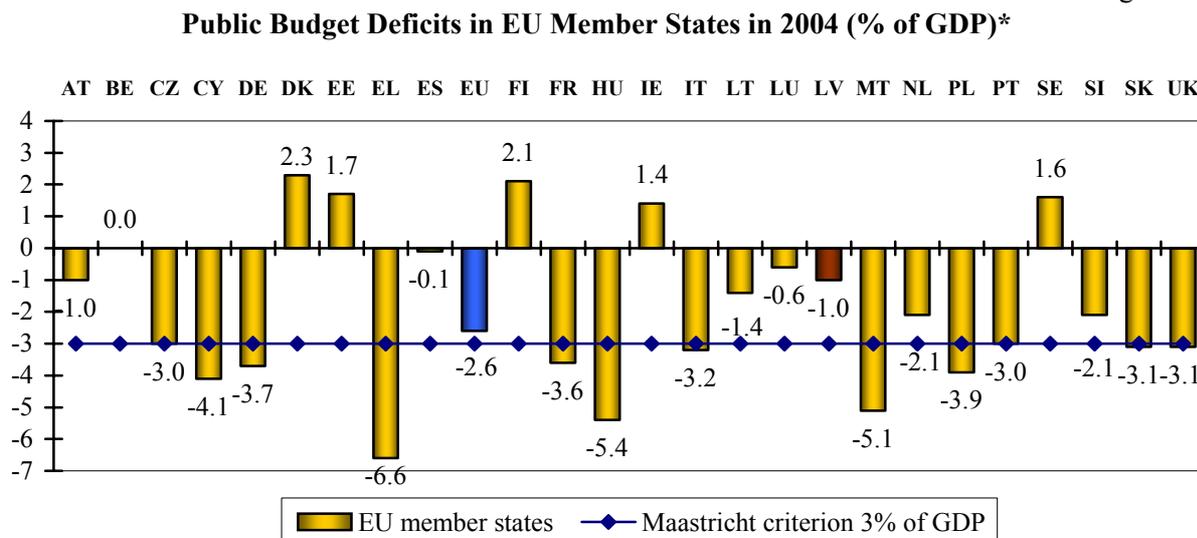
	2001	2002	2003	2004	2005 *
Revenues (million LVL)	1696.9	1874.0	2107.4	2522.2	3206.0
(% of GDP)	32.5	32.5	33.0	34.0	36.2
Expenditures (million LVL)	1801.1	2022.0	2212.5	2599.6	3318.9
(% of GDP)	34.5	35.1	34.6	35.1	37.5
Net loans (million LVL)	-2.7	-17.5	-2.7	1.0	-21.9
Fiscal balance (million LVL)	-101.5	-130.5	-102.4	-78.4	-91.6
(% of GDP)	-1.9	-2.3	-1.6	-1.1	-1.0

* – provisional data

As can be seen in the Figure 4.1, in 2004 the average level of the budget deficit in the EU was 2.6% of GDP¹ (3% of GDP in 2003). On the whole, public finances improved in 15 EU member states and deteriorated in 10 member states in 2004. In 2004, the biggest general government deficits as percentage of GDP were observed in Greece (-6.6%), Hungary (-5.4%), Malta (-5.1%), Cyprus (-4.1%), Poland (-3.9%), Germany (-3.7%), France (-3.6%). Six EU member states showed general government budget surpluses in 2004: Denmark (+2.3%), Finland (+2.1%), Estonia (+1.7%), Sweden (+1.6%), Ireland (+1.4%), Belgium (+0%). According to the methodology of the ESA 95 European System of National Accounts, the budget deficit in Latvia amounted to 1% of GDP in 2004.

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

Figure 4.1



* According to the methodology of the ESA 95 European System of National Accounts.
 AT – Austria, BE – Belgium, CZ – Czech Republic, CY – Cyprus, DE – Germany, DK – Denmark, EE – Estonia, EL – Greece, ES – Spain, EU – EU-25 member states, FI – Finland, FR – France, HU – Hungary, IE – Ireland, IT – Italy, LT – Lithuania, LV – Latvia, MT – Malta, NL – Netherlands, PL – Poland, PT – Portugal, SE – Sweden, SI – Slovenia, SK – Slovakia, UK – United Kingdom

The Saeima approved the public budget for 2005 with a fiscal deficit in the amount of 1.68% of GDP. However, the provisional data on budget execution show that 2005 was concluded with a deficit much smaller than planned, i.e., in the amount of 91.6 million LVL or approximately 1% of GDP.

The Saeima approved the public budget for 2006 with a fiscal deficit of 145.23 million LVL or 1.5% of GDP.

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

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

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

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

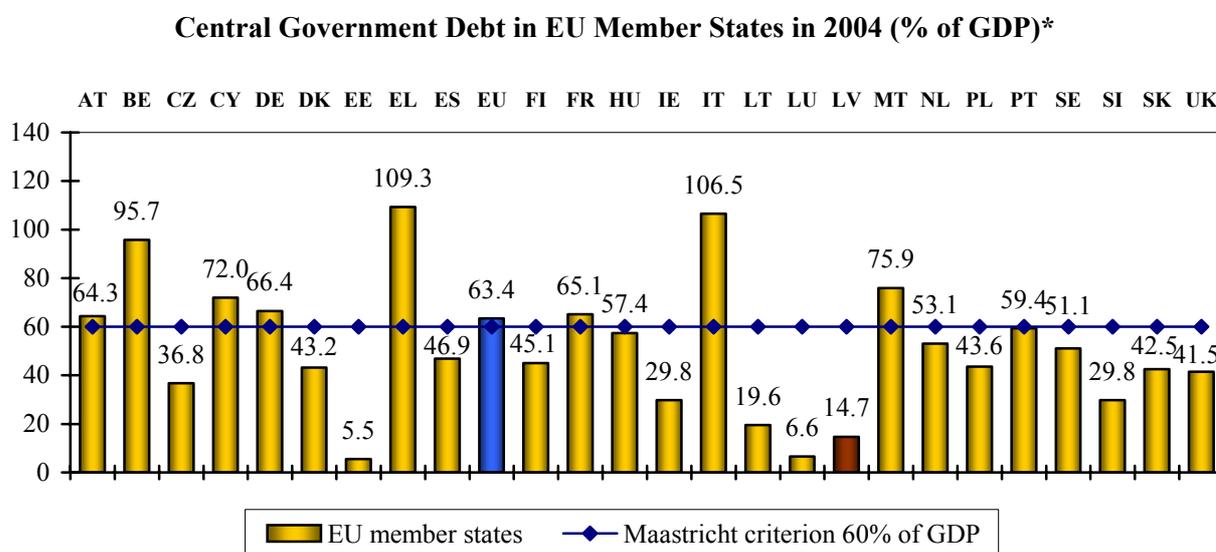
Due to the reduction of tax rates the tax revenues against GDP have dropped from 33% in 1998 to 27.5% in 2004. Meanwhile the tax base has been broadened, excluding taxable exemptions and improving the administration of revenues.

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 63.4% of GDP¹. In 2004 the highest central government debts in percentage of GDP were observed in Greece (109.3%), Italy (106.5%),

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

Belgium (95.7%), Malta (75.9%), Cyprus (72.0%), Germany (66.4%), France (65.1%) and Austria (64.3%), while the lowest general government debts in percentage of GDP were registered in Estonia (5.5%), Luxembourg (6.6%), Latvia (14.7%) and Lithuania (19.6%).

Figure 4.2



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

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

In the last years the central government debt in Latvia has increased from 571 million LVL at the end of 2000 to 975 million LVL at the end of 2004, or from 12.0% to 13.2% of GDP (see Table 4.2). At the end of November 2005 the central government debt amounted to 908.1 million LVL. It is expected that the central government debt will continue growing gradually in the following years and would reach 13.6% of GDP in 2008.

Table 4.2

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

	2002	2003	2004
Central government debt	756.1	846.3	975.0
including:			
internal debt	291.6	426.7	423.0
of which:			
short-term debt	37.9	52.7	73.0
medium-term debt	253.6	224.1	224.1
long-term debt	–	97.0	125.8
currency debt	–	52.7	–
external debt	464.5	419.6	552.0
of which:			
loans	209.2	137.6	133.1
Eurobonds	255.3	282.1	421.8
	(% of GDP)		
Central government debt	13.1	13.2	13.2
of which:			
internal debt	5.1	6.7	5.7
external debt	8.1	6.6	7.4

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

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

Table 4.3 reflects costs related to the central government debt. These costs tend to rise along with the increase of the debt. According to the forecasts, the costs of servicing the central government debt will go up by 2.5 million LVL in 2005 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 central 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 foreseen that the costs related to the servicing of the central government debt will continue growing in the following years, reaching 77 million LVL in 2009.

4.1.2. General Government Consolidated Budget Revenues

In 2005 the budget revenues increased faster than GDP and amounted to 3205.4 million LVL or 36.3% of GDP (provisional data).

Table 4.4

General Government Consolidated Budget Revenues (% of GDP)

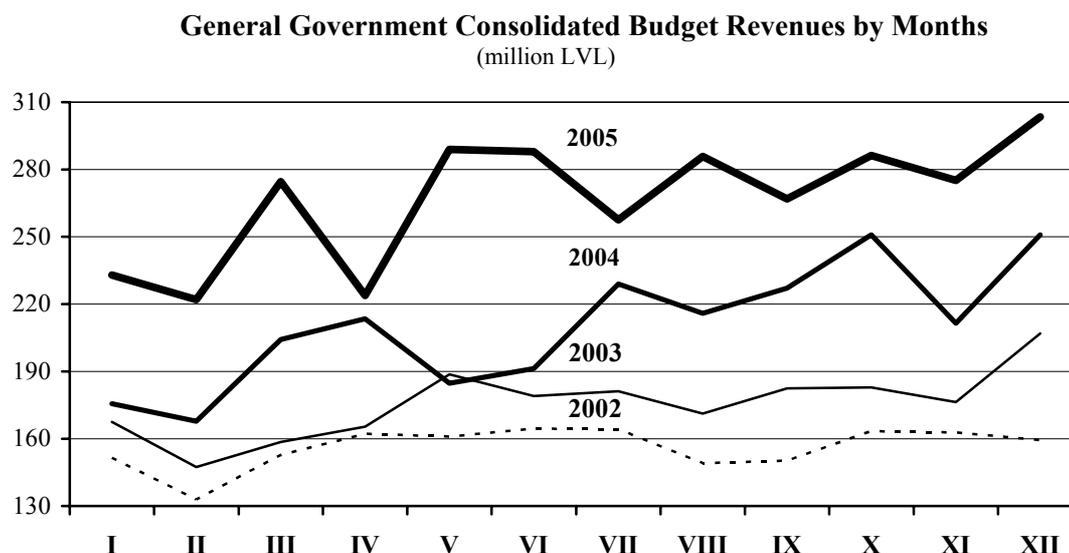
	2000	2001	2002	2003	2004	2005*
Revenues	34.2	32.5	32.5	33.0	34.0	36.3
I Tax revenues	28.9	27.8	27.8	27.9	27.3	28.3
1. Indirect taxes	10.9	10.1	10.1	10.8	10.0	11.4
– value added tax	7.1	6.7	6.7	7.2	6.6	7.7
– excise tax	3.5	3.1	3.1	3.3	3.2	3.5
– customs duties	0.3	0.3	0.3	0.3	0.2	0.2
2. Income taxes and property taxes	8.0	8.2	8.3	8.0	8.4	8.0
– corporate income tax	1.6	1.9	1.9	1.5	1.7	2.0
– personal income tax	5.5	5.4	5.5	5.7	5.9	5.3
– property taxes	0.9	0.9	0.8	0.8	0.8	0.7
3. Social security contributions	9.8	9.2	9.2	8.8	8.6	8.5
4. Other taxes	0.2	0.3	0.3	0.3	0.3	0.4
II Non-tax revenues	5.3	4.7	4.7	5.1	6.7	7.9

* provisional data

In 2005 the general government consolidated budget revenues exceeded the level reached in the preceding year by 27.1%, among them tax revenues increased by almost 24% and non-tax revenues grew by 40.7%, mostly due to the resources of the EU funds.

2005 was more successful year for the central government budget in terms of tax collection, as the value added tax revenues increased the most.

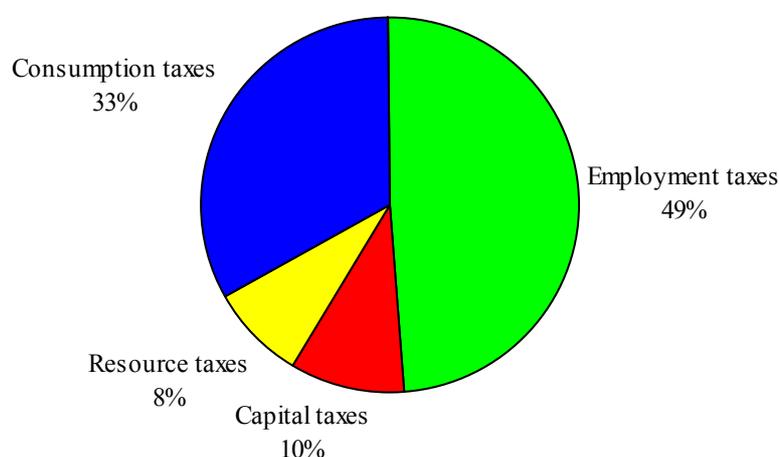
Figure 4.3



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 in 2005 the share of consumption taxes has considerably grown, but the share of employment taxes has decreased.

Figure 4.4

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



Almost half of all tax revenues or 13.8% of GDP is the collection of **employment taxes** (social security contributions and personal income tax). The share of taxes in total labour costs in Latvia equalled to approximately 41% in 2005. This is a relatively high indicator, mostly due to the low level of non-taxable income.

Social security contributions in the majority of the new EU member states are twice higher than the collection of personal income taxes, while in the group of EU-15 member states they are approximately the same. However, it should be noted that these proportions differ considerably from state to state. In 2005 the social security contributions in Latvia exceed the collection of personal income taxes by 1.6 times.

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

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

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

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

81% 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 member states (19.6%).

Collection of value added tax considerably increased in 2005 due to the high inflation and improvements of tax administration. It was almost by 40% bigger than in the previous year.

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

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

Due to Latvia's accession to the EU, customs duty revenues dropped considerably by 8.7% in 2004 in comparison with the previous year, while in 2005 they increased by 12% in comparison with 2004. As from May 1, 2004, customs duties are not applied to transportation of goods within the EU, but the customs tariffs set up by the EU are applied to goods imported from the countries outside the EU.

Capital taxes (corporate income tax and property taxes) amounted to 9.7% of all taxes in 2005. Since 2002 a gradual reduction of the corporate income tax rate was started, bringing the rate down from 25% in 2001 to 15% in 2004. The rate was 22% in 2002, but amounted to 19% in 2003.

Due to the lowered corporate income tax rate, in 2003 the collection of this tax dropped by almost 15% in comparison with the preceding year, while in 2004 the corporate income tax revenues considerably increased (by 36.1%) in comparison with 2003. In 2005 the corporate income tax revenues have gone up by 41% in comparison with 2004, and this is related to increased profit of taxpayers and improvements of tax administration.

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

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

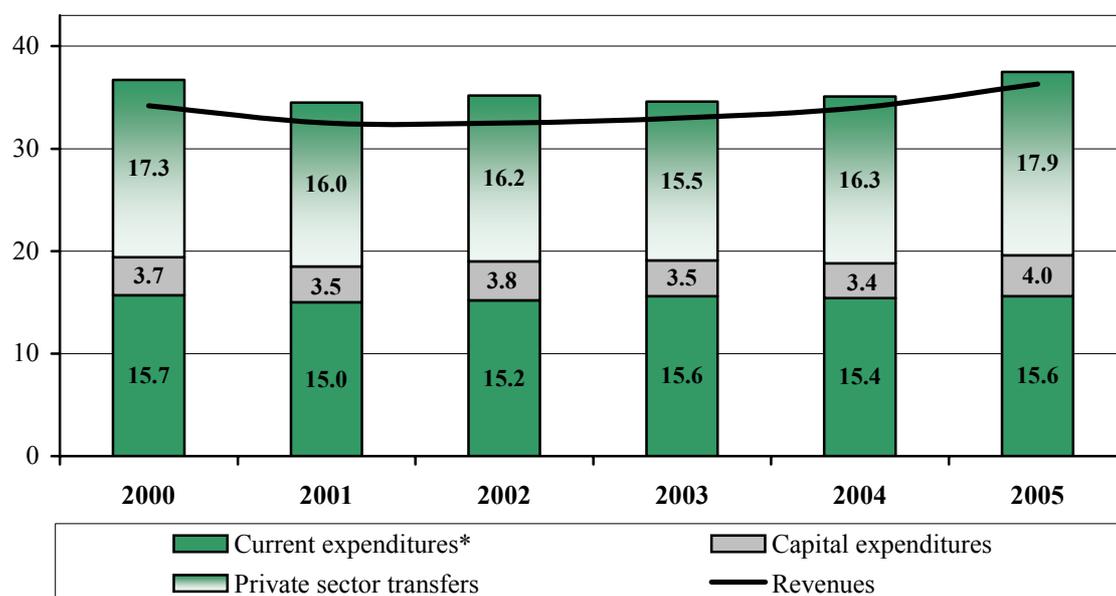
Payments of natural resource taxes are directly linked with economic activities of Latvian companies and environmental loads caused by them. Hence, tax revenues are growing, as the total economic activity increases, and are decreasing, as companies and local governments implement environmental protection measures. Collection of this tax in 2005 was by 26% higher than in 2004.

4.1.3. General Government Consolidated Budget Expenditures

General government consolidated budget expenditures went up slightly faster than the revenues in 2005. The amount of expenditures was by 27.7% higher than in the preceding year, exceeding GDP growth rate (in current prices) and equalled to 3206 million LVL (provisional data). Thus, the general government consolidated budget expenditures increased against GDP and constituted 37.5% of GDP. Capital expenditures increased more rapidly (by 40%), and also transfers to private sector (especially agriculture) grew faster.

Figure 4.5

Revenues and Expenditures of 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 agriculture, which were by 2.5 times higher than in 2004. Expenditures for social security and welfare, transport and healthcare also increased substantially.

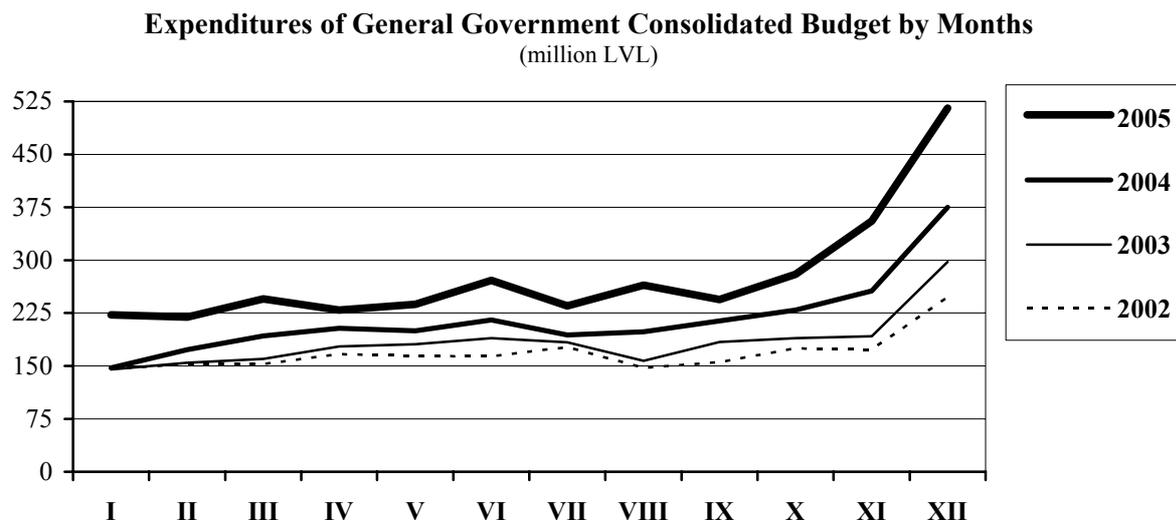
Table 4.5

Expenditures of General Government Consolidated Budget
(percentage)

	2003		2004		2005 (January-November)*
	structure	of GDP	structure	of GDP	Changes against the respective period of 2004
Expenditures – total	100	35.0	100.0	35.5	25.5
General governmental services	8.4	2.9	7.5	3.0	12.5
Defence	3.6	1.3	3.1	1.2	19.5
Public order and safety, law enforcement	7.0	2.4	5.5	2.2	15.4
Education	17.5	6.1	15.0	6.0	17.6
Healthcare	9.4	3.3	8.3	3.3	20.4
Social security and welfare	30.5	10.7	26.1	10.5	15.0
Housing and community amenity, environmental protection	5.1	1.8	4.6	1.9	32.9
Recreation, sports, culture and religion	4.0	1.4	3.2	1.3	16.4
Agriculture, forestry and fishery	4.9	1.7	5.6	2.2	146.1
Transport and communications	4.9	1.7	6.0	2.4	42.2
Other economic activity	1.7	0.5	1.5	0.6	71.6
Other expenditures not classified in major groups	3.1	1.1	13.4	5.4	24.5

* current data of general government consolidated budget expenditures

Figure 4.6



In order to increase the efficiency of the use of state budget resources for capital investment, the **Public Investment Programme (PIP)** is being developed in Latvia since 1995. PIP comprises those infrastructural investment projects for which funding from the public budget is planned and allocated every year. Those local government investment projects, which do not have co-financing from the basic budget or public loan guarantees, are left out of the PIP.

Total amount of the PIP, which consists of central government basic budget, special budget, public loans and guarantees, and other sources (gifts, own resources of project implementers), has not exceeded 2.2% of GDP since 2001 and constituted 2% 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.

According to calculations of the Ministry of Economics, the PIP share from the basic and special budgets increased and constituted about 2.3% of GDP in 2005. This can 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. In addition to central government basic budget subsidy from general revenues and payment revenues marked for special purposes, which amounts to 134.8 million LVL, investments from foreign financial assistance in the amount of 65.2 million LVL are planned for projects in 2005. Financial resources from the European Regional Development Fund, Cohesion Fund, and Schengen Programme foreseeing to ensure conformity of the EU external border control are envisaged as foreign financial assistance for implementation of these projects.

It was planned to invest 200 million LVL as public investment into PIP projects in 2005, which is by 2.4 times more than in 2004. The priority sectors of the PIP this year included transport (111 million LVL), environmental protection (26 million LVL) and internal affairs (14.4 million LVL).

Growth of the volume of central government basic budget investment considerably lags behind the volumes of the increase of its demand. The limited availability of the public budget resources for the 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 central government fixed assets and economic returns of these assets.

Action priorities and planned activities. In order to determine medium-term public investment policy in the country, the government has approved the guidelines *Notification of Public Investment Programme for 2006-2010*. The mentioned guidelines constitute a base for a medium-term budget investment planning as they determine medium-term budget goals and priority lines of action.

Development of PIP notification is one of the stages in the PIP planning cycle. Its task in the PIP planning cycle is to include basic principles for the preparation of sectoral investment programmes in the medium term, defining provisional volumes of sectoral investment (including the envisaged funding for projects co-financed from the 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 the policy directions.

It should be noted that, in preparation of public budget for the last two years, PIP planning process did not correspond to the procedure set by the government and had insufficient link with the public budget preparation process.

In order to improve medium-term budget planning process, all institutions (including ministries) by March 1, 2006 work out and submit to the government their action strategies for the next three years, directly linking together policy planning documents, measures for their implementation with the available and required budget financing, including investment. Medium-term goals and action plan for their fulfilment have to be included in the strategy. The action plan and the respective budget are formed by the principle of budget programmes. Performance indicators have to be set for each budget programme. Preparing budget programmes in this way, transparency of public budget resources will be improved, duplication of the use of resources will be prevented, and efficient and co-ordinated use of public budget resources to achieve the goals of the institution will be ensured.

4.2. Prices

4.2.1. Consumer Prices

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

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

In 2005 the inflation rate was 7% (12-months inflation, December over December) (see Figures 4.7 and 4.8) including 7% for goods and 6.9% for services. In the 1st half of 2005 the inflation showed a trend towards decrease, but in September the rapid growth of fuel prices essentially increased the total level of prices by 1.5% (against August 2005). As a result of this, 12-months inflation reached the high level of the previous year.

Table 4.6

Consumer Price Changes in Latvia by Months
(%)

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

Figure 4.7

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

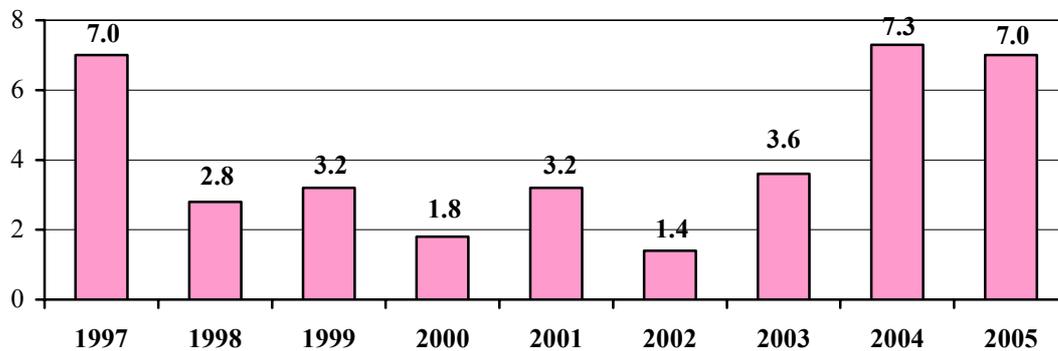
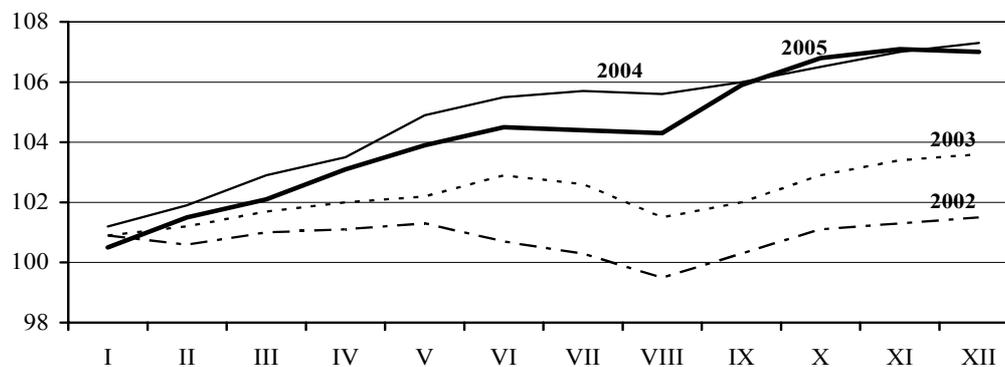


Figure 4.8

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



The rapid growth of prices also in 2005 is mostly determined by the following factors:

- *the rise of world oil prices*, which essentially affected the growth of domestic fuel prices in 2005 (by 19.4%) and the corresponding consumer price increase by 0.84 percentage points 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, should be taken into account;
- the high euro exchange rate against the lats (LVL), which substantially increased prices of imported goods (by 15.2% in the 3rd quarter of 2005 in comparison with the 3rd quarter of 2004);
- the increase of food product prices due to the inclusion of Latvia into the Common Agricultural Policy of the EU, and the relatively low level of food prices in Latvia in comparison with Estonia and the related convergence;
- *the rise of administratively regulated price*: in October 2005 prices of liquefied gas and heat energy rose considerably by 29.9% and 5.7% respectively, especially with the beginning of the heating season;
- *the 2nd round effect of the sufficiently high inflation rate of 2004 (inflation spiral)*. Inflation rate did not decrease essentially in 10 months of 2005, based on the rapid growth of crediting and the implemented mechanisms compensating inflation of the previous period (indexation of wages, pensions and other payments).

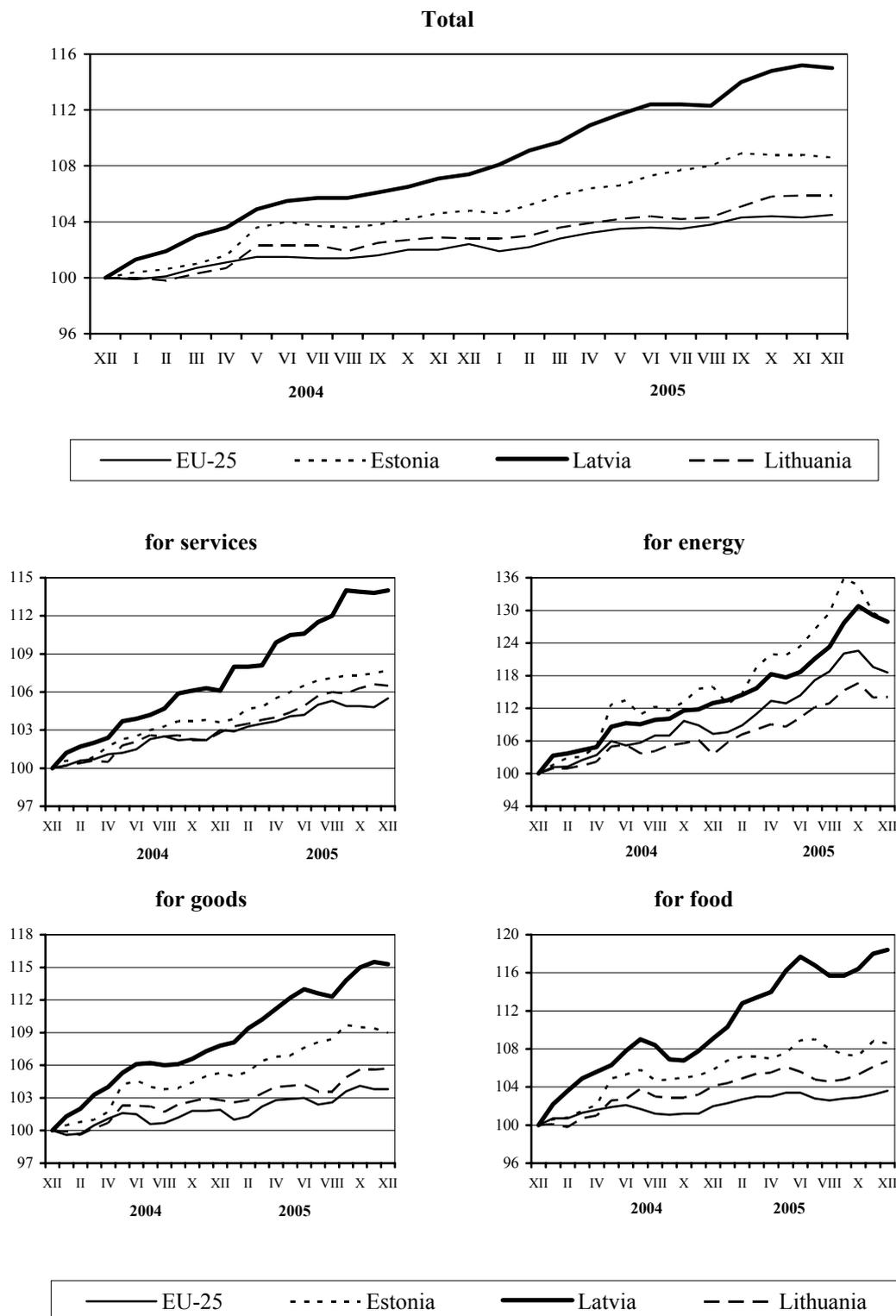
In 2005 like in 2004 the consumer price inflation in Latvia was the highest among the EU member states and Baltic States as well. It was lower in the neighbouring countries Lithuania and Estonia. Annual inflation in Lithuania was 3%, while in Estonia it amounted to 3.6% (see Figure 4.9). The considerably faster rise of prices in Latvia was mostly determined by the increase of food prices and growth of administratively regulated prices.

Energy prices grew faster in Latvia (by 13.2%), while in the EU in total, Estonia and Lithuania energy prices increased equally – by 10.4% on average.

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

Figure 4.9

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



Source: Eurostat

4.2.2. Producer Prices

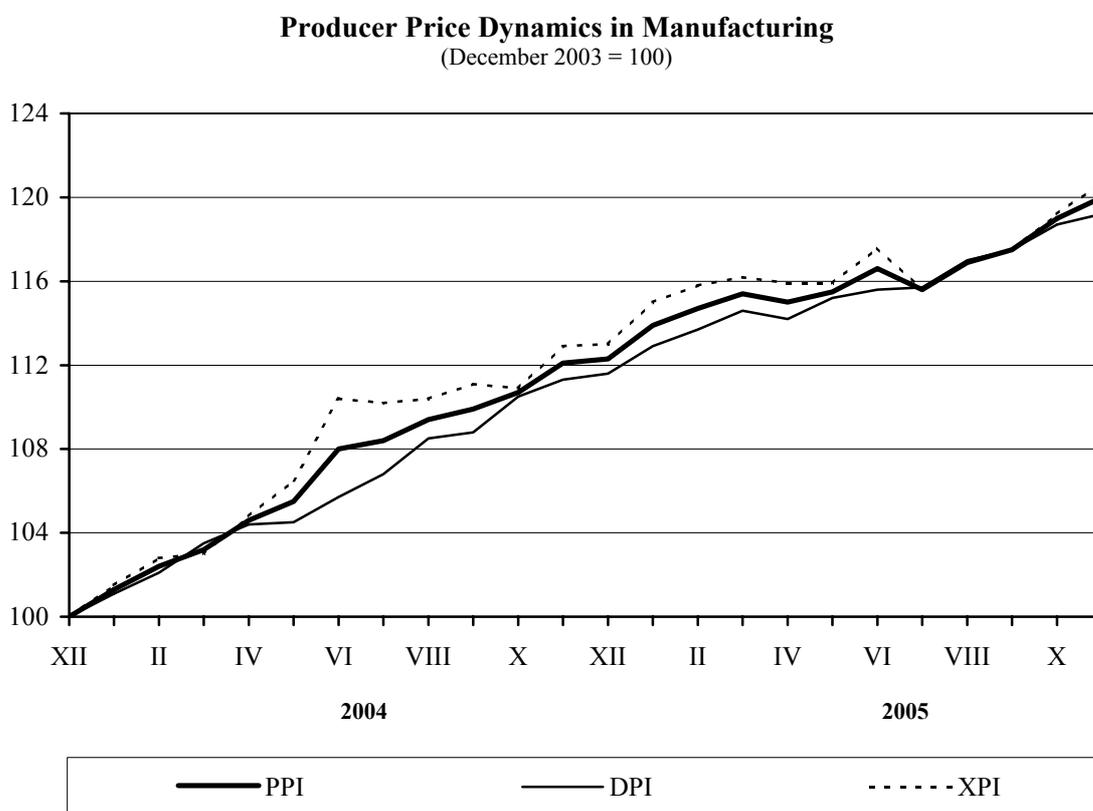
Producer prices grew slowly in 2000-2003. Their fluctuations were mainly related to the currency rate changes, as changes in export prices greatly determine the overall dynamics of producer price changes.

In December 2004 the producer prices went up much faster (by 11.4%) than in December 2003. In December 2005 the producer price growth was already more moderate (by 7.0% in comparison with December 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 determined by world prices of the respective products and currency rate fluctuations. As world prices and/or currency rates change, incomes from export and expenses on import also change, causing direct or indirect changes of domestic prices.

During the year (December 2005 over December 2004) prices for manufacturing industry products sold in the domestic market rose slower (by 6.7%) than prices of exported manufacturing industry products (by 7.5%).

Figure 4.10



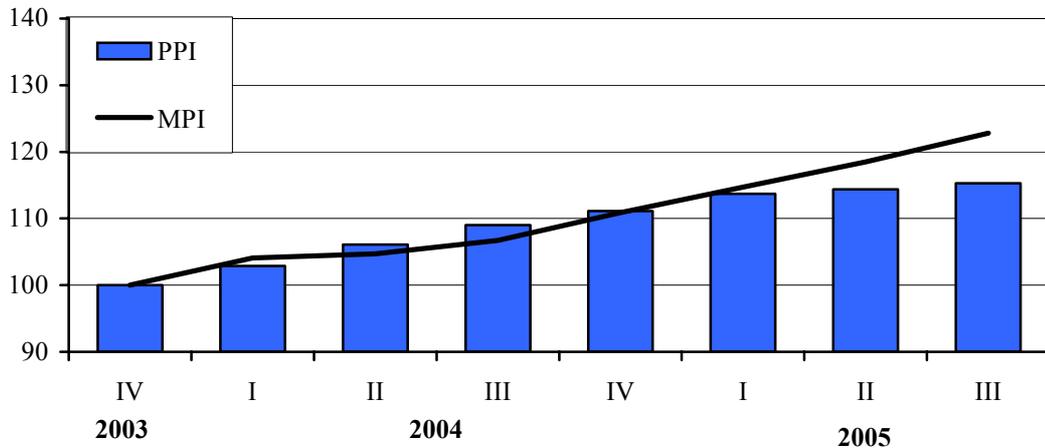
RCI – producer price index, DPI – producer price index for products sold in the domestic market, XPI – producer price index for exported products

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

The price growth of exported products in 2005 was mainly affected by the rise of world prices and increased euro exchange rate against the lats.

Figure 4.11

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

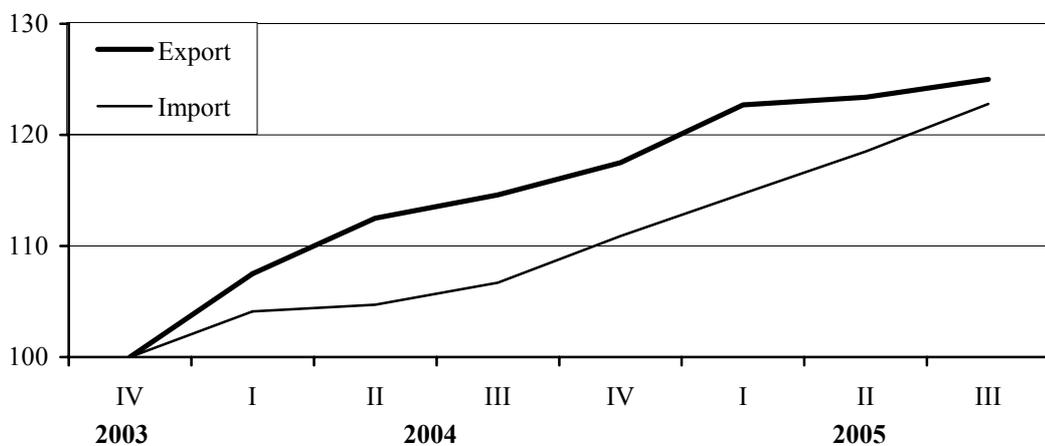


PPI – producer price index, MPI – producer price index for imported products

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

Figure 4.12

Dynamics of Import and Export Prices (4th quarter of 2001 = 100)



Increase of the export unit value in 2004 and 9 months of 2005 was almost at the same level as for the import unit value, however, slightly exceeding it. Thereby trade conditions remained unchanged in this period.

4.3. Balance of Payments

4.3.1. Current Account

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

Trade balance deteriorated in 2004 (see Table 4.7), 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.

The negative trade balance against GDP decreased in 9 months of 2005 in comparison with the respective period of the preceding year, as the exports of goods rose faster than the imports (see Section 3.2.4).

Balance of services deteriorated in 9 months of 2005 in comparison with the respective period of the preceding year despite improvement of the balance of transportation, as the expenses of Latvian travellers abroad rose faster than the expenses of foreign tourists in Latvia and also exports of various other services (communications, construction, financial, information and computer services) increased at a slower pace than imports.

Balance of revenues from factorial services has improved due to the considerable increase of remuneration received by the residents, which are employed abroad.

On the whole, the current account balance has remarkably improved in 9 months of 2005, and the deficit is by 2.7 percentage points lower (against GDP) than in 9 months of the preceding year.

Table 4.7

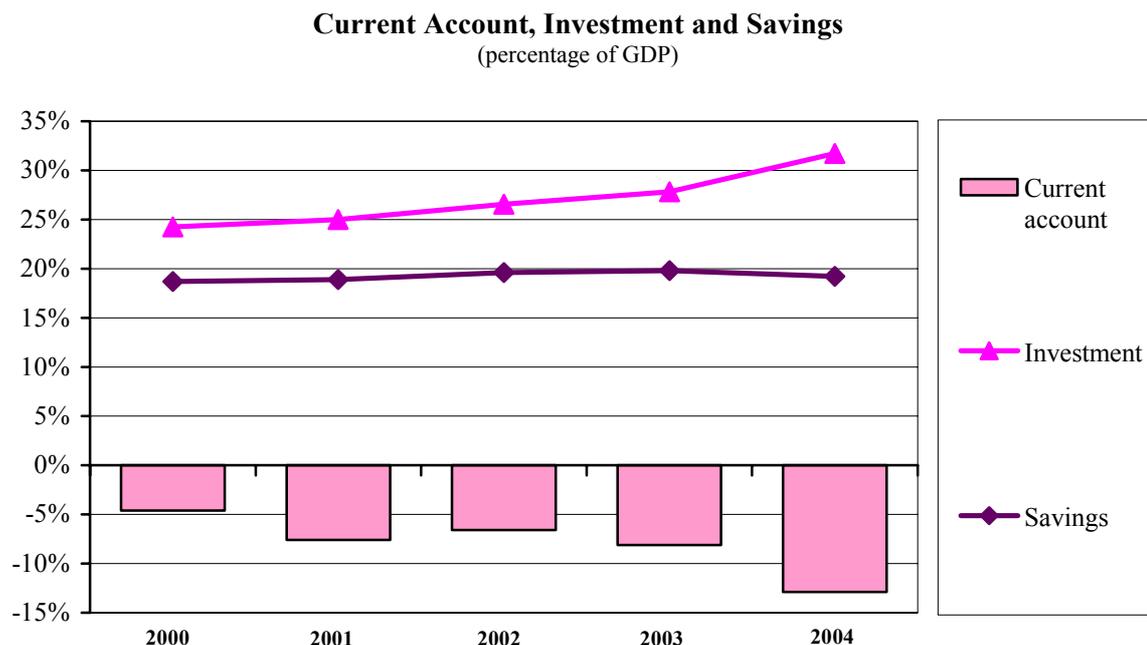
Latvian Balance of Payments
(percentage of GDP)

	2001	2002	2003	2004	2004	2005
					January-September	
A. Current account	-7.6	-6.6	-8.1	-12.9	-14.1	-11.4
Trade balance	-16.2	-15.8	-17.8	-20.3	-20.7	-17.7
<i>exports</i>	27.0	27.3	28.3	30.7	30.6	34.3
<i>imports</i>	-43.1	-43.1	-46.1	-51.0	-51.3	-52.0
Balance of services	6.1	5.8	5.2	4.4	4.8	3.9
Net income	0.7	0.6	-0.1	-2.0	-2.5	-1.4
Current transfers, net	1.7	2.8	4.7	5.0	4.3	3.8
B. Capital account	0.5	0.2	0.7	1.0	1.2	1.3
C. Financial account	7.1	7.2	7.2	11.3	11.1	10.6
Direct investment	1.4	2.7	2.3	4.3	4.1	3.6
<i>abroad</i>	-0.2	0.0	-0.3	-0.8	-0.9	-1.1
<i>in Latvia</i>	1.6	2.7	2.6	5.1	5.0	4.7
Portfolio investment	1.5	-2.2	-2.0	1.7	0.8	-2.6
<i>assets</i>	-0.7	-2.4	-2.6	-0.2	-1.8	-3.9
<i>liabilities</i>	2.2	0.2	0.6	1.9	2.6	1.3
Other investment	7.8	6.5	7.4	8.5	8.9	14.8
<i>assets</i>	-1.0	-5.0	-6.1	-12.8	-14.1	2.0
<i>liabilities</i>	8.8	11.5	13.5	21.3	23.0	12.8
D. Net errors and omissions	0.0	-0.8	0.2	0.6	1.7	-0.4
E. Reserves	-3.7	0.0	-0.6	-2.9	-2.5	-4.7

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 against GDP in Latvian economy has not essentially changed and amounts to approximately 20%. Investment, in contrast, grew at a more rapid rate, especially in 2004.

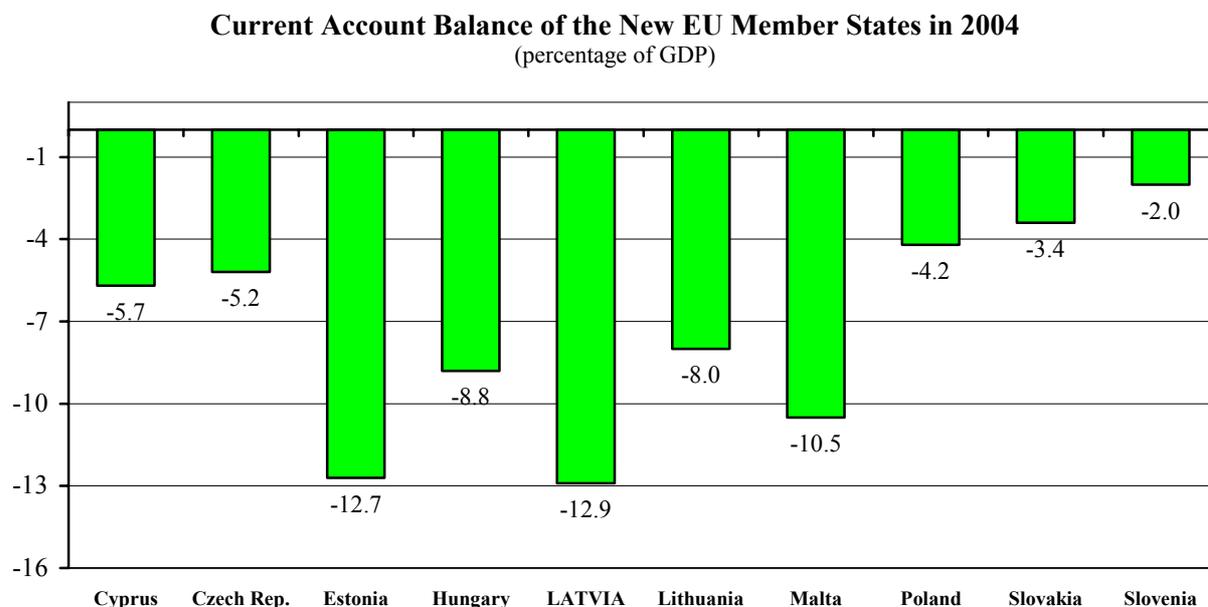
Figure 4.13



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

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

Figure 4.14



* Source: Statistical Annex of European Economy, autumn 2005, Table 44

In 2004 the Latvian current account deficit against GDP was the highest among the new EU member states (see Figure 4.14). No country was with a positive current account balance, the lowest current account deficit was in Slovenia.

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



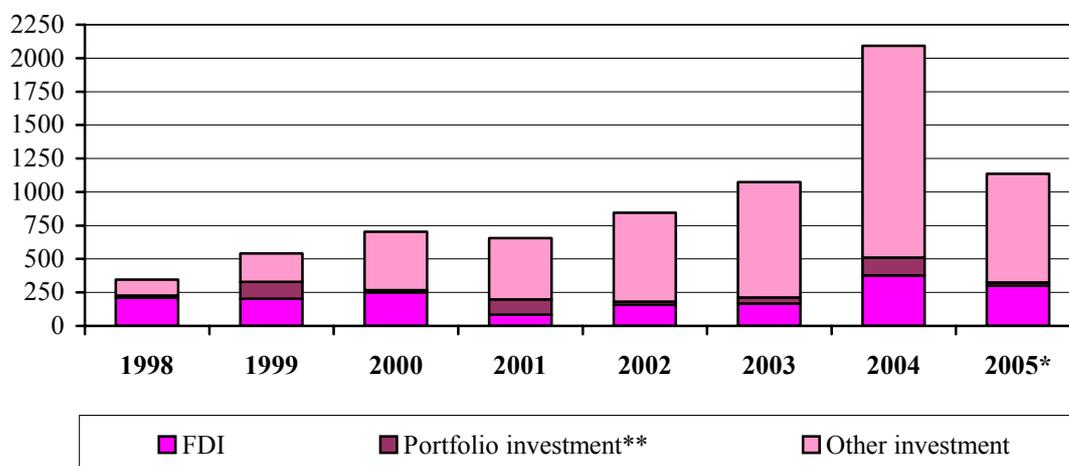
* 2005 data for January-September

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.

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 commitment to continue the reforms in future, strong national currencies and accession to the European Union. Therefore the majority of the new EU member states have credit ratings favourable for investment.

Figure 4.16

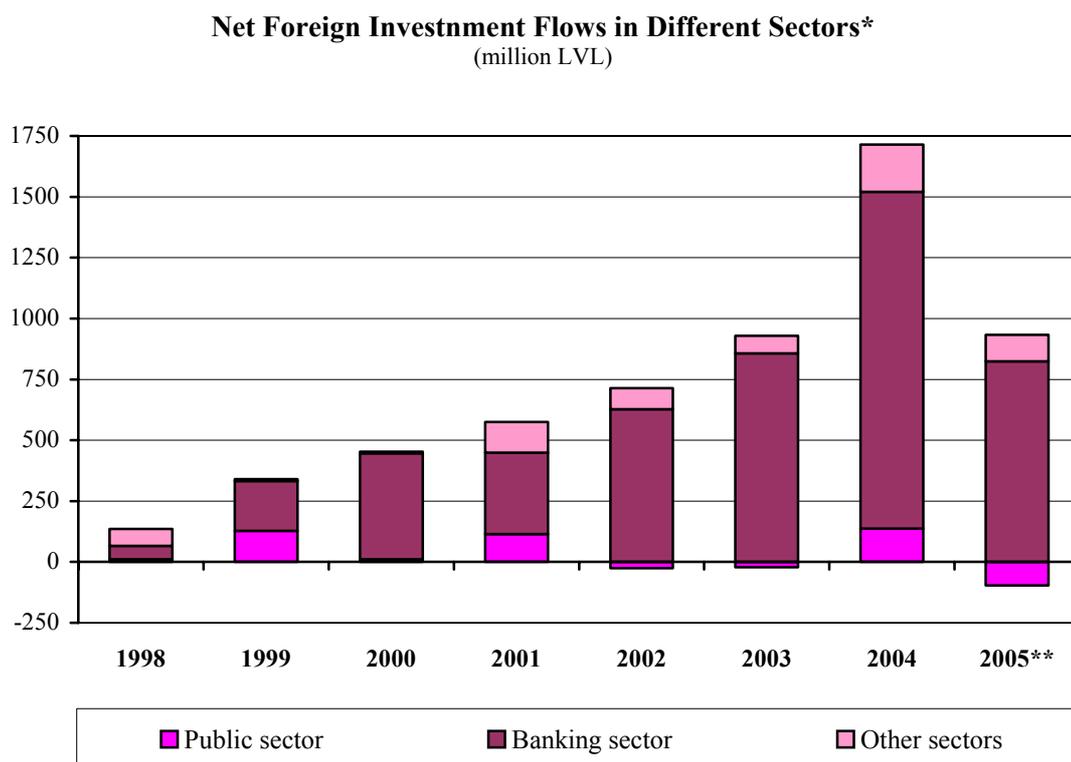
Inflow of Foreign Investment into Latvian Economy by Types of Investment
(million LVL)



* 2005 data for January-September

** portfolio investment with financial derivatives

Figure 4.17



* Excluding FDI

** 2005 data for January-September

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. Inflow of foreign direct investment in Latvian economy went down in 9 months of 2005, but this investment covered 41% of the current account deficit, which as already mentioned, has considerably decreased.

The share of portfolio investment in the incoming financial flows is small and does not exceed 10% in the last three years.

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

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

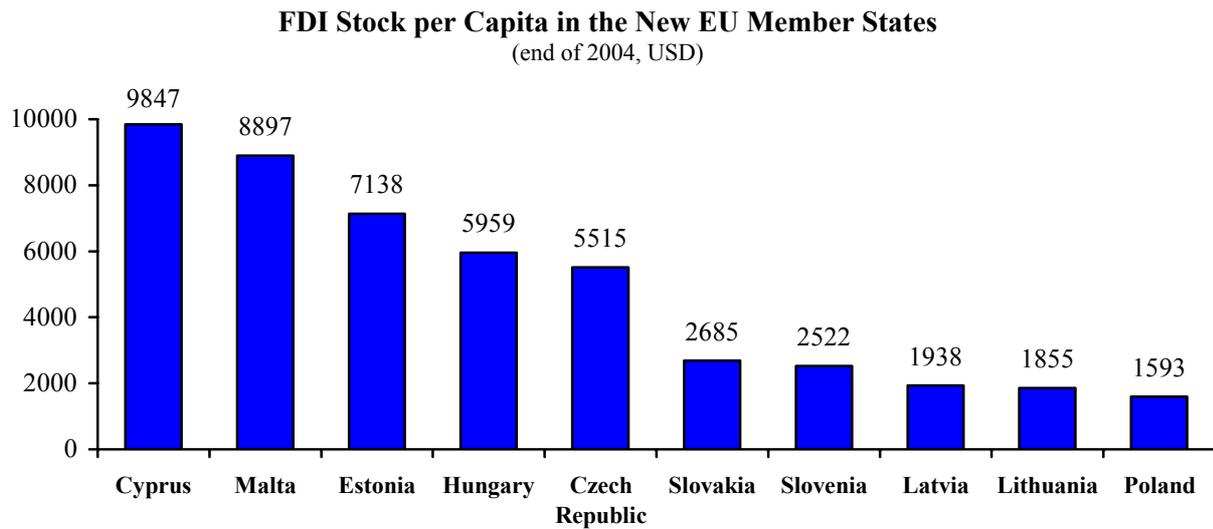
Therefore, Latvia is a capital-attracting country. In 9 months of 2005 the attracted capital exceeded GDP by 25%, while the debt of Latvia to the rest of the world was 93.2% of GDP, including the central government debt (7%). The amount owed to Latvia by the rest of the world equalled to 68% of GDP.

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 the funding for investment in fixed assets.

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

Figure 4.18

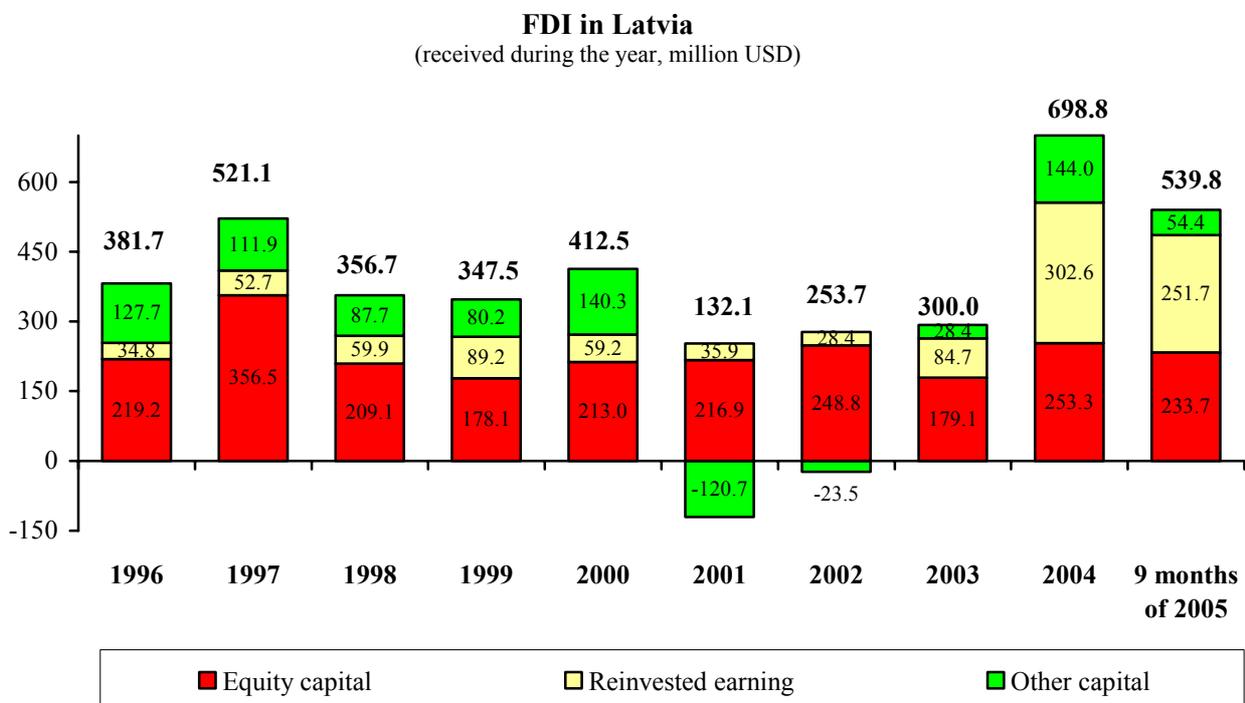


Source: UNCTD, World Investment Report 2005

At the end of 2004, the FDI stock amounted to 2360.8 million LVL or 31.5% of GDP and the volume of the FDI inflow in the last four years amounted to 17% on average of investment in fixed assets.

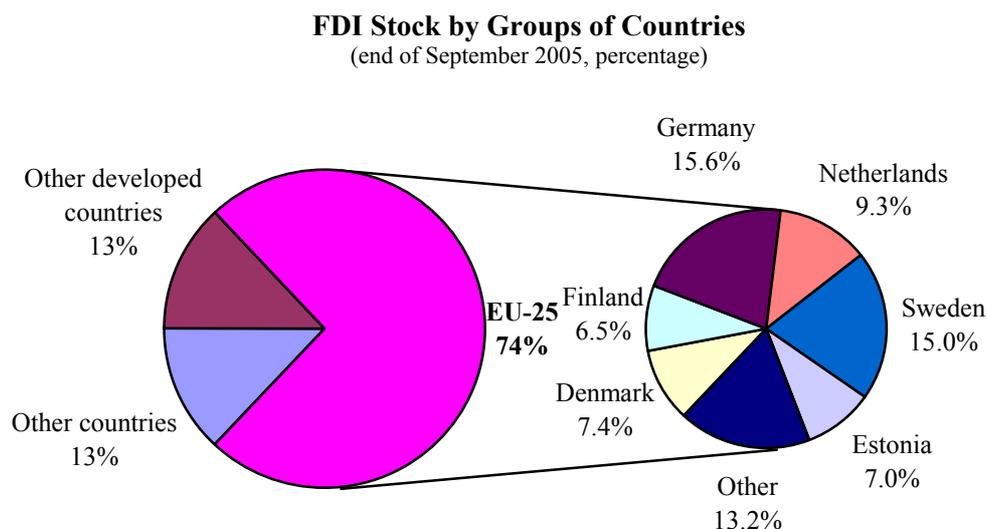
In 9 months of 2005, the volume of the FDI inflow in Latvia was 299.4 million LVL, which was by 11.7% more than in 9 months of 2004. The growth was mostly ensured by increase in own capital of investment companies.

Figure 4.19



Investments of developed countries dominate in the geopolitical structure of the FDI stock. In 9 months of 2005 the FDI stock of developed countries increased by 15.1% and constituted 77% of the total FDI stock in Latvia. It has to be noted that investment of EU member states increased by 22.5% in 9 months of 2005 and equalled to 61% of the total FDI stock.

Figure 4.20



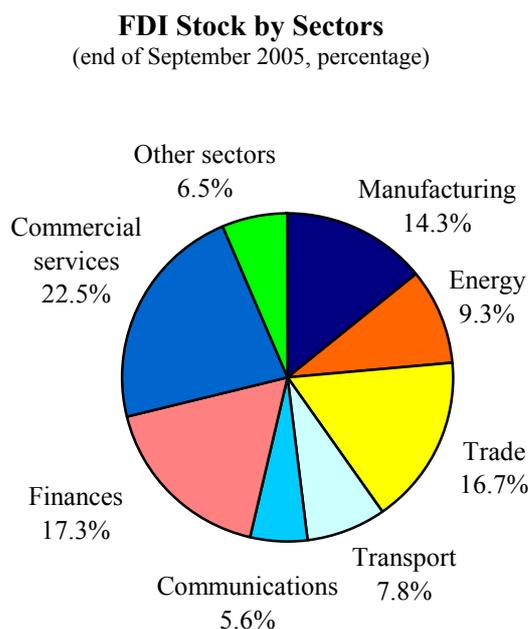
FDI stock from the new EU member states increased by 53.1% in 9 months of 2005 and constituted 13% of the total FDI stock at the end of September.

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

In 9 months of 2005, the most significant amounts of direct investment in Latvia were made by German, Russian, Dutch, Estonian, British, Lithuanian, Swedish and American entrepreneurs, contributing 99.2% of all investment inflow.

The highest share in the sectoral structure of FDI stock belongs to the commercial services sector. In 9 months of 2005, FDI in this sector grew by almost 23.5%, and the share of this sector in the FDI stock structure amounted to 22.6% at the end of September. Especially fast growth of FDI in this period was in sectors of construction (by 44.5%), fisheries (by 48.4%), energy (by 28.3%) and agriculture (by 21.7%). In 9 months of 2005 the FDI grew by 22.4% in production sectors and by 14.6% in services.

Figure 4.21



Amount of FDI stock in manufacturing increased by 16.3%, and the share of this sector was 14.3% at the end of September 2005.

The biggest investments in manufacturing were made by Germany (17.4% of the 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 investments in medium technology sectors were made by Netherlands (28.8%) and Sweden (30.3%).

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. In order 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 main goal of the Bank of Latvia² is to maintain price stability in the country. The central bank is an independent decision making-institution not subordinated to decisions or instructions of the government or governmental institutions. The Bank of Latvia performs its functions under supervision by the Saeima.

Since the middle of February 1994 the Bank of Latvia had unofficially pegged the exchange rate of the lats (LVL) to the SDR³ basket of currencies (1 SDR = 0.7997 LVL) thus *de facto* implementing the policy of fixed currency exchange rate. As from January 1, 2005 the peg of the LVL to the SDR basket is replaced with the peg to the euro (1 EUR = 0.702804 LVL). The change of the lats' 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 lats against the euro, namely, 1 EUR = 0.702804 LVL. Latvia will have to participate in the ERM II for at least two years, fulfilling the Maastricht criterion on exchange rate stability. During this period the Bank of Latvia has to reach full compliance with the European Central Bank (ECB), adjusting the monetary policy instruments.

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

On July 21, 2005 the Cabinet of Ministers adopted decision to establish the Management Committee for Introduction of the Single Currency of the European Union in Latvia, with a task to develop the plan of measures required to ensure successful joining the euro zone by Latvia.

The timetable for introduction of the euro, approved by the Cabinet of Ministers, envisages that Latvia will join the EMU on January 1, 2008. Still it must be noted that the introduction of the euro in Latvia will be an issue of EU multilateral relations, affecting the common interests of all EU member states. Thereby the timetable for introduction of the euro, approved by the Cabinet of Ministers, will get an official status only after completion of all negotiations and other formal procedures.

As soon as the European Council passes the decision on Latvia's readiness to participate in the EMU, the national currency of Latvia will be replaced with the euro and the Bank of Latvia will terminate implementation of an independent monetary policy. Until then the lats will remain the national currency of Latvia.

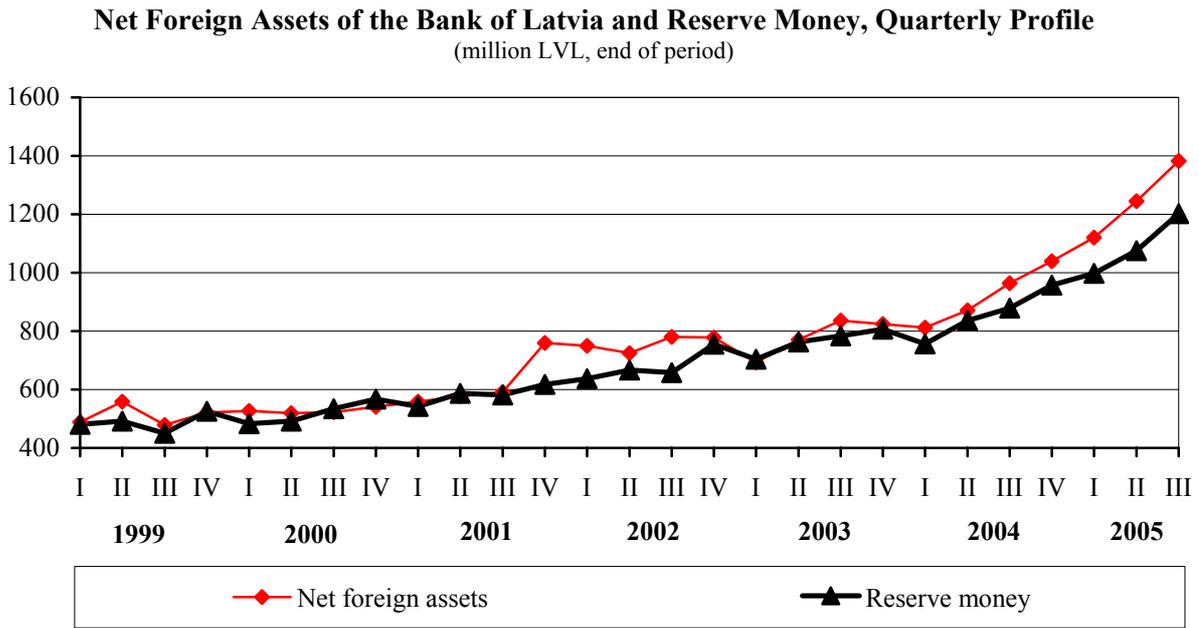
¹ Data of the *Financial and Capital Market Commission* and the Bank of Latvia are used in this section.

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).

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.

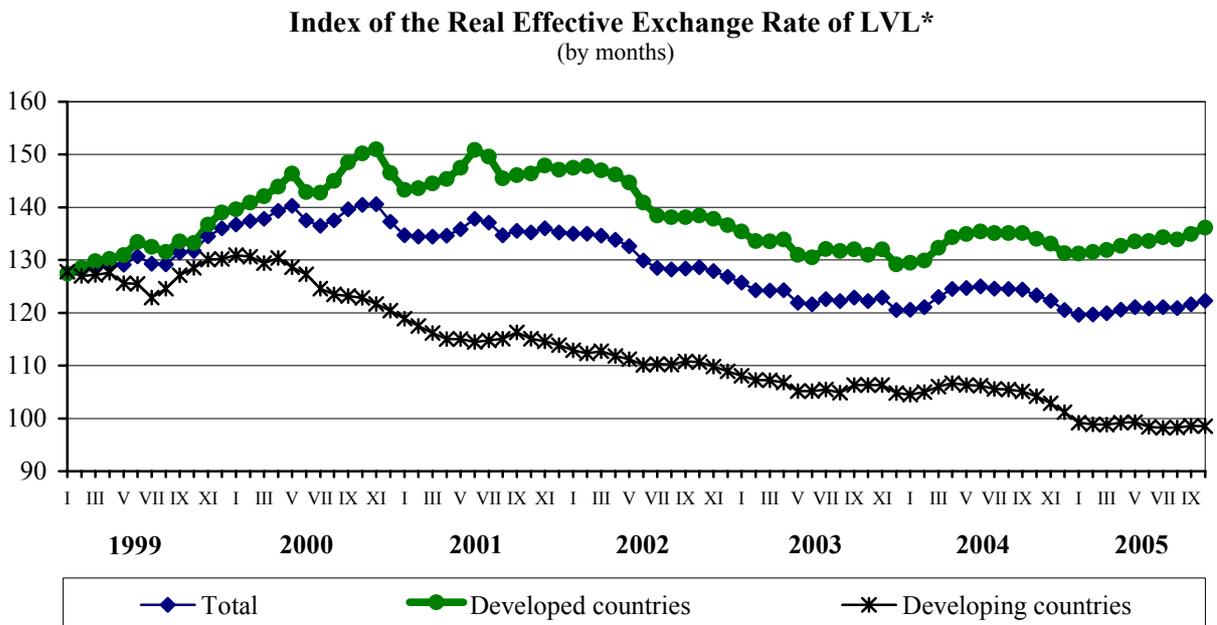
Figure 4.22



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 in Latvia. 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.

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 coverage of reserve money (currency in circulation and deposits in the Bank of Latvia) with net foreign assets was 114.5% at the end of October 2005. Net foreign assets of the Bank of Latvia have gone up by 32.9% in comparison with the end of October 2004.

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) amounted to 2357 million USD at the end of November 2005 (2019 million USD at the end of 2004, 1535 million USD at the end of 2003).

The Bank of Latvia calculates the real effective exchange rate of the lats¹ 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).

Comparing with 2000 and 2001, the real exchange rate of the lats has depreciated with regard to currencies of both the developing and the developed countries. However in the last years it tends to appreciate with regard to currencies of the developed countries due to relatively high inflation. Decline of the real effective rate of the 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 (96%) in total assets (see Table 4.8).

Table 4.8

Participants of the Financial and Capital Market*

	31.12.2003.			31.12.2004.		
	Number	Assets, million LVL	Share in total assets, %	Number	Assets, million LVL	Share in total assets, %
Banks	23	5717	96.08	23	7850	96.49
Insurance companies	19	141	2.37	17	156	1.92
Investment management companies	8	4	0.07	10	2	0.02
Investment funds	16	27	0.45	15	36	0.44
Investment plans**	7	26	0.44	19	48	0.59
Private pension funds	5	2	0.03	5	2	0.02
Savings-and-loans companies	28	4	0.07	32	5	0.06
Other	-	29	0.49	-	37	0.46
Total		5950	100		8136	100

* Data of the *Financial and Capital Market Commission*

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

22 banks and one branch of a foreign bank³ operated in Latvia in 2005.

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 (on September 30, 2005 the state owned only 5.3% 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 61.8% of the total paid-up equity capital of banks on September 30, 2005 (57.8% at the end of 2004, 53.9% at the end of 2003). Nine banks were subsidiaries of foreign banks (their market share in the total bank assets was 52%).

The market share of five biggest banks has not essentially changed in the last years and amounted to 66% of total assets, 75% of loans and 69% of deposits on September 30, 2005.

Total amount of bank assets reached 9795 million LVL at the end of September 2005, growing by 33% during one year, while the amount of issued loans went up by 53% and the volume of attracted investment increased by 21%. To a great extent, this growth occurred due to the rapid development of

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

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

³ Also credit institutions or their branches, which are registered in European Economic Area countries and have submitted applications to the *Financial and Capital Market Commission*, may provide banking services in Latvia.

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

Commercial banks operate with profit. In 9 months of 2005 the total profit of the banking sector reached 144.1 million LVL (for comparison: the profit amounted to 116 million LVL in 2004). Return on assets (ROA)¹ reached 2.2% at the end of September 2005 while return on equity (ROE)² reached 28% (1.7% and 21.4% respectively at the end of 2004, 1.4% and 16.7% respectively at the end of 2003). The volume of services provided by Latvian banking sector is still substantially smaller than in the developed countries, therefore this sector has great potential for the future growth. Moreover, a considerable part of Latvian population has not yet started to use banking services.

17 **insurance companies** operated in Latvia in 2005, of which five were life insurers and 12 provided non-life insurance. In Latvian financial and capital market, the share of insurance companies in the total assets constitutes approximately 2%.

Total of gross premiums written in the insurance market reached 130 million LVL in 2004, which was by 4% more than in 2003, while the volume of paid gross indemnities was 56.4 million LVL (by 28% more than in 2003). In 2005 the development rate of the insurance market remained at the level of previous periods. Total of gross premiums written in the insurance market reached 114.6 million LVL in 9 months of 2005, which was by 14.9% more than in the respective period of 2004, while the volume of paid gross indemnities was 49.6 million LVL or by 18.4% more than in 9 months of 2004.

Accession to the EU has encouraged the increase of competition in this sector. Since May 1, 2004, non-bank financial institutions of EU member states no longer need to receive licence or open a branch in Latvia in order to offer their services in this country. Foreign companies now are allowed to insure assets of their subsidiaries in Latvia not only with local insurers, and this has reduced growth of real estate insurance volumes in Latvian market. 150 notifications by insurance supervision bodies of 21 European Economic Area countries on the intention of insurers licensed in these countries to use the principle of service provision freedom in Latvia were received by June 30, 2005. Also three notifications about opening a branch in Latvia were received. Three notifications by Latvian insurers on the use of the principle of service provision freedom in EU member states were sent to insurance supervision bodies of EU member states.

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

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 9.5% of GDP at the end of 2003). The market capitalisation reached 1270 million LVL at the end of September 2005. 39 companies were listed on the stock exchange at the end of 2004, while the shares of 45 issuers were in the public turnover at the end of September 2005.

Activity of RSE is increasing gradually. RSE index RIGSE reached 414 points (January 1, 2000 = 100) at the end of 2004 (288 points at the end of 2003) and 576 points at the end of September 2005. Growth of the capital market in the nearest future might be positively influenced by appearance of such stable investors as pension funds and investment companies in the securities market and by the efficiency of raising capital through the securities market.

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

The Finnish securities trader HEX Group, which is also the owner of the only licensed stock exchange in Latvia (RSE), has merged its operations with Swedish company OM, which is a leading developer of the 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

¹ ROA – ratio of profit/losses to assets.

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

necessary technological means for integration of Latvian capital market into united markets of the Nordic countries.

As of July 1, 2001, supervision over the financial sector is being carried out 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 support development and stability of financial and capital market.

Normative acts regulating operation of Latvian banks essentially comply with the 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 increased gradually (9000 LVL as from January 1, 2006). The law stipulates that the compensation will reach 13 000 LVL by January 1, 2008. As from January 1, 2003, the compensation is also guaranteed to legal persons in the same amount as to physical persons.

4.4.3. Deposits and Loans

Stability of the banking sector, growing welfare of population and increasing economic activity predetermine stable growth of basic monetary indicators of the banking system of Latvia. Growth of monetary indicators, which had been observed over the previous years, was also retained in 2005 (see Table 4.9 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 4.9

Monetary Indicators of the Banking System of Latvia

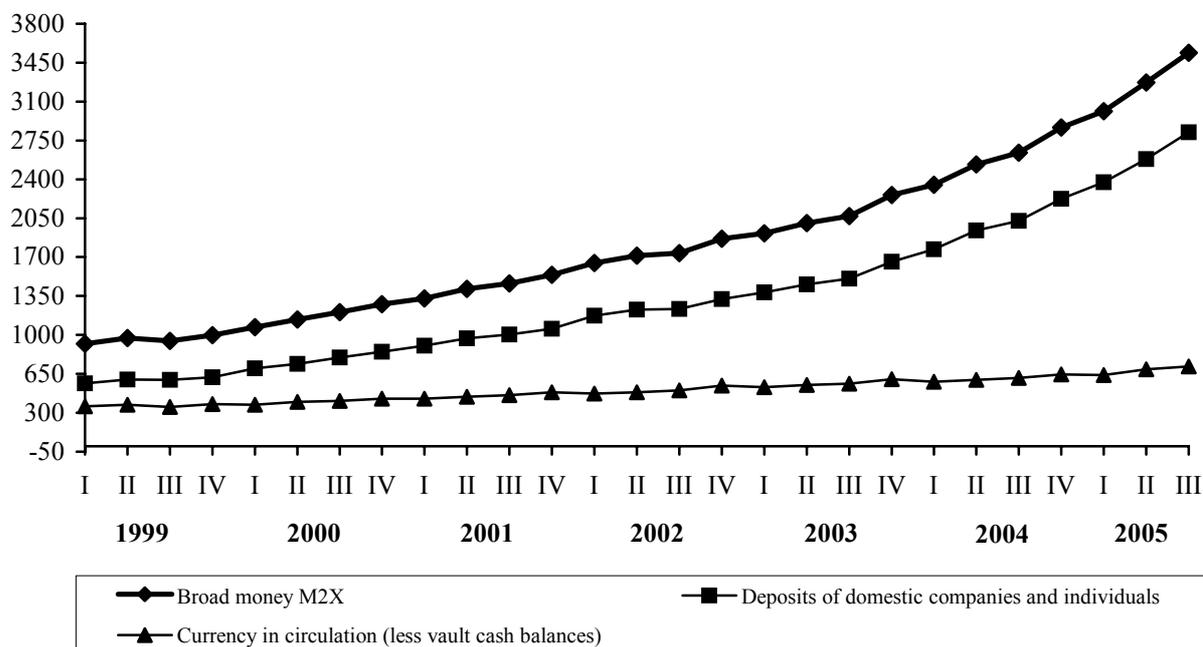
(end of period)

	2001	2002	2003	2004	2005*
(million LVL)					
Net foreign assets	517.9	352.1	75.4	-231.0	-1158.1
Net domestic assets	1023.6	1512.8	2183.4	3098.8	4893.8
Domestic loans	1433.8	2004.3	2822.0	3910.4	5960.8
to government (net)	79.1	154.7	250.2	173.4	85.3
to companies and individuals	1354.7	1849.6	2571.8	3948.1	5875.5
Other assets (net)	-410.2	-491.4	-638.6	-849.3	-1102.4
Broad money M2X	1541.4	1864.9	2258.7	2867.9	3735.7
Currency in calculation (less vault cash balance)	485.2	543.1	601.1	645.4	745.1
Deposits of individuals and companies	1056.2	1321.8	1657.7	2222.5	2990.6
of which:					
demand deposits	622.1	776.8	941.7	1295.6	...
time deposits	434.1	545.1	716.0	926.8	...
(changes over the preceding period, per cent)					
Domestic loans	35.6	39.8	40.8	40.0	51.0
of which:					
to companies and individuals	49.8	36.5	39.0	46.8	55.7
Broad money M2X	20.8	21.0	21.1	27.0	30.3
Currency in circulation (less vault cash balance)	13.4	11.9	10.7	7.4	15.4
Deposits of individuals and companies	24.5	25.1	25.4	34.1	34.6
GDP (in current prices)	9.9	10.3	11.0	16.0	...

* end of November 2005

Figure 4.24

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



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. By the end of November 2005, the volume of deposits of companies and individuals had increased by 35% in comparison with the end of 2004.

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 constitute 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 the Latvian banking system on the whole. However, due to strict measures of bank supervision and control, such probability is small. A major part of liabilities drawn by non-residents are placed into liquid assets, and risks related to dynamic quantitative changes of these deposits are well managed. Trust in banks is also enhanced by the *Law on Deposit Guarantees*.

The share of **loans** to companies and individuals in GDP equalled to 51% in 2004 (40.2% in 2003 and 19% in 2000)¹. Both the enlivened economic activity and the reduction of credit risks have encouraged growth of crediting. Total volume of loans grew by 40-50% annually in the last years.

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). The share of long-term loans in the total credit portfolio was 48% at the end of September 2005 (42% at the end of September 2004).

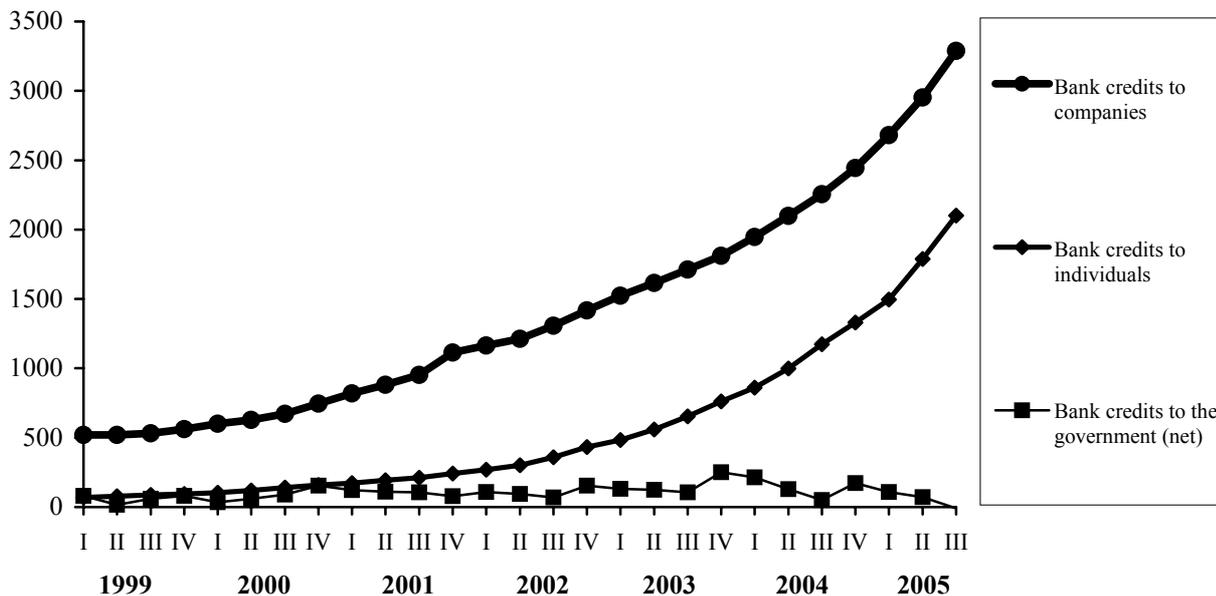
While the amounts of crediting are increasing, the quality of loans is not deteriorating. At the end of September 2005 the quality of loans issued by banks was as follows: 98.5% of all issued loans were evaluated by banks as standard, 0.6% as “close watch” and only 0.9% as loans generating no income (substandard, doubtful, or lost)². In compliance with requirements of the Bank of Latvia, loans generating no income are secured by special savings, hence this category of loans does not present a serious threat to stability of banks. 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.

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

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

Figure 4.25

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

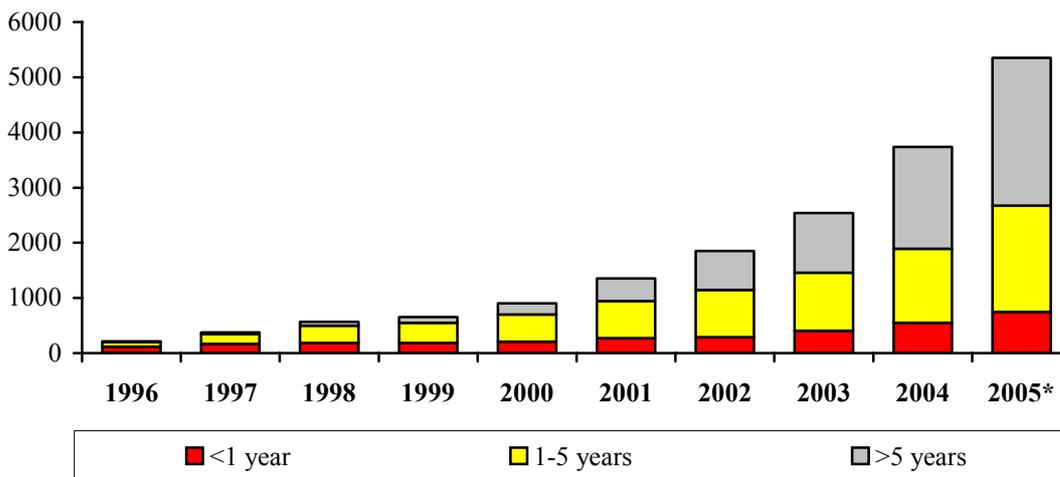


At the end of September 2005, the biggest amounts of loans had been granted to the following national economy sectors: real estate operations (21% of total domestic loans), financial mediation (19.1%), trade (15.1%), and manufacturing (13.7%). Real estate operations constitute a sector, where the volume of loans issued in the last years increased most rapidly (by 84.7% in 2004).

At the end of September 2005, 88% of total issued loans had been granted to resident borrowers. 31% of total loans granted to resident borrowers were loans in LVL.

Figure 4.26

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



*end of September 2005

Mortgage crediting increases rapidly. 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. Rapid growth of mortgage crediting continues in 2005, and the share of mortgage loans in credit portfolios of banks reached 41% at the end of September.

Responding to the rising domestic demand, the Bank of Latvia raised the refinancing rate by 0.5 percentage points to 4% in March and November of 2004 and increased the norm of reserves from 3% to 4% in July 2004, to 6% in August 2005 and to 8% in December 2005, in order to slow down the rapidly growing lending. However, the efficiency of these measures in Latvia has been limited by the fixed currency exchange rate regime and several specific factors, such as the low share of loans granted to resident borrowers in GDP, relatively easy access by banks to foreign resources, and a relatively high share of loans issued in foreign currencies in the total structure of loans.

To unify conditions of mutual competition between banks and 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 reserves.

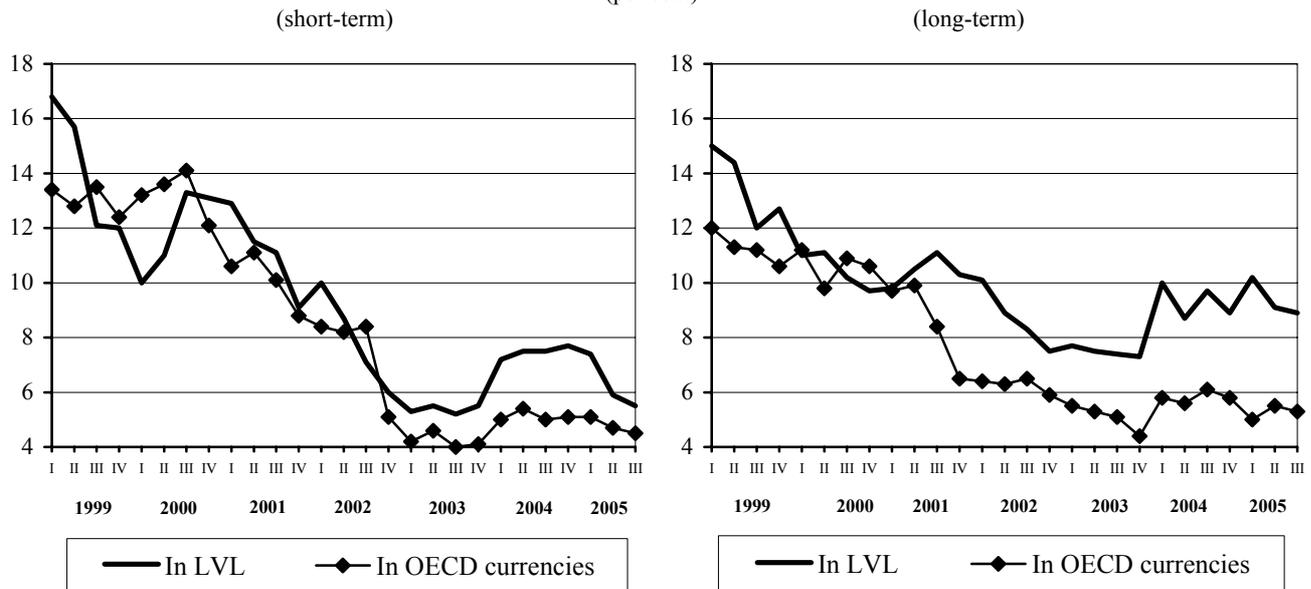
The dynamics of loan interest rates is displayed in Figure 4.27.

Average weighted annual interest rate for short-term loans in LVL to companies and individuals was 5.6% in November 2005, the rate for long-term loans in LVL was 9.7%, while the respective rates for loans in OECD currencies were 4.7% and 6%¹.

Meanwhile, average weighted annual interest rate for short-term deposits in LVL was 2.5% in November 2005, the rate for long-term deposits in LVL reached 3.5%, while the respective rates for deposits in OECD currencies were 2.7% and 3.8%. Decline in loan interest rates during the next years will depend on the pace of domestic savings formation and on competition in the banking sector.

Figure 4.27

Average Weighted Interest Rates on Loans in Credit Institutions, Quarterly Profile
(per cent)



5. Labour Market

5.1. Employment and Unemployment

Economic development in the recent years has made a positive impact on the situation in labour market in Latvia. Although the population of working age (15-64 years) has diminished since 2000, the number of economically active persons has increased and the employment rate is growing. The proportion of economically active persons in this age group was 67.2% in 2000, but the average indicator in 3 quarters of 2005 already amounted to 69.6%.

Table 5.1

Main Indicators of Employment and Unemployment¹

Indicators	2000	2001	2002	2003	2004	3 quarters of 2005
Population aged 15-64 years (thousand)	1600.3	1594.2	1591.4	1589.3	1587.3	1583.8
Economically active persons aged 15-64 years (thousand)	1074.7	1082.0	1094.8	1099.6	1105.5	1102.1
Employed persons (thousand)	917.6	937.5	962.5	981.5	988.2	998.8
Participation rate (%)	67.2	67.9	68.8	69.2	69.7	69.6
Employment rate (%)	57.3	58.8	60.5	61.8	62.3	63.1
Unemployed persons (thousand)	158.3	144.6	134.5	119.2	118.6	105.1
Unemployment rate (%)	14.4	13.1	12.0	10.6	10.4	9.3
Registered unemployed persons (end of period, thousand)	93.3	91.6	89.7	90.6	90.8	87.0
Registered unemployment rate (end of period, %) ²	7.8	7.7	8.5	8.6	8.5	8.2

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

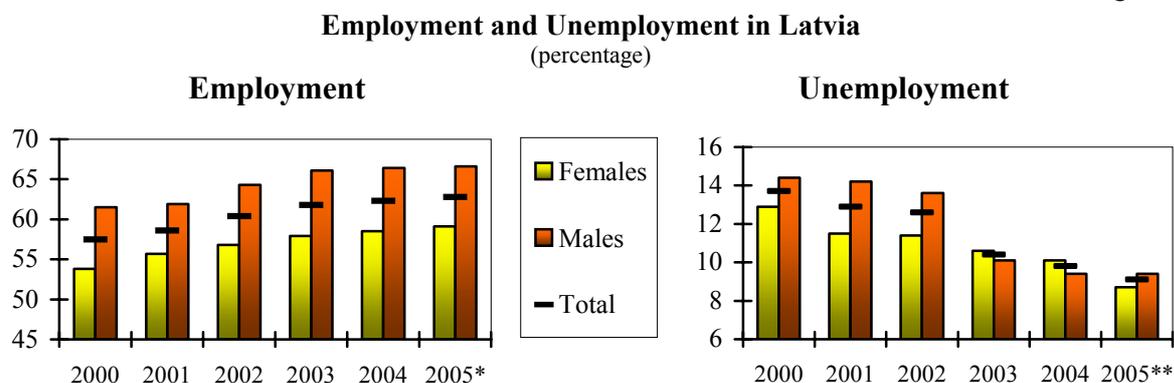
² Share of registered unemployed persons in economically active population from 2002, according to the new methodology.

In the last five years (2000-2004) the **employment rate** has increased by 4.8 percentage points. In 2000 the employment rate in Latvia was 4.9 percentage points lower than the EU average, but in 2004 the backwardness was only 1 percentage point. Employment rate continued increasing in 2005 and reached 63.1% (result of the first 3 quarters of the years), which is by 0.8 percentage points higher than in the respective period of 2004.

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

The employment target set by Latvia in the National Lisbon Programme of Latvia for 2010 is 67%, i.e., by 3 percentage points lower than the level set by the EU.

Figure 5.1



Source: Eurostat, Structural Indicators, 28.12.2005.

* forecast of the Ministry of Economics, ** Eurostat forecast for 2005

Female employment in Latvia is still higher than the EU average, and this difference tends to grow, as in 2002 the female employment rate in Latvia exceeded the EU rate by 2.1 percentage points, but the difference reached 2.8 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, hotels and restaurants, and other services).

Male employment in Latvia tends to increase every year, but still lags behind the average EU rate (by 6.7 percentage points in 2002 and 4.5 percentage points in 2004).

Employment rates in Latvian regions are still very different. In 2004 the employment rate in Rīga 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, while 30% were employed in the countryside.

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. In 3 quarters of 2005 the employment rate rose by 1%. The highest growth in the number of employees in 2004 was observed in the electricity, gas and water supply (by 18.4%), construction (by 16.9%) and financial mediation (by 14.7%). In 3 quarters of 2005, comparing with the respective period of 2004, the biggest increase in the number of employees was observed in hotels and restaurants (by 29.2%) and in the commercial services sector (by 28.3%) (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	3 quarters of 2005
Total	925.6	917.6	937.5	962.5	981.5	988.2	998.8
Agriculture	128.4	104.4	107.4	103.4	96.7	88.5	80.1
Forestry	20.1	19.4	22.9	34.6	30.6	34.9	31.4
Manufacturing	180.9	168.3	164.2	164.0	171.2	161.1	156.2
Electricity, gas and water supply	20.9	20.3	19.3	22.0	20.7	24.5	22.2
Construction	50.4	55.1	66.6	59.6	73.5	85.9	91.9
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	150.7
Hotels and restaurants	15.6	22.0	22.1	24.2	24.4	25.4	30.4
Transport, warehousing and communications	83.3	78.3	77.3	84.8	93.2	93.5	93.0
Financial mediation	14.3	12.3	13.7	12.7	15.6	17.9	18.4
Commercial services	30.6	43.6	39.5	37.1	40.5	38.4	45.7
Public administration and defence; compulsory social security	59.5	69.9	66.9	66.7	66.5	71.6	75.8
Education	91.9	83.6	85.8	84.5	75.7	79.2	81.8
Health and social care	57.0	46.5	47.9	58.5	57.0	52.8	55.0
Other services	48.1	43.3	48.1	51.2	55.2	57.9	57.1

In 2004 Latvia was the 15th among the 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 the data of Labour Force Survey, CSB).

The rate of *registered unemployment* in Latvia was 8.5% at the end of 2004, but in November 2005 it amounted to 7.5%, i.e., by 1 percentage point less than at the end of 2004.

The highest rate of registered unemployment still remains in Latgale region. At the end of 2004 it exceeded 25% 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 rates of registered unemployment are in Rīga city (4.5%), Rīga district (5.7%) and Ogre district (5.5%).

Share of the unemployed, who have not been able to find a job during one year in the total number of unemployed people, is gradually decreasing. This share amounted 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).

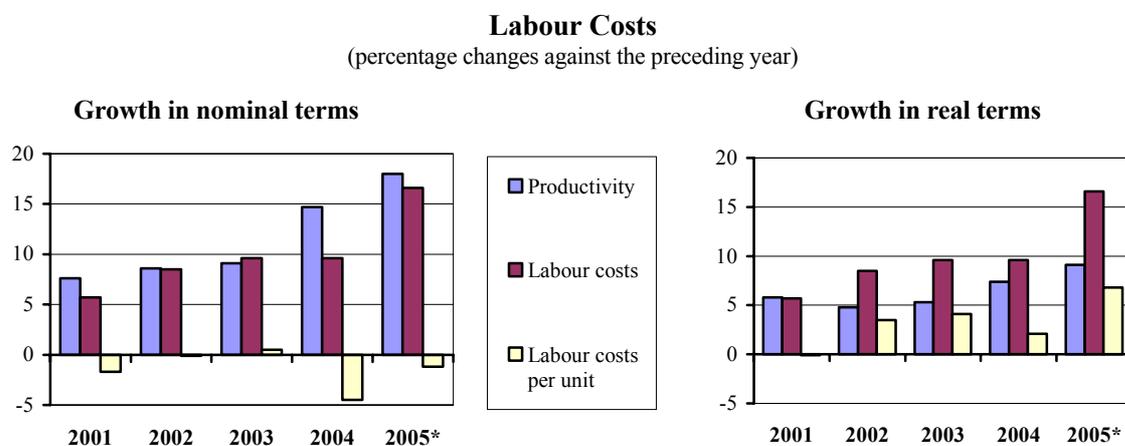
More than half of the unemployed at the end of 2004 were aged 30-49 years. The share of pre-pension age unemployed in the total number of unemployed persons increases every year, and this is mostly related to the increase of pension age according to the law on pensions.

Number of unemployed people decreases not only due to the increased employment rate. In the last years after Latvia's accession to the EU, labour drain takes place to some old EU member states, where labour markets are open to citizens of the new EU member states (Ireland, the United Kingdom and Sweden). Therefore, shortage of labour force in several sectors is starting to develop in Latvian labour market.

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, while in 2004 and 2005 productivity went up at a more rapid pace. Increase of wages for growth in real terms considerably exceeded growth of productivity.

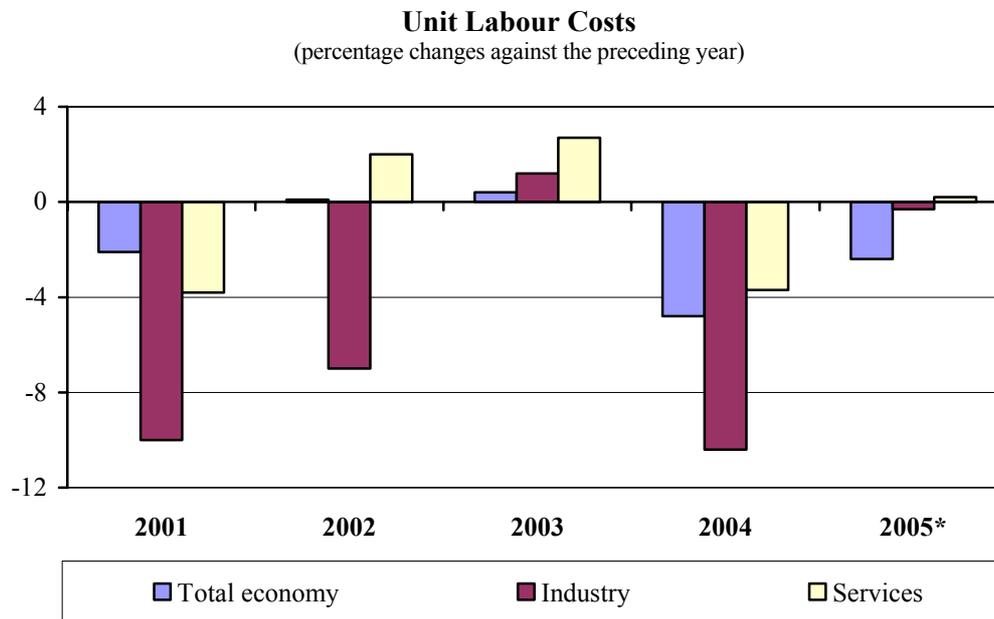
Figure 5.2



* estimation of the Ministry of Economics

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

Figure 5.3



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

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

The second process is related to rise of the 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 labour costs per production unit decreased also in service sectors in 2004 and grew minimally in 2005.

It is clear that the 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 plays the determinant role in the long term.

5.3. Employment Policy

Latvian employment policy is closely related to employment policy of the EU. The Treaty on European Union has a definite goal to promote economic and social development and high employment rate. In order to fulfil this, member states and the Community work out a co-ordinated strategy in employment (see Box 5.1).

In accordance with the Community employment policy, member states and candidate countries developed National Employment Plans annually till 2005. As from 2005, the employment plans are a component of the National Reform Programmes (National Lisbon Programme). In 2005 Latvia

developed the National Lisbon Programme of Latvia for 2005-2008 (hereinafter Programme) (see Section 6.1).

Box 5.1

EU employment policy

In March 2000 in Lisbon, the European Council accepted strategy with the aim to achieve sustainable economic growth with more and better jobs and bigger social cohesion, setting long-term employment targets: 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).

After five years of the strategy implementation it was established that improvement is too slow to reach the set targets by 2010. Therefore 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. Fulfilling this decision, the European Commission developed and the European Council accepted (in July 2005) the single action plan in conformity with the Integrated Guidelines package, reflecting in it the basic problems of economic growth and employment, by merging the hitherto separate Broad Economic Policy Guidelines and Employment Guidelines. In the employment sphere, guidelines are formulated in 3 blocks. The first block contains measures for inclusion of bigger number of people into employment, at the same time modernising social security systems. The second block includes measures for improved harmonisation of mutual interests of employees and employers and for increased flexibility of the labour market. The third block contains measures to increase investment into human resources, improving mastering of general and professional education.

This is reflected in more detail in 8 Integrated Guidelines for employment:

- to implement employment policies aimed at achieving full employment, improving quality and productivity at work, and strengthening social and territorial cohesion;
- to promote a lifecycle approach to work;
- to ensure inclusive labour markets, enhance work attractiveness and make work pay for job-seekers, including disadvantaged and inactive people;
- to improve matching of labour market needs;
- to promote labour market flexibility combined with employment security and reduce labour market segmentation, adequately taking into account the role of social partners;
- to ensure employment-friendly wage and other labour cost developments;
- to expand and improve investment in human resources;
- to adapt education and training systems in response to the new competence requirements.

In accordance with the Lisbon Strategy, member states have to build policy for implementation of the mentioned employment targets and priorities, ensure good management of employment policy, creating broad partnership for change, involving parliamentary structures and interested participants, including at the regional and local levels.

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

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

Also the European Commission, assessing results of implementation of employment measures, noted several times that, despite the positive development of labour market on the whole, Latvia has to pay bigger attention to faster inclusion of the unemployed and economically inactive people into employment, improving tax-benefit systems and more widely implementing active labour market measures. 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 professional training were noted. The Commission pointed at the necessity to solve issues of reducing the regional differences more actively.

Priorities of Latvian employment policy in the Programme are as follows:

- to promote economic activities in the least developed regions;

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

In order to fulfil the mentioned tasks, along with measures for encouraging the economic activities three groups of measures were developed, which include promotion of labour supply, development of mutual adaptability capacities of employees and enterprises, and development of education and skills.

As a result of implementation of these measures, it is envisaged to raise employment rate to 67% on average by 2010, including 62% for women and 50% for people in the age of 55-64 years. This means that it is envisaged to reach targets set in the Lisbon Strategy only for employment of older people and women, which already exceeds the EU average.

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

One of the most important tasks is to modernise work organisation and balance opportunities of at-work and out-of-work life, safety at work, gender equality, etc. At present, the level of labour quality in Latvia falls behind the situation in the EU member states in many aspects. In 2004, less than one-tenth of employees in the age of 25-64 years has participated in professional 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 EU member states. Number of people suffering from occupational diseases tends to grow. 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 slightly 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.

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

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

¹ Employment rate for persons 55-64 years old is increasing in the recent years and reached 48% in 2004, but still lags behind the Lisbon target of 50%. Situation is worse among young people (15-24 years old), where employment rate is mere 30.5% and has even decreased by 1 percentage points in comparison with 2003.

At the same time, availability of education at all levels will be improved and measures to reduce the number of students, who do not graduate or do not achieve professional qualification will be implemented, creating pedagogical correction programmes, applying educational services to socially excluded population groups, etc. Availability of higher education and its conformity with labour market needs will be increased.

In order to improve the life-long learning system, a life-long learning strategy is being developed and professional orientation system is being improved.

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 to fund 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 the 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 and development of healthcare and social infrastructure.

6. Economic Policy and Priorities of Structural Policy

6.1. National Lisbon Programme of Latvia for 2005-2008

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

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

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

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

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

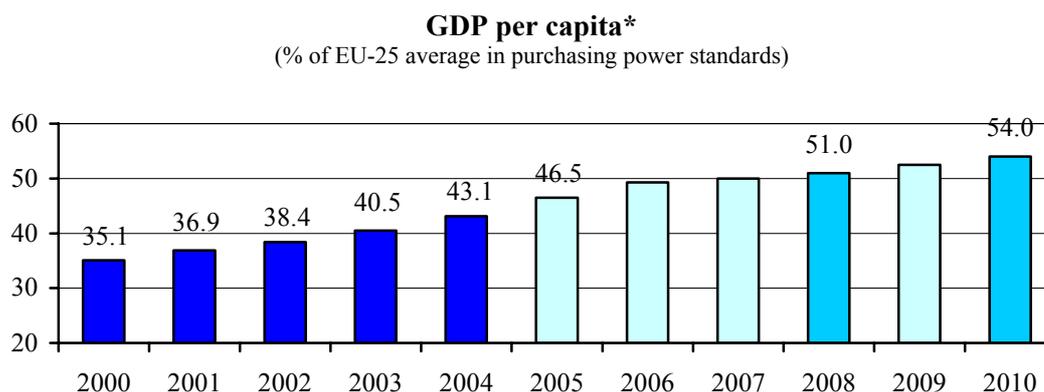
National Lisbon Programme of Latvia for 2005-2008 prescribes that Latvian GDP per capita has to reach 51% of the EU average in 2008 (it amounted to 43% in 2004) and 54% in 2010 (see Figure 6.1). In order to reach this goal, annual GDP growth of 6-8% has to be ensured in 2005-2008.

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

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

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

Figure 6.1



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

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

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

Ensuring macroeconomic stability

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

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

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

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

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

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

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

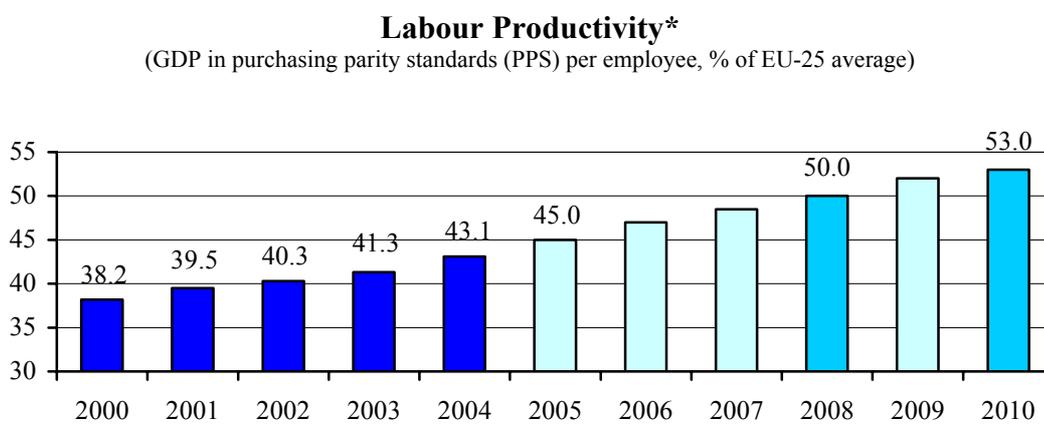
¹ The government has set January 1, 2008 as the target date for introduction of the EU single currency in Latvia.

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

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

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

Figure 6.2



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

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

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

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

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

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

Stimulating knowledge and innovation

One of the main goals of Latvia's economic policy is to establish effective and competitive sectoral structure. The present dominant model of the economy of Latvia, which is characterised by

using advantages of the cheap labour and available natural resources as well as manufacturing products with low value added, will not be able to ensure high economic development rates and promote achievement of the higher prosperity level in the future.

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

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

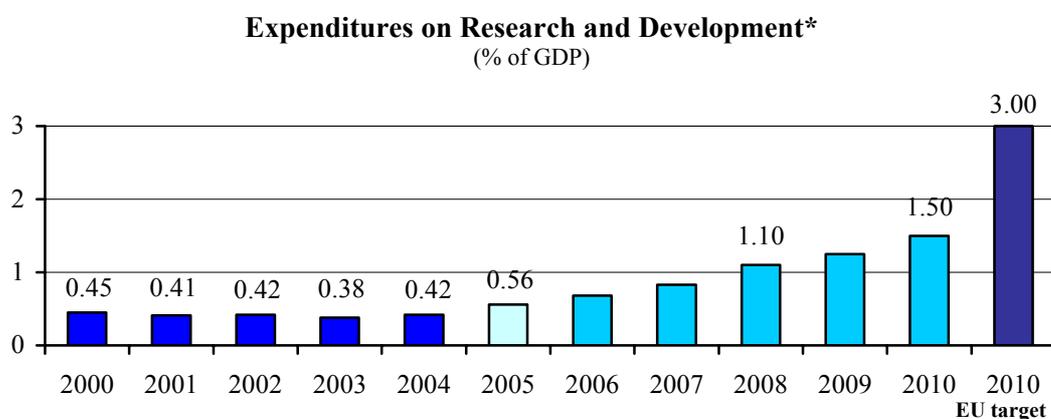
- to increase public investment and foster private investment in R & D;
- to ensure renewal of the intellectual potential in science, improving the system of doctoral grants and modernising the scientific infrastructure;
- to promote transfer of knowledge and technologies in production (including business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

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

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

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

Figure 6.3



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

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

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

Developing favourable and attractive environment for investment and work

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

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

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

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

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

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

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

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

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

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

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

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

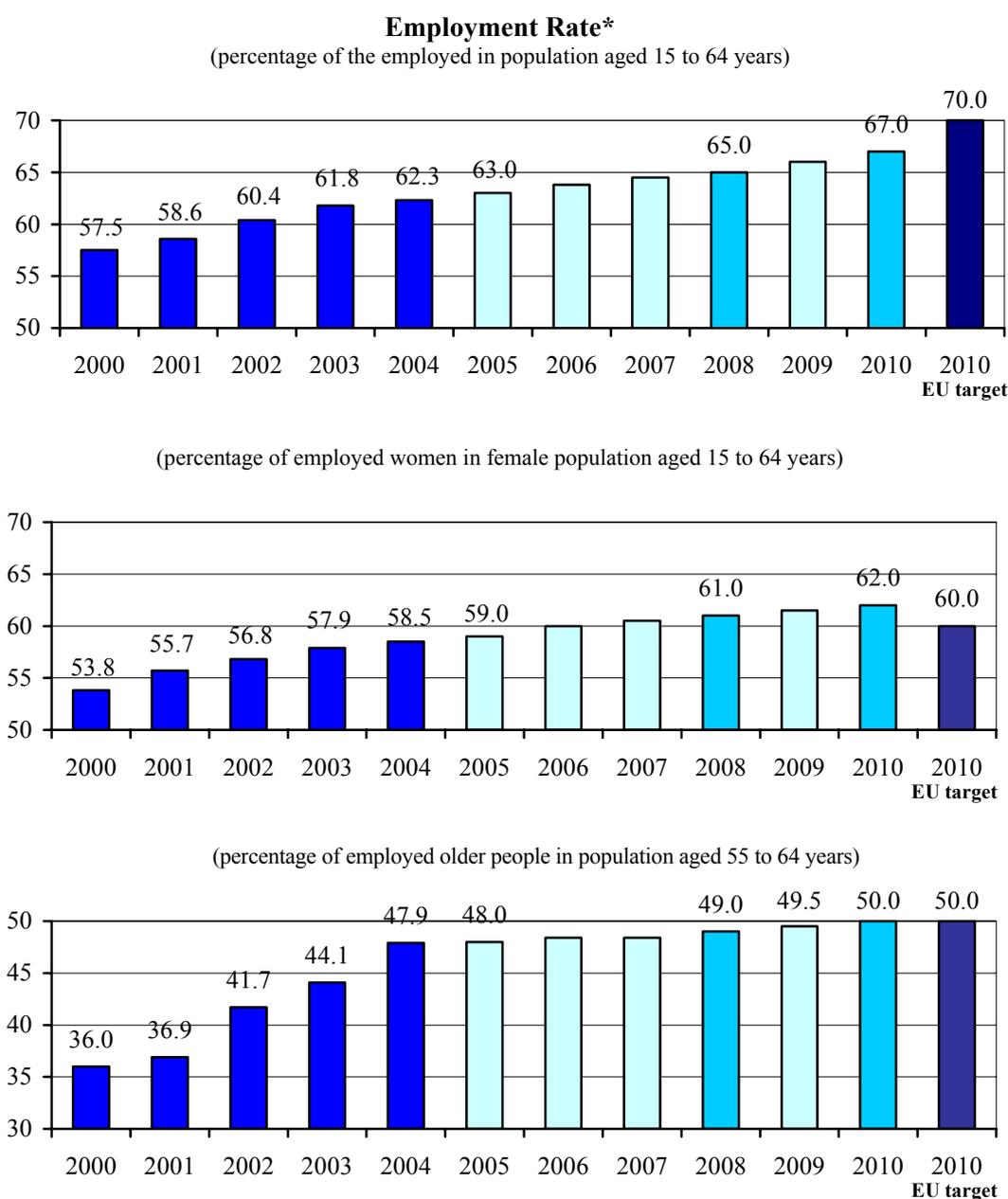
The Programme also emphasises the necessity to participate in the development process of sectoral normative acts in institutions of Latvia and the EU, in order to encourage competition in sectors, where high level of administrative regulation and inefficient use of public resources exist. In 2005-2008,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

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

Fostering employment

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

Figure 6.4



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

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

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

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

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

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

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

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

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

To lessen the marked regional differences in employment rates, the Programme stresses the necessity to contribute more attention and funds to measures of starting business and to promotion of geographic mobility in the least developed regions.

There is not a single decisive measure that would guarantee substantial decrease of undeclared employment (shady economy). Set of measures involving all interested parties is important. For that reason, the Programme envisages solution of the problem both by raising administrative capacities of the State Labour Inspectorate, improving control over observance of the labour law norms, increasing level of society's awareness about the issues of labour law, as well as developing model of co-ordination mechanism for effective exchange of information with the corresponding public administration bodies and other institutions, and by strengthening the roles of trade union and employer associations, encouraging employers to unite in employer organisations in order to create favourable environment for raising the reputation of socially responsible business activity, and also stresses the necessity to raise the minimum wage and increase the untaxed minimum in order to reduce tax burden on low-level wages.

Improving education and skills

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

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

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

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

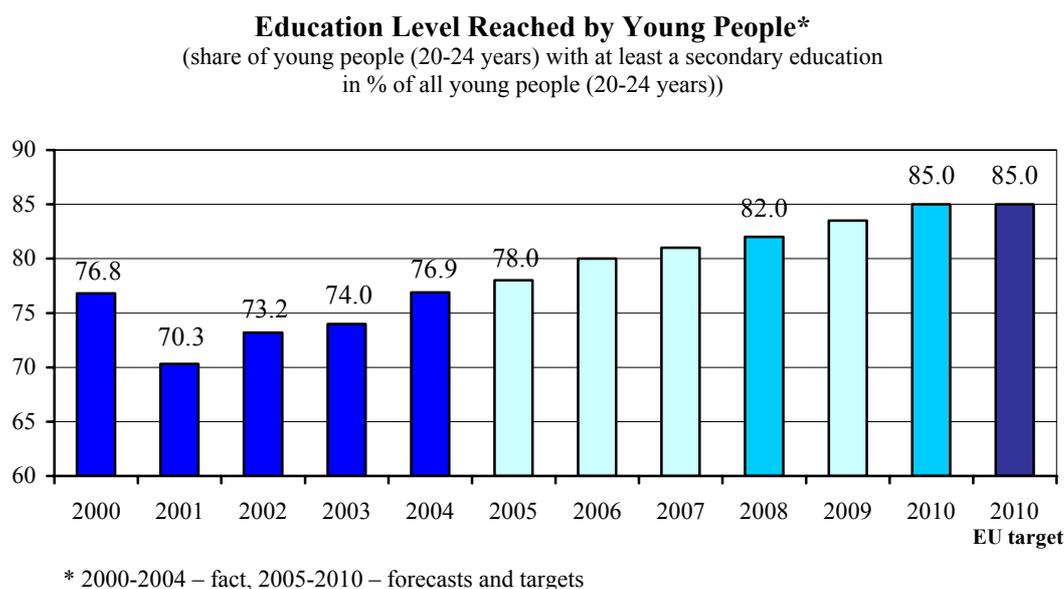
The Programme envisages the following main tasks for improvement of education and skills in 2005-2008:

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

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

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

Figure 6.5



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

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

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

Ensuring implementation of the Programme

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

- the *Supervisory Board of the Lisbon Strategy* – established in order to ensure the fulfilment of the tasks set up in the Lisbon Strategy in Latvia. The Board is chaired by the Minister of Economics approved by the Cabinet of Ministers as the co-ordinator of Lisbon Strategy implementation and supervision. Ministers and representatives of the Saeima, local governments and social partners, who are linked to the Lisbon process, are included in the Board. Tasks of the Board are to co-ordinate development of the *National Lisbon Programme of Latvia*, involve public institutions, the Saeima, local governments and social partners in the development process of the Programme, supervise fulfilment of the Programme and inform the society about the fulfilment of the tasks;
- the *Advisory Working Group of the Lisbon Strategy* – established in order to ensure development of the *National Lisbon Programme of Latvia* and its implementation at the inter-institutional level. The Working Group is chaired by the State Secretary of the Ministry of Economics. Senior officials of ministries linked to the Lisbon process are included in the Working Group.

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

On the basis of the European Council decisions, annual assessment of the progress in implementation of the national reform programmes is envisaged, including implementation of the *National Lisbon Programme of Latvia*. In case of necessity, *the National Lisbon Programme of Latvia for 2005-2008* will be updated after assessment of the progress.

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 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 the Development Plan or the Single Programming Document (SPD). The Single Programming Document for the Structural Funds Objective 1 programme 2004-2006 for Latvia was approved by June 17, 2004 resolution of the European Commission C(2004) 2121 (see Box 6.1).

Box 6.1**Priorities of the Development Plan**

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

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

- 1.1. improvement of environmental infrastructure and tourism;
- 1.2. development of accessibility and transport system;
- 1.3. development of information and communication 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. development of public research.

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

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

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

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

- 4.1.1. investment in agricultural holdings;
- 4.1.2. setting up of 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. adjustment of fishing effort;
- 4.2.2. fleet renewal and modernisation of fishing vessels;
- 4.2.3. development of processing and marketing of fishery and aquaculture products, development of fishing port facilities and aquaculture;
- 4.2.4. development of coastal fishery, socio-economic measures, promotion of conquering new market outlets and support to producer organisations.

Priority 5 – technical assistance (22 million EUR).

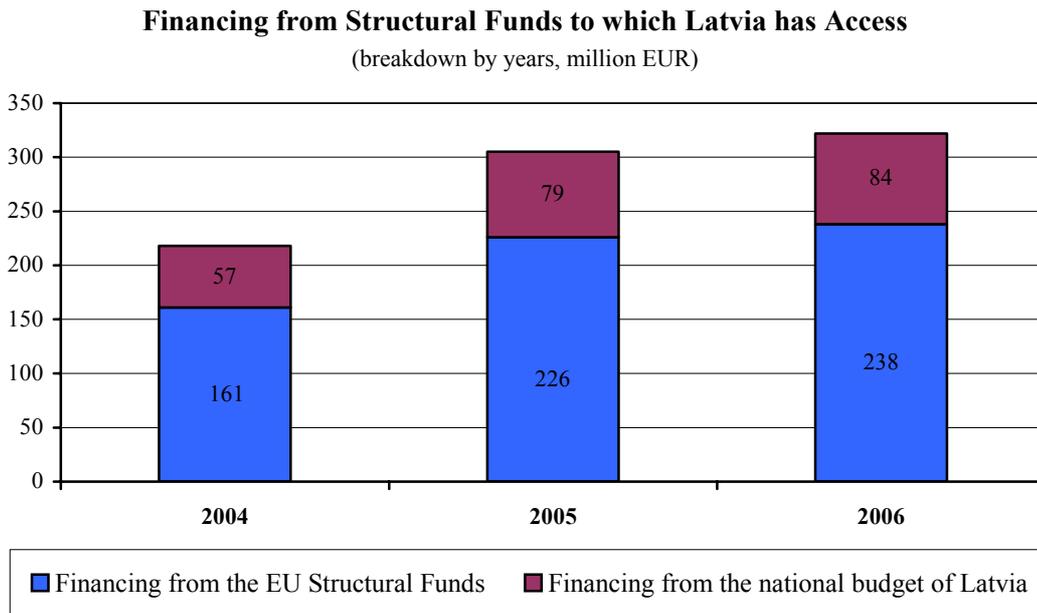
The total funds accessible to Latvia in the Structural Funds framework to which the beneficiaries will be able to apply are made up of financing from the EU Structural Funds and co-financing from the national budget of the Republic of Latvia and budgets of local governments. In almost all cases the financing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

The aggregate financing accessible to Latvia in the framework of the Structural Funds programmes in the period from 2004 until 2006 amounts to 845 million EUR (including 625 million EUR from the EU Structural Funds and 220 million EUR from the national budget of the Republic of Latvia) (see Figure 6.6).

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

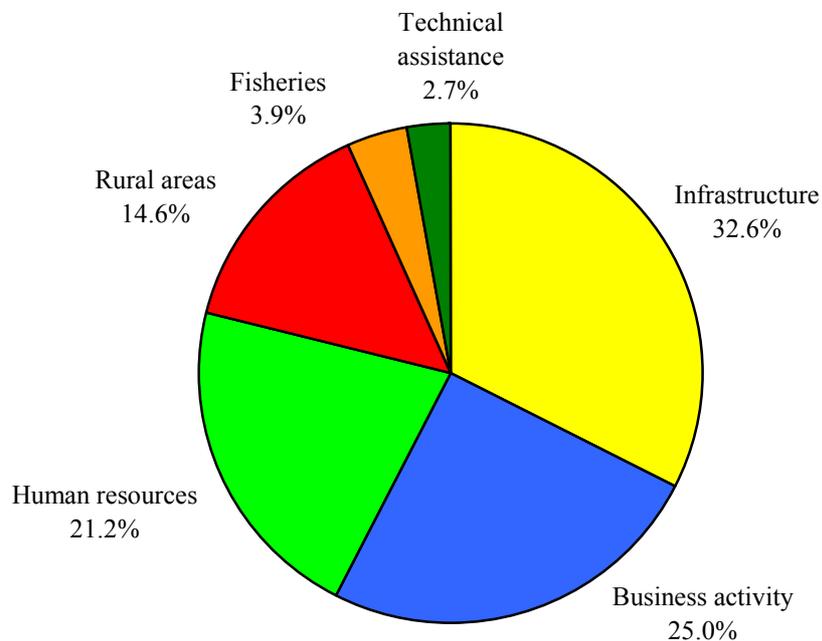
- European Regional Development Fund (369 million EUR);
- European Social Fund (139 million EUR);
- European Agricultural Guidance and Guarantee Fund (93 million EUR);
- Financial Instrument for Fisheries Guidance (24 million EUR).

Figure 6.6



Breakdown of aid from the Structural Funds by sectors shows that the biggest part of financing (32.6%) is envisaged for infrastructure projects and projects for promotion of business activity development (25%) (see Figure 6.7).

Figure 6.7

Breakdown of aid from the Structural Funds by sectors for 2004–2006

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 of July 28, 2005 essential progress was not

¹ The informative report „On readiness of Latvia for absorption of the European Union's financial resources” of the Ministry of Finance, August 2, 2005.

achieved in mere 8 of 92 SPD activities (5 activities in the ERDF framework, 1 activity in the ESF framework, 1 activity in the EAGGF framework and 1 activity in the FIFG framework).

As of July 22, 2005 the requested financing from the Structural Funds equals to 594.12 million LVL and the number of approved projects is 2 612 (see Table 6.1).

Table 6.1

Breakdown of Financing from the Structural Funds by SPD Activities

SPD priority		SF	SF financing	Approved projects		Payments to beneficiaries	Community expenditures declared by the EC
				projects	Public expenditures		
			million LVL	number	million LVL	million LVL	million LVL
1.	Promotion of sustainable development	ERDF	189.19	219	137.32	4.48	4.48
2.	Promotion of business activity and innovations	ERDF	146.55	128	55.70		
3.	Development of human resources and promotion of employment	ESF	122.91	372	24.82	2.66	0.00
4.	Promotion of development of rural areas and fisheries	EAGGF and FIFG	119.58	1844	97.13	33.44	19.25
5.	Technical assistance	ERDF	15.89	49	2.54	0.00	0.00
Total			594.12	2612	317.51	40.58	23.73

The aggregated information allows concluding that the biggest activity of project applicants is observed in the framework of Priority 4 “Promotion of development of rural areas and fisheries”. 1844 projects in total have been approved for the Rural Assistance Service and the public expenditure of the approved projects make up 97.13 million LVL amounting to almost 73% of the planned public financing for this priority. Number of approved projects in the framework of Priority 2 “Promotion of business activity and innovations” at the Latvian Investment and Development Agency and the State Regional Development Agency is 128, but the public expenditure of these projects make 55.7 million LVL that amount to mere 40% of the planned public financing for this activity.

To ensure bigger activity of project applicants, the Latvian Investment and Development Agency in co-operation with the Ministry of Economics carries out a series of improvements in the framework of support programmes under its responsibility. Project application procedures are being simplified, supportable activities and expenditures are being expanded. It is foreseen, that the amendments will come into force from January 2006, depending on the programme.

As of July 22, 2005 – 40.58 million LVL have been paid to beneficiaries of the financing. This amount corresponds to 8.9% of the total accessible financing from the Structural Funds for 2004 – 2006.

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

Box 6.2

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

Being one of the branch ministries, the Ministry of Economics is responsible for the 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 the measures to support the small and medium-sized business activity;
- access to financing for small and medium-sized enterprises;

Box 6.2. continued

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

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

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

As on November 1 of this year almost all activities falling under the responsibility of the Ministry of Economics have been approved. On November 7 of this year the national programme of Activity 3.1.3 “Training and consultations for persons launching commercial activity and activity as a self-employed person” was submitted to the Steering Committee for examination.

On August 19 of this year the Management Committee of the ERDF co-ordinated the national programme “Loans (including microcredits) for launching commercial activity” developed by the Ministry of Economics and the national programme “Improvement of heat supply systems by lowering the content of sulphur in heating fuel”.

The goal of the national programme “Loans (including microcredits) for launching commercial activity” is to promote access of small and medium-sized commercial companies to financing. In the framework of this programme it is envisaged to create financial instrument co-financed by the public sector, which would allow small and medium-sized commercial companies to get loans including microcredits on preferential terms. Resources attracted for implementation of the programme amount to 20.99 million LVL. Beneficiary of the financing and implementer of the programme is the SJSC “Latvijas Hipotēku un zemes banka” (Mortgage and Land Bank of Latvia). In the framework of the programme the Mortgage and Land Bank of Latvia will provide opportunity for small and medium-sized commercial companies to get loans, including microcredits, in order to ensure launching of commercial activity.

The goal of the national programme “Improvement of heat supply systems by lowering the content of sulphur in heating fuel” is to ensure transfer of Latvian local governments from heating fuel with high sulphur content to other type of heating fuel. The envisaged financing of the national programme is 3.71 million LVL. Conclusion of contract with applicants for the project is currently under way.

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

On September 20, 2005 the CFCA announced the tender of open projects under the responsibility of the Ministry of Economics in the framework of the SPD Sub-Activity 1.1.4.2 “Modernisation of heat supply systems in accordance with environmental requirements and rise of energy efficiency both on the production and distribution side of the heat supply system and on the final consumer side”. The accessible public financing is 7.89 million LVL.

As of August 12, 2004 the Latvian Investment and Development Agency (hereinafter – LIDA) 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. Aid for Modernisation of the Business Infrastructure:
 - 1.1. Support to Investment in Private Infrastructure for Access to Public Networks;
 - 1.2. Support to Shared Private Infrastructure (Laboratories) Development;
 - 1.3. Support to Private Infrastructure Modernisation in Line with 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 of November 1, 2004 the LIDA accepts project applications from companies for co-financing from the EU Structural Funds in the state support programme (SSP) “Support for training, re-training and raising of qualification of employed”.

As of January 1, 2006 – 383 projects were submitted to the LIDA, of which the largest part (82 projects) make an infrastructure grant scheme “Support to Private Infrastructure Modernisation in Line with Standards” and (175 projects) a grant scheme “Consultation services”. The total required financing comprises 51.26 million LVL, while the total amount of contracts concluded for receiving support equals to 40.94 million LVL and the amount of paid projects comprises 14.85 million LVL (see Table 6.2).

As of November 1, 2005 – the most active businesses were in Riga and Riga district (197 projects submitted for 20.45 million LVL); as for the other regions: 36 projects for 8.27 million LVL were submitted from Zemgale, 40 projects for 7.43 million LVL were submitted from Vidzeme, 33 projects for 10.83 million LVL were submitted from Kurzeme and 13 projects for 1.65 million LVL were submitted from Latgale. As the activity of businesses from Latgale region is very low, the Ministry of Economics has conducted a public procurement resulting in choice of the consulting firm, which will consult Latgale businesses on opportunity to receive co-financing from the Structural Funds, including preparation of the project.

To level out differences between EU member states, Latvia, after accession to the EU, has access to resources from the **Cohesion Fund**, which replaces the ISPA funds that were available for Latvia before the EU accession. 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, if financing is received from the Structural Funds as well. The total project costs have to reach at least 7 million LVL (10 million EUR).

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

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

The total financing from the Cohesion Fund accessible to Latvia in the period of 2000–2006 amounts to 710 million EUR, of which 310 million EUR comprise the financing for projects 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 comprise the financing for the Cohesion Fund project applications to be submitted in 2005 and 2006.

Table 6.2

**Projects Submitted to the LIDA for Receiving the Structural Funds Financing
by Types of Grant Schemes as of January 1, 2006**
(million LVL)

Grant scheme	Amount planned in SSP 2004-2006	Accepted project applications		Concluded contracts		Paid contracts	
		Number	Amount of support planned by applicant	Number	Amount of support	Number	Amount of support
Support to Investment in Private Infrastructure for Access to Public Networks	5.00	23	4.20	14	1.84	3	0.17
Support to Private Infrastructure Modernisation in Line with Standards	37.69	82	40.15	72	34.98	32	14.13
Support to Shared Private Infrastructure (Laboratories) Development	5.00	7	2.16	5	1.69	1	0.06
Support to development of new products and technologies	10.27	29	2.45	14	1.16	0	0
Consultation services	9.23	175	1.55	103	0.90	48	0.42
Participation of commercial companies in international exhibitions, fairs and trade missions	3.08	28	0.18	15	0.10	10	0.05
Support for training, re-training and raising of qualification of employed	10.05	39	0.57	21	0.27	4	0.02
Total	80.32	383	51.26	244	40.94	98	14.85

As of November 1, 2005 – 35 Cohesion Fund projects for Latvia were approved with the total financing of 930.5 million EUR (including the Cohesion Fund financing of 530.6 million EUR), of which 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).

The European Commission has granted 0.7 million EUR for the project “Technical Assistance to Implementation of the 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.

As of October 20, 2005 – 132 million EUR or 25% of the Cohesion Fund financing for 2000-2006 approved for Latvia were received in repayments from the European Commission, while 91 million EUR or 17% of the financing were paid to contractors in the framework of the concluded contracts.

6.2.2. Foreign Trade Policy

EU foreign trade policy issues are discussed and co-ordinated within the weekly meetings of the Article 133 Committee of the EU Council. The European Commission after consulting with the Article 133 Committee submits proposals to the Council on implementation of the common trade policy (see Box 6.3).

EU supports the promotion and strengthening of the multilateral trading system as only multilateral trading rules enable promotion of economic development and prosperity of the whole world. Parallel to this, the EU establishes and constantly maintains a network of bilateral relations in the framework of various preferential, regional and free trade agreements.

Box 6.3

Trade and competitiveness

European Union is among the biggest and most open economies in the world and the largest exporter of goods and services, as well as the largest investor abroad.

One of the most crucial EU trade policy tasks is improvement of external competitiveness, by achieving for EU exporters and importers a freer access to the third countries’ markets, since there still exist considerable market access limitations, concerning also EU goods, services and foreign direct investment. It is particularly important to acquire access to markets of emerging economies (China, India, Brazil) as currently EU exports are geographically oriented to markets with a stable yet not dynamic demand.

Strategically directed trade policy can positively affect competitiveness, ensuring that domestic market is sufficiently open to healthy competition with the rest of the world and that technological progress is promoted. At the same time it is important for producers to have sufficient access to markets of third countries as well as to ensure the prevention of distorting the existing trade by unfair competition.

At present, the EU has planned to take several measures for improvement of its external competitiveness:

1. To reduce some of the remaining EU market limitations for agricultural products, industrial raw materials, commodities and processed goods and services. EU trade policy has to ensure that on the EU borders tariffs and non-tariff barriers (e.g., rules of origin, pre-shipment inspection, import licensing procedures, investment measures and rules for determination of customs value for goods) for raw materials, commodities, components and services in the process of value-added formation do not unnecessarily raise the costs for EU industry, otherwise European producers will be in less favourable conditions than their competitors.

2. To encourage trade partners to open their markets, using as a leverage the EU ability to reduce its market protection. This can be achieved in the framework of multilateral trade negotiations, by successfully concluding the WTO Doha Development Round and promoting bilateral or regional initiatives, e.g., regional free trade agreements between the EU and *Mercosur* (Argentina, Brazil, Paraguay, Uruguay) and the Arab countries of Persian Gulf, etc.

3. To safeguard EU entrepreneurs against unfair competition, using trade defence instruments. In addition, it is necessary to achieve adoption of more stringent WTO rules, not allowing countries to use trade defence instruments unfairly.

4. To promote protection of intellectual property rights and the distribution of EU norms and international standards in the world, improving the observance of intellectual property rights protection on bilateral and multilateral level (particularly in the EU neighbouring countries and China with regard to EU high quality goods). It is planned to introduce the strategy for implementation of intellectual property rights protection, adopted by the European Commission in November 2004.

5. To anticipate and manage the transitional effects of market opening, by facilitating and accelerating market liberalisation. In the framework of Financial Perspective 2007-2013 it is planned to take into account the possible influence of trade opening, envisaging a place for it in the structural funds and creating a reserve fund for unforeseen economic shocks.

6. To contribute to the long-term creation/development of export markets for EU exports, by encouraging the integration of larger regional markets and supporting development strategies in emerging economies, thus expanding and strengthening the institutional framework.

For Latvia as a small and open economy with limited resources, rapid growth of national economy greatly depends on the ability to create and sell competitive goods and services in the world market. As about 20% of Latvian foreign trade takes place outside the EU internal trade framework with third countries, for promotion of Latvia’s competitiveness it is important to form a policy encouraging the entry of businesses into emerging markets.

Multilateral relations

EU as the largest trade block in the world had a remarkable role in starting the current round of the World Trade Organisation (WTO) multilateral trade negotiations in 2001 in Doha (the so called Doha Development Agenda – DDA), in order to decrease global poverty and achieve further liberalisation of multilateral trade. The main task of the round is to achieve deeper opening of markets of goods and services in WTO member countries, to improve rules of multilateral trade and to promote the access of developing countries to markets of developed countries.

The most important aim of the DDA is to improve integration of developing countries into the international trade system, by inter alia using trade-related assistance, which is the reason why this round is called the development round. It is necessary to achieve a more precise definition of multilateral trade system rules, thus helping the developing countries to strengthen their capacity to protect their rights. Additionally, the round envisages flexible rules for the least developed countries, i.e. they are not required to undertake new commitments.

Successful conclusion of the round requires a balanced contribution of all negotiating partners and a balance between all areas of negotiations (agriculture, industrial goods (NAMA), services, trade facilitation, rules, development issues).

It is envisaged to conclude the round of Doha multilateral trade negotiations by 2007. After the failure of the previous WTO Ministerial Conference in Cancun in 2003, the agreement in all areas of negotiations has been reached at the WTO 6th Ministerial Conference that took place in Hong Kong on December 13-18, 2005, so it could be possible to agree on the conclusion of the whole round by the set date. It is of great importance for the EU to achieve a favourable outcome of the round and its conclusion.

Even a month before the start of the conference, it was still impossible to reach agreement among the developed and developing countries in the most important areas of negotiations, i.e., market access of agricultural and non-agricultural goods and services. A satisfactory outcome was neither achieved on the issues of trade facilitation, rules and development. In general, negotiations continue in a very complicated manner.

According to calculations of the World Bank, the total gain from liberalisation of multilateral trade in 2015 will amount to 290-520 billion US dollars (benefits from increase in profit of companies and purchasing power of consumers), 70% of which will go to the developing countries. It is expected that, with conclusion of the round, the economic benefit will reach 1% of the total GDP in the world. Two thirds of the benefit will be received by consumers and businesses in the agricultural sector, the largest beneficiaries of which will be the developing countries and consumers of the developed countries. Benefits of Latvia from liberalisation of the multilateral trade system will be a freer market access of goods and services to the third (non-European Union) countries, which in turn will encourage economic growth of the country. Therefore Latvia fully supports reaching the aims of the round by 2007.

Bilateral relations: economic dialogue with Russia, Ukraine, US

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

Several issues are still left unsolved for Russia, e.g., the ones concerning sanitary and phytosanitary measures, technical barriers to trade, rail tariffs, agriculture, etc.

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, offers new opportunities for economic integration and convergence, and encourages market accessibility and development of infrastructure, which is also significant. The 16th EU-Russia Summit took place in London on October 4, 2005. It focused on the practical implementation of the road maps of the Four Common European Economic Spaces (CEES: freedom, security and justice, external security, education, science and culture), which were agreed on by the 15th EU-Russia Summit that took place in Moscow on May 10, 2005. The next EU-Russia Summit in the 1st half of 2006 will take place in Russia, while in the 2nd half of 2006 it will take place in Finland.

Economic co-operation of the EU and Russia is regulated by the concluded Partnership and Co-operation Agreement. This agreement will expire in 2007.

Regarding the energy dialogue between the EU and Russia, further development of this dialogue and faster ratification of the Energy Charter by Russia is of significant interest to Latvia.

Entry of **Ukraine** in the WTO is also substantial for Latvia. With Ukraine's entry, further mutual trade relations with this country will be based on the legal base of the WTO.

With Ukraine's entry in the WTO, the EU would take the next steps in extension of EU-Ukraine economic relations.

EU-Ukraine Summit took place in Kiev on December 1, 2005, which was the first meeting of such level after the "orange revolution" in Ukraine. The EU-Ukraine Action Plan was signed on February 21, 2005. The Action Plan was developed, taking into account the possible conclusion of FTA, and it prescribes action rules and trade spheres, which would encourage harmonisation of Ukrainian legislation in compliance with the EU requirements.

It will be necessary to build special integration relations with Ukraine after its entry to the WTO. Decision to conclude FTA or association agreement with Ukraine would be a positive signal for progress of its reforms.

Co-operation between the EU and **US** takes place within the framework of the Transatlantic Dialogue, New Transatlantic Agenda, Transatlantic Partnership and other documents, which determine implementation of priorities for further expansion of co-operation. Latvia supports these initiatives, because each of them helps improving economic co-operation and integration between US and the EU, which form the biggest share of international trade in the world. The close co-operation of Latvia with US, which has taken place up to now, is a good contribution to the co-operation dialogue between the EU and US, and Latvia is ready to active participation in this dialogue, representing its interests.

EC has started consultations with member states on strengthening the EU-US Economic Partnership – Stakeholder Dialog, in order 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 on the way to competitive economy.

EU-US Work Programme for Enhancement of Transatlantic Economic Integration and Growth was worked out on the basis of proposals of entrepreneurs and social partners on further strengthening transatlantic dialogue.

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

Bilateral economic co-operation agreements of Latvia

In order to continue and activate bilateral economic co-operation after accession to the EU, Latvia has concluded bilateral economic co-operation agreements with **Belarus, Ukraine, Kazakhstan, Azerbaijan** and **Georgia**. In 2005 the Ministry of Economics held negotiations on conclusion of bilateral economic co-operation agreement with **Uzbekistan**. Work has started to conclude economic co-operation agreements with **Russia** and **Armenia**.

The mentioned agreements are important umbrella agreements regulating bilateral economic co-operation and comprising co-operation in industry, tourism, transport, pharmaceuticals, agriculture, financial services, communications, professional training, investment policy, area of technologies and innovation and other spheres, which promote further development of economic co-operation.

Economic co-operation agreements concluded between Latvia and third countries envisage establishment of Intergovernmental Commission and Joint Committee, which in turn ensure supervision of validity of these agreements, analyse opportunities and improve further co-operation.

The 2nd meeting of the **Latvia-China** Joint Committee was held in Riga on August 23-25, 2005, and the protocol on priority issues and further action of both parties was signed during this meeting.

The 1st meeting of the **Latvia-Belarus** Intergovernmental Committee took place on November 10-11, 2005. The protocol on priority issues and further action of both parties was signed during this meeting.

It is planned to hold the 1st meeting of the **Latvia-Ukraine** Intergovernmental Commission in Riga during the 1st half of 2006.

Steel

Taking into account the changes in the steel sector, growing globalisation trends in steel markets and changes in these markets, it is necessary to forecast clear directions of the further development, at the same time envisaging an adequate legal base. Analysis of the mentioned issues and adoption of respective decisions take place in the working groups of the Article 133 Committee/Steel of the EU Council of Ministers.

At present, Latvia as EU member state applies provisions of double control system with quantitative restrictions to several steel product import from Russia, Kazakhstan and Ukraine. Adequate agreements on steel trade are concluded with these countries. The quantitative restrictions (quotas) define a fixed amount of steel product import from these countries into the EU.

In 2005 import quota amount from the respective countries has not affected traditional import flows. Double control system without quantitative restrictions is applied to particular steel products from Moldova, Macedonia and Romania, and prior surveillance system is applied to imports of several steel products from all third countries.

Textile

Textile sector takes an essential place in international trade. During the last years the role of several third countries (such as China, India and Pakistan) in textile trade has grown particularly. Textile trade issues in the European Union are examined by the Article 133 Committee/Textile of the EU Council of Ministers.

Taking into consideration the sensitivity of the textile sector characterised by the high number of employees, until January 1, 2005 the trade of textiles and clothing between World Trade Organisation (WTO) member countries was regulated by the Agreement of Textiles and Clothing, which foresaw gradual abolishment of quotas between WTO member countries.

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

China's commitments to WTO determine that, until 2008, WTO member countries are authorised to introduce market protection measures against China in case if there are well-grounded proofs that import of Chinese textiles may pose a threat to traditional trade flow and its development. In order to ensure the supervision of import growth and timely detection of threat, as of January 1, 2005 the EU applies automatic licensing against imports of Chinese origin textiles and footwear into the EU and customs supervision is applied additionally.

Taking into account the rapid increase of Chinese imports, on June 10, 2005 the EU and China concluded agreement on textile trade with China until 2008. It prescribes import restrictions for 10 categories of goods of Chinese origin (gradual annual import growth in the amount of 8 – 12.5% is taken into account in calculation of quotas).

Trade defence instruments

Trade defence instruments (anti-dumping, anti-subsidy, and safeguard measures, hereinafter TDI) in the European Community are administered by the European Community institutions in accordance with the unified principles, as TDI are a constituent part of the common trade policy of the European Community. Latvia as an EU member state, representing economic interests of Latvia in TDI sphere in the Anti-dumping and Anti-subsidy Committee of the European Commission and the Safeguard Committee of the European Commission, has decision-making and advisory rights in trade defence investigations and draft decisions taken by the Commission.

The aim of the anti-dumping and anti-subsidy measures is protection of local producers of the European Union against unfair competition by third countries companies. Determinant for application of the safeguard measures is such an import growth, which causes injury to Community industry, but does not constitute an unfair competition.

As of September 30, 2005, 133 anti-dumping and 14 anti-subsidy measures as well as one safeguard measure (against imports of preserved mandarins) against imports of various goods are in force in the European Community. As of September 30, 2005 there are 95 active cases in the Commission, and the Ministry of Economics in co-operation with other public institutions, companies and their associations performs analysis and examination of these cases, prepares national positions and actively defends economic interests of Latvia.

The trade defence investigations most essential for Latvia, where the Ministry of Economics has actively protected interests of Latvia, are as follows:

- anti-dumping proceeding concerning imports of potassium chloride originating in Belarus and Russia (see Box 6.4);

- anti-dumping proceeding concerning imports of ammonium nitrate originating in Russia and Ukraine;
- anti-dumping proceeding concerning imports of certain iron or non-alloy steel seamless pipes and tubes originating in Croatia, Romania, Russia and Ukraine;
- anti-dumping proceeding concerning imports of farmed salmon from Norway.

Box 6.4**Anti-dumping proceeding concerning imports of potassium chloride originating in Belarus and Russia**

Since 1992, anti-dumping duty is in force in the European Community concerning imports of potassium chloride from Belarus and Russia, which are the most important sources for import of this commodity in Latvia. Ministry of Economics has actively stood up for abolition and review of anti-dumping duty, on the basis of the enlarged EU market. As a result, until April 13, 2006 when the anti-dumping review procedure will be completed, so called "Special Enlargement Undertakings" will be in force, which have an aim to facilitate adaptation of the EU-10 member states to the potassium chloride price level and to set transitional preferences for import of this commodity from Russia and Belarus.

So that interests of the Community, including Latvia, would be protected as effectively as possible in proceeding carried out by the Commission, it is essential for the interested parties (producers, importers, exporters, consumers) to make themselves known to the Commission and the Ministry of Economics. Only through co-operation and active participation in proceedings carried out by the Commission, it is possible to achieve more effective protection of their interests.

6.2.3. EU Internal Market

On May 1, 2004 Latvia became a participant in one of the biggest internal markets of the world, which includes 28 countries (EU member states plus European Economic Area countries Norway, Iceland and Liechtenstein) with more than 450 million consumers. The EU policy is aimed at development of the single internal market, where free movement of production factors is ensured (the 4 freedoms that apply to goods, services, persons and capital) in order to promote sustainable and stable development of EU economy and prosperity of EU population.

Implementation of the principles of the free movement of goods and services and the right of establishment, which are set up in Articles 28-30 and Articles 43-55 of the Treaty establishing the European Community in Latvia is supervised and co-ordinated by the Ministry of Economics, constantly identifying the norms that may potentially hinder implementation of EU internal market freedoms, inter alia assessing normative acts still in the development stage.

Restrictions on EU internal market freedoms were greatly prevented before Latvia's accession to the EU, but the practice indicates that obstacles to cross-border transactions still exist. The Latvian business survey "Technical barriers to trade in the EU internal market" conducted by the Ministry of Economics in 2005 led to conclusion that incomplete functioning of the principle of mutual recognition is the most frequent obstacle to free movement of goods and it manifests in many different ways in the range from requirements for repeated registration of goods to disapproval of tests for goods.

An opportunity to preventively avert obstacles to free movement of goods and free movement of information society services is provided by the procedure of notifying draft technical regulations prescribed in Directive 98/34/EC. The procedure of how the exchange with information on draft technical regulations in the European Union takes place has been introduced in order to provide an opportunity for the European Commission and EU member states to preventively assess whether draft technical regulations proposed by an EU member state include requirements, which have the potential to create barriers to free movement of goods and information services in the EU internal market, and in order to cancel the illegitimate restrictions. Directive 98/34/EC is introduced in Latvia by the Cabinet of Ministers Instruction No. 1 "Procedure How the State Administration Institutions Provide Information on Draft Technical Regulations" adopted on March 30, 2004. In 2005 the Ministry of Economics as the institution responsible for exchange of information related to draft technical regulations has sent 524 draft technical regulations developed by other EU member states to authorities and non-governmental organisations of Latvia for assessment. Most of the received draft technical regulations were developed by Germany, France, the United Kingdom and Austria. Draft technical regulations were most often developed in relation to communication technologies, transport sector, food and technical products. 11 texts of draft technical regulations of Latvia were notified to the European Commission in 2005. In one case the European Commission has concluded that the draft technical regulations have the potential to create barriers to the free movement of goods.

Effective functioning of the EU internal market also depends on timely and qualitative introduction of internal market directives. The performed measures, among them regular provision of the most current information on transposition of EU directives at the Meetings of Senior Officials and the Cabinet of Ministers, have allowed to substantially improve Latvian statistics of transposition of internal market directives: in September 2005 Latvia had 29 or 1.8% non-transposed internal market directives (70 or 4.6% in 2004).

In the area of cross-border service provision, essential obstacles are created by the existing business licensing requirements and cumbersome administrative procedures, which require additional financial and time resources from entrepreneurs and most adversely affect small and medium-sized enterprises (42.5% of SME operate in the sphere of services). From the aspect of free movement of services and business law, Latvia positively evaluates the European Commission's initiative on draft directive related to services in the internal market, which appeared in January 2004. The draft directive on services is aimed at creation of the legal regulation required to remove the existing restrictions to movement of cross-border services in the EU internal market. The draft directive sets measures for simplification of administrative procedures, creation of single contact points, where provider of services could go through all formalities required for service provision, implementation of the country of origin principle according to which the service provider would be subject to the laws of the member state in which he is established, principles that are to be observed by EU member states in creation of permit issuance systems, etc.

According to results of the business survey "Technical barriers to trade in the EU internal market" conducted by the Ministry of Economics at the beginning of 2005, most of entrepreneurs (63%) have not faced the technical barriers to trade not a single time since Latvia's entry in the European Union. However, the number of entrepreneurs (32%), which have faced the problems and for the most part repeatedly, is also noteworthy.

To prevent the usual practice that entrepreneurs, facing the EU internal trade barriers, do not fight them and accept the unfair rules of foreign or domestic authorities and even frequently back down from their business goals, Latvian SOLVIT Centre was established at the Ministry of Economics on May 1, 2004 by recommendation of the European Commission. At present, such centres already operate in 27 EU and EFTA member countries and mutually co-operate, reviewing complaints of inhabitants and entrepreneurs on illegitimate EU internal trade barriers.

According to data of the survey, entrepreneurs are still little informed on opportunities provided by the SOLVIT network, so the Ministry of Economics has developed and is actively implementing a campaign for popularisation of the SOLVIT Centre. Publicity of SOLVIT has been fostered by turning of inhabitants and entrepreneurs to the centre. Since May 1, 2004 the SOLVIT Centre initiated 4 cases, while 10 cases were initiated by November 2005. SOLVIT centres of other member states initiated 3 cases against Latvian authorities in 2004 and already 11 cases in 2005.

6.3. Sector-Specific Development Policies

6.3.1. Industrial Development Policy

One of the main goals of the national economy development in Latvia is to create an efficient and competitive industry, which would ensure high and stable growth. Industrial policy in Latvia is being shaped in accordance with the policy development directions of the European Union, at the same time identifying and solving issues that are urgent for local industrial enterprises in co-operation with organisations, 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 as follows:

- Single Strategy of National Economy (approved by the Cabinet of Ministers on August 17, 2004);
- National Lisbon Programme of Latvia for 2005-2008 (approved by the Cabinet of Ministers on October 19, 2005);
- Long-term Economic Strategy of Latvia (accepted by the Cabinet of Ministers on July 17, 2001);

- Industrial Development Guidelines of Latvia for 2004-2013 (accepted by the Cabinet of Ministers on February 24, 2004);
- National Innovation Programme for 2003-2006 (accepted by the Cabinet of Ministers on April 1, 2003).

In 2005, the National Lisbon Programme of Latvia for 2005-2008 was developed (see Section 6.1), which defines the measures to create preconditions for development of knowledge-based economy in Latvia. The most essential priorities in the field of industry are orientation to high value-added production and increase of the share of high technologies in the export structure as well as rise of productivity level. The goals and tasks defined in the National Lisbon Programme of Latvia will be taken into account, by working out support programmes of EU Structural Funds in the period of 2007–2013.

In 2005 the European Commission published the new communication on industrial policy, where the assessment of competitiveness of individual industrial sectors and the appropriate proposals for further action at the level of the EU and its member states are acknowledged as important (see Box 6.5).

Box 6.5

Communication from the European Commission “Implementing the Community Lisbon Programme: A policy framework to strengthen EU manufacturing – towards a more integrated approach for industrial policy”

The new communication from the European Commission (EC) on industrial policy is developed in order to contribute to the achievement of the Community Lisbon Strategy goals, promoting establishment of a stable industrial base. The EC communication was approved on October 5, 2005. The point of the new EC communication is to develop further formation of sector-specific industrial policy and determine the main measures for improvement of legal acts regulating the industrial sector and for ensuring the synergy between different sectors.

The communication is based on the screening of 27 industrial sectors, which is aggregated in 27 sectoral summaries. The screening of sectors is aimed at assessment of the general competitiveness level of individual EU industrial sectors and the main features and challenges of sectors. Both quantitative and qualitative indicators are used for the screening of sectors. Unfortunately, data on the new 10 EU member states have not been included in the screening, and the European Commission has promised to expand it in the nearest future.

On the basis of the undertaken screening of sectors, the EC plans to develop seven cross-sectoral initiatives that are oriented to addressing the common challenges of several sectors as well as initiatives for specific industrial sectors.

Cross-sectoral initiatives:

- development of strategy in the intellectual property area, and the fight against counterfeiting (2006) – draft directive on patenting the computer-implemented inventions has proved that it is difficult to unite interests of all enterprises in a single draft of a legal act. The Commission points out that the protection of intellectual property is a very essential issue, which would promote attraction of investment and development of new business models. For this purpose the Commission plans to perform consultations with social partners and other interested parties in 2006 in order to reach agreement on the Community intellectual property protection framework. The Commission will also analyse the current situation with a focus on competitiveness issues and come up with suggestions on how to improve the situation in 2006;
- establishment of a high level group on energy, environment, and competitiveness (end of 2005). The high level group is planned as an advisory platform bringing together Members of the Commission’s Directorates General of the Enterprise and Industry, Competition, Energy, and Environment, as well as relevant stakeholders of member states. The group’s aim is to examine the links between industrial, environmental and energy legislation in order to ensure their mutual coherence and reaching goals of competitiveness and sustainable development;
- access to markets (measures in international trade) (beginning of 2006). The Commission plans to work out a Communication on the revision of Market Access Strategy and corresponding policy instruments in order to focus on those sectors and markets of those countries with the greatest potential for strengthening the international competitiveness;
- legislative simplification (2005). EC will continue the started development of the Better Regulation Initiative. It is planned to publish a Communication containing a regulation’s simplification work programme. The three identified current priorities are simplification of legislation in the automotive production, construction sector and waste management;
- improving sectoral skills (2006). Shortage of knowledge and skills is identified as a key challenge in a wide range of different industries. To supplement the already existing programmes in this field, EC plans to conduct analysis on problems related to shortage of knowledge and skills in specific sectors, namely, to identify requirements to employees in this sector and establish which knowledge and skills are lacking;
- managing structural change in manufacturing (end of 2005). EC has identified the following industries, for which potential structural adjustment is an issue: the textiles, leather, furniture, footwear and ceramics industries, printing, building of motor vehicles, shipbuilding, steel industry and segments of the food industries. EC plans to ensure close connection of Structural Funds programmes with solution of structural change and restructuring issues and modernisation of labour market in this regard;
- integrated European approach to industrial research and innovation (2005). In addition to the already adopted EC Communications and initiatives, it is planned to establish a European Industrial Research and Innovation Monitoring System in 2006 in order to provide a consolidated overview and analysis of the situation and development trends in this area.

Box 6.5. continued

Sector-specific initiatives:

- creation of pharmaceuticals forum (first meeting in 2006). The forum will consist of representatives of the member states at ministerial level, senior representatives of industry and other key stakeholders. Work will focus on research and development issues and regulatory matters at member state level;
- mid-term review of life sciences and biotechnology strategy (2006-2007). Closer co-operation with industry through the Competitiveness in Biotechnology Advisory Group and a triangular dialogue with industry and member states is planned;
- setting up 2 new high-level groups on the chemical industry (mostly related to adoption of REACH) and the defence industry;
- taskforce on ICT competitiveness. The aim of the taskforce is to identify problems for development of ICT competitiveness and possible policy responses (for example, in terms of better regulation, skills, intellectual property, and standardisation);
- mechanical engineering policy dialogue. The dialogue will analyse the strengths and weaknesses of the sector and possibilities of development and solving the sector's problems in the longer term;
- conducting studies on competitiveness of industries. Studies for the ICT, food, and fashion and design industries are planned.

Analysis of competitiveness and development trends of individual industries is also continued in Latvia. In December 2004 a study on the textile and clothing production sector was completed.

A study on development of the machine building and metalworking sector was conducted in 2005. This sector has an important place in the manufacturing structure, besides the machine building and metalworking is closely related to productivity increase in other sectors, because it operates as supplier of equipment and technologies. With the rapid development of the sector in the last years, it has developed efficient networks of co-operation with Latvian and foreign partners, which include markets of raw material supplies and sales, especially in export. Several projects for improvement of educational system and curricula are being implemented and new professional training centres are being established. The current problems include the productivity level, which lags behind the respective indicators of EU countries, insufficient modernisation of enterprises and introduction of new technologies, lack of new specialists and low share of innovative enterprises. The following key groups of activities to ensure development of the sector are identified:

- ensuring the required labour force of adequate skills to the sector, which is to be considered the most substantial factor determining development of the sector in the following 10 years;
- continuing modernisation of equipment, technologies and production infrastructure;
- keeping and expanding the sales markets;
- providing the financing and improvement of the respective legislative conditions.

In 2005, studies on development of the chemistry and pharmacy sector (the study will be completed by the end of 2005) and of the information and communication technologies sector were started.

As the supply of skilled specialists is one of the main priorities for all industries and a shortage of the required specialists in the future may hinder development of these industries, several studies on development of human resources in industries, among them the electronics and electrotechnical sector and machine building and metalworking sector, were conducted in the framework of the activity "Support to conducting labour market studies" financed by the European Social Fund in 2005. Both these industrial sectors are characterised by rapid growth, hence the demand for highly skilled specialists is growing while the pace of their training lags behind the development rates of the sector. The studies include recommendations for public administration institutions, educational establishments, enterprises of the sector and organisations representing entrepreneurs on the activities to be done for improvement of situation. Concerning the educational sector, the key recommendations are related to increasing the number of student places in engineering and technology studies, improvement of the material and technical base for teaching, raising skills of teachers, and development of motivation system to involve new teachers. An equally important aspect is to ensure that general education establishments prepare pupils, which can continue studying in engineering and technology studies, mostly ensuring teaching of hard science subjects at secondary schools. An important aspect is provision of information to youth about opportunities opened by studies and work in engineering and technology sectors, and popularisation of these sectors in the society.

Latvia participates in various EU and international projects in the areas of industrial policy, innovation and research development. In September 2005, Latvia organised informative seminars on

opportunities of enterprises and research institutions to take part and submit project applications for funding from the research programme of the European Research Fund for Coal and Steel. The mentioned programme finances pilot projects and demonstration projects of applied research, related to introduction of innovative solutions in coal or steel production sectors. The term for application of the projects is September 15 of each year, a more detailed description of the programme is available on the website www.cordis.lu/coal-steel-rtd. Although Latvia is not a member state of the European Space Agency (ESA), co-operation takes place in several areas. In 2005 the European Commission approved provision of funding from the 6th EU Framework Programme for the SURE project jointly organised by the ESA and EU, where access to the International Space Station (ISS) for research implementation is offered to research institutions and small and medium-sized enterprises. It is expected that priority will be given to representatives of the 10 new EU member states. The term for submitting the application is April 15, 2006. More detailed information on the SURE project is available on the website www.spaceflight.esa.int/sure. In February 2006 an informative seminar will be held at the Ministry of Economics, where potential interested persons will be acquainted with the opportunities offered by this project.

6.3.2. Energy Policy

The main directions of energy policy are promotion of competition, raising level of energetic independence, increasing security of energy supply, encouragement to use renewable and local energy resources, and environmental protection.

Ministry of Economics in co-operation with representatives of energy companies, scientists, economists and representatives of associations has started to work out guidelines for development of energy sector in Latvia, which will include governmental policy, development targets and priorities in energy sector both in medium term and long term.

The dominant role in electricity supply is played by JSC “Latvenergo”, which generates more than 90% of all electricity generated in Latvia and ensures import of electricity, its distribution and supply to consumers. As from September 1, 2005, all functions of electricity transmission system operator are performed by SJSC “Augstsprieguma tīkls” fully owned by JSC “Latvenergo”. In addition there are more than 100 small power plants and 15 licensed distribution and sales companies. Natural gas is only supplied by JSC “Latvijas Gāze” but about 70 companies are competing in the supply of liquefied gas.

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

The most important precondition for creation of market relations in electricity supply sector is the changes in the sector’s structure, hence separating elements of a natural monopoly (transmission and distribution services) from competing elements (generation and trade). Creation of the sector’s organisational structure correspondent to market conditions is taking place in accordance with requirements of the new wording of Section 201 of the Energy Law and requirements of the Electricity Market Law.

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

At present, JSC “Latvijas Gāze” is the only merchant in the **natural gas market** of Latvia. In compliance with licences issued by the *Public Utilities Commission*, “Latvijas Gāze” carries out transmission, distribution, storage and sales of natural gas.

Amendments to the Energy Law made on May 26, 2005 envisage main conditions for opening the natural gas market and were developed, taking into account Directive 2003/55/EC of the European Parliament and of the Council concerning common rules for the internal market in natural gas. The law includes issues concerning operation of systems, duties and rights of market participators, and competition opportunities in the natural gas market.

By choosing regulated procedure of access, member states carry out the necessary measures to confer rights of accessing the system to natural gas companies and qualified users inside or outside the area which contains an interconnected system, on the basis of published tariffs and other conditions and obligations which are to be complied with when the system is used.

Box 6.6

Harmonisation of laws and regulations with EU directives

The key fields in harmonisation of legal acts with EU legislation are oil and oil product reserves, security of supply, energy efficiency, and continued introduction of market principles in the energy sector:

- **security of supply and creation of oil product reserves.** 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 normative acts 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 it adopted Regulation No. 106 “On the Procedure of Energy Supply and Fuel Sale to Users During an Energy Crisis”, and on November 8, 2005 the Cabinet of Ministers Regulation No. 853 “Procedure for the Establishment and Storage of Petroleum Product Reserves” was adopted. On May 28, 2002 the Cabinet of Ministers adopted Regulation No. 218 “Regulations 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 May 5, 2005 the Saeima passed the Electricity Market Law (in force as of June 8, 2005) with the aim to create preconditions for operation of efficiently functioning electricity market, so that electricity would be supplied to all electricity users safely, qualitatively and for justified prices, ensure all electricity users’ rights to choose electricity merchant freely, and promote electricity generation by use of renewable energy resources. On March 17, 2005 the Saeima passed the law “Amendments to the Energy Law” (in force as of April 15, 2005), by which the previous electricity sector regulation was excluded from the law and Section 20¹ of the Energy Law was expressed in a new wording according to the market requirements;
- **gas sector.** On May 26, 2005 the Saeima passed the law “Amendments to the Energy Law” (in force as of June 29, 2005), which determines principles of natural gas market operation. The aim of the law is to create conditions for competition in the natural gas market of Latvia and harmonise regulatory normative acts with requirements of EU legislation. Transitional provisions of the law prescribe that time and procedure for coming into force of legal norms, which regulate principles of natural gas market operation, are determined by a special law.

Investment in energy sector

The energy sector typically absorbs large investment. Energy companies such as JSC “Latvenergo” and JSC “Latvijas Gāze” contribute voluminous own resources to implementation of projects and are able to attract considerable credit funds. Riga CHP-1 was opened on November 10, 2005. Reconstruction of Riga CHP-1 lasted a little bit longer than two years. Investment in amount of 77 million LVL were made. In September 2005 JSC “Latvijas Gāze” completed construction of gas pipe to Rēzekne.

State support in the energy sector is only given to projects that are linked to adjustment of the heat supply 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 Sigle Programming Document. These priorities are sub-divided into measures, which in turn are sub-divided into activities. Priority 1 (Promotion of territorial cohesion) includes Measure 1 (Improvement of environment and infrastructure and promotion of tourism). This measure includes several activities, which are in competence of the Ministry of Economics. One of these activities is aimed at provision of support for public sector institutions in modernisation of heat supply systems according to environmental requirements and improvement of energy efficiency of heat supply systems both in production and distribution and for the end consumers. In the framework of the EU Structural Funds for 2004-2006, 14.96 million LVL will be channelled for the mentioned projects.

Open tender has been announced for financing from the EU Structural Funds – European Regional Development Fund (ERDF). The projects have to envisage modernisation of heat supply

systems according to environmental requirements and improvement of energy efficiency of heat supply systems both in production and distribution and for end consumers. The project was started on March 1, 2005 and its total costs are 7 million LVL.

Supporting reconstruction of district heating systems, construction of heat sub-distribution units and other heat regulation equipment and reduction of heat losses in buildings, 60 projects were submitted to the State Investment Programme of 2005. Support was given to 8 of these projects in the total amount of 778 946.73 LVL, including state subsidies of 298 000 LVL.

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, esthetic and modern buildings.

Implementation of the construction policy in the country is determined by the *National Programme on Construction*. This integrated target programme for development of the construction sector for 2002-2012 was accepted by the Cabinet of Ministers on August 30, 2002. The main goal of this 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. All ministries are involved in its implementation.

The Building Council of Latvia and non-governmental organisations play an increasingly bigger role in improvement and implementation of the construction policy.

Box 6.7

Improvement of normative acts

By improving the normative base of construction in 2005, administrative procedures in the process of preparation for construction were reduced, procedure for carrying out small rebuilding was simplified, procedure of building demolition and compulsory insurance of civil liability in construction were determined. Licensing of legal persons for business activity in construction was replaced with registration of construction businesses, the time required for the procedure and the number of documents to be submitted were reduced, while the public accessibility of construction businesses register has provided opportunity for wide public to control legality of operation of companies. Similar role is played by ensuring accessibility of register of certified architects and construction practice specialists.

To reduce arbitrary construction and violations of requirements of normative acts, amendments to the Code of Administrative Violations of Latvia prescribe higher penalties both on construction participants and officials.

Latvia as an EU member state takes part in creation of the EU single normative base. At the same time the transposition of the 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 the Eurocode (EN 1990 family) standards in design of building structures.

Measures have also been taken to improve systems for conformity assessment of construction products, construction supervision, market surveillance and control, and to ensure environmental accessibility. Economy of energy resources has a special place in the aspect of sustainable environment, therefore it is important to increase energy efficiency of buildings, that has to be taken into account both in designing and construction. Issues of building management, including maintenance and audit and certification of buildings, have become pressing both from the aspect of energy economy and the aspect of extending using time and improving buildings.

With growing amounts of construction, the deficit of specialists and skilled contractors of all levels increases. With expansion of construction market, some construction specialists go to other EU member states, where payment for work is considerably higher because wages of employees in the construction sector of Latvia still are the lowest in the European Union.

Construction specialists in Latvia are trained by Riga Building College and two higher educational establishments – Latvia University of Agriculture and Riga Technical University. It is positive that the number of students in construction speciality has considerably increased at both higher educational establishments in 2005. This year, 276 students have started their studies at Latvia University of Agriculture and 410 – at Riga Technical University. Taking into account that the majority of them study for fee and have to work during studies, the experience of previous years allows to

anticipate that some of them will not graduate, so the increase in the number of specialists will not be so considerable at the end of studies.

Non-governmental organisations of the sector make an important contribution in the increase of the competitiveness and quality of construction by organising improvement of professional skills of specialists. Certification of specialists in various construction areas is conducted by 8 building specialist certification centres (hereinafter CC) of non-governmental professional organisations, accredited by the Latvian National Accreditation Bureau (LATAK), and the Latvian Architects Society. 4003 certificates of construction practice and architectural practice are included in the general register.

Box 6.8

Development of construction in 2005

In nine months of 2005 the volume of construction in the country has increased by 15.7% (in average prices) in comparison with nine months of 2004 and has reached 550.5 million LVL. Construction exports have decreased, but still exceed the imports by 3.2 times.

Volumes of new construction have increased by 29.2% or 61.7 million LVL (in average prices), while volumes of repair and reconstruction work have risen by 4.9% or 13 million LVL.

Volume of new construction and repair work has increased by 2.5 times in construction of sport buildings, by 1.5 times in construction of living houses and hotels and buildings of similar use, and by 1.4 times in construction of streets and roads.

In nine months of 2005, living houses with total space of 368 thousand square metres and many important national economy objects were commissioned, for example, the business centre and living house “Centra nams”, two newly built study blocks of the Baltic Russian Institute, and new kindergarten in Dreilīņi in Rīga, reconstructed bus terminal, “Park hotel Latgola”, and reconstructed stadium “Esplanāde” in Daugavpils, grain terminal of the JSC “Ventspils Grain Terminal” in Ventspils, new pre-school educational establishment “Namiņš” in Jūrmala, Jaunmārupe primary school in Rīga district, cheddar cheese production facility of the JSC “Preiļu siers” in Preiļi district, new beer brewery JSC “Cēsu alus” in Cēsis district.

Central Statistical Bureau data indicate that construction costs are growing continuously. In the 3rd quarter of 2005 construction costs in Latvia have increased by 9.9% on average in comparison with the 3rd quarter of the previous year. The biggest increase in costs (by 13.6%) was for maintenance and operation of machines and mechanisms. Wages of workers went up by 12.7%, prices of construction materials increased by 8.6%. The fastest increases in construction costs were observed in construction of transport objects and underground main pipelines (by 15.9% and 11.8% respectively).

In spite of the considerable price rise, construction of housing has increased considerably. In the 1st half of 2005, 1576 building permits for construction of new family houses were issued. It was promoted by the fast development of crediting system.

It should be noted that, despite the stability of the sector, territorial distribution of investment and construction activities in the country is still very uneven (it is the highest in Rīga, Rīga district, Ventspils and Liepāja), level of corruption possibility is comparatively high, development rates of scientific potential in the sector are insufficient, the growing demand for skilled specialists in construction is not fully met because the studies in architecture and construction specialities have unreasonably low coefficient of state co-financing expenditure.

Development of construction sector is still hindered by interpretation of the requirements of normative acts by institutions involved in preparation of construction, frequent changes of normative acts regulating construction, lack of territorial planning and building rules, and intransparency of processes in local governments, which creates suspicions on possible corruption.

Capacity of state supervision institutions of construction product conformity assessment system is 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 states as regards their compliance with Latvian national interests is not established.

Division of functions of the organisational structure of the sector is inefficient because the general supervision and co-ordination of construction in the country is carried out by the Ministry of Economics, yet supervision of particular areas 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 big 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, amalgamated local governments, rural communities, or united boards) operate in Latvia.

Shortcomings of organisational structure of the sector are also indicated by the low-quality organisation of the state and local government construction procurement, so inefficient use of budget resources arises.

In 2006 the main attention will be paid to increase of transparency of the construction process, raising informedness of society and its involvement in decision-making, lessening administrative obstacles in construction, ensuring ability of the construction sector to meet demand.

The following tasks are to be considered, which are important for development of the sector and need to be solved urgently:

- 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;
- improvement of organisational structure and control system of the sector;
- improvement of market surveillance of construction products;
- promoting development of scientific disciplines related to construction.

To ensure transparency of construction process and decision-making, increase awareness of society and improve construction supervision and control functions, a single construction information system is being worked out, which will include register of issued building permits and commissioned buildings, register of construction businesses, register of construction practice and architectural practice, and other information topical for the sector.

Development of normative acts for improvement of construction regulation and for raising quality and safety will be continued.

European standards will be adapted both in construction product conformity, and designing of building structures, and raising energy efficiency of buildings.

In co-operation with the German Institute of Building Machinery, training of higher education institutions' teachers and specialists of the sector will be started for introduction of Eurocode standards in designing of the building structures.

It is planned to establish an institution for performing the national functions of the European technical approval.

Measures will be proposed for improvement of professional education system and professional qualification recognition system in construction specialities.

To increase awareness of construction participants and the public, seminars on topicalities of the sector in areas of normative regulation, construction products, designing, technologies, quality, labour protection and other areas are planned in addition to current information on the Ministry of Economics website and monthly information days.

In carrying out the measures also social partners will be involved: Latvian Architects Society, Latvian Civil Engineers Society, Latvian Construction Contractors Association, Latvian Building Inspectors and Supervisors Association, Latvian Heating, Gas and Water Technology Engineers' Union, Latvian Building Materials Producers' Association, Latvian Window and Door Manufacturers' Association, Latvian Building Materials Traders' Association, Latvian Builders' Trade Union, Technical Experts Association, Latvian Association of Local and Regional Governments, Latvian 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".

6.3.4. Tourism Policy

For determination and implementation of state policy for tourism development, a complex base of tourism policy planning documents is being formed in Latvia. Guidelines of Tourism Development Policy of Latvia for 2004-2008 (see Box 6.9), which define basic principles of tourism development policy, set goals of tourism development and identify main lines of action for attainment of these goals were worked out and adopted by the Cabinet of Ministers in 2004.

Box 6.9**Guidelines of Tourism Development Policy of Latvia**

Guidelines of Tourism Development Policy of Latvia are a medium-term policy-planning document that 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 – distinctive and recognised tourist destination.**Lines of action for attainment of this objective:**

- strengthening the tourism image of Latvia,
- identifying “new” visitors to Latvia,
- presence in priority and prospective tourism markets.

2nd objective – development of incoming and domestic tourism.**Lines of action for attainment of this objective:**

- 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 objective:**

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

To ensure the attainment of objectives set in the Guidelines of Tourism Development Policy of Latvia (hereinafter – Guidelines), draft Tourism Development Programme of Latvia for 2006-2008 was worked out and promulgated at the meeting of State Secretaries on November 10, 2005. Specific activities of tourism development are determined, working out annual action plan of tourism development. Action Plan of Latvian Tourism Development for 2005 was approved by the Cabinet of Ministers Regulation No. 297 on May 9, 2005. The approved Action Plan and the worked out draft programme include horizontal activities of tourism development, which are implemented by the Ministry of Economics, Latvian Tourism Development Agency and other state institutions in co-operation with local governments, private sector and non-governmental organisations.

Box 6.10**Trends of Latvian tourism development**

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), that indicates successful development of the sector on the whole and allows to expect even better results in the future. In 2004 the number of received foreign travellers exceeded 3 million for the first time, reaching 3.033 million (increase by 22.8% in comparison with 2003), and their expenses in Latvia reached 142 million LVL (increase by 14% in comparison with 2003). This trend of growth continues in 2005 as well. Statistical data for the 1st half of the year show, that 1 576 thousand travellers visited Latvia, which is by 31% more, than in the corresponding period of the previous year. In the 1st half of 2005 the amount of expenses of foreign travellers has also grown – foreign visitors in Latvia have spent 73.3 million LVL, which is by 19.2 million LVL more than in the 1st half of 2004. However, in spite of these positive trends, the number of travellers staying more than 24 hours in Latvia has not increased (merely about 30% of all travellers), and indicators of tourism balance of payments are still negative (expenses of Latvian residents during their trips abroad exceed expenses of foreign travellers in Latvia).

In 2004 start from the second half of year the Central Statistical Bureau started regular survey of Latvian residents about travels in Latvia, that allows to get data on domestic tourism. The obtained results indicate that in the 1st half of 2005 about 43% of Latvian residents travelled in Latvia for recreation purposes. The most popular tourist destination was Riga (about 25% of all pleasure trips).

Growth of tourism sector in 2005 was mostly promoted by the following factors:

- Latvia’s accession to the European Union;
- implemented measures of Latvian tourism marketing in the tourism target markets;
- appearance of supply of low-cost airline services;
- growing popularity of short holidays in Europe;
- development of urban and business tourism;
- establishment of medium-price and low-price hotels.

Comparing development of tourism in other EU member states after accession to the EU, one can forecast growth of tourism in the following years also in Latvia, therefore measures promoting tourism development have to maintain growth in the sector on the whole, ensure continuous development of tourism infrastructure, tourism products and services and their quality, consolidation of Latvia as a tourist destination and growth of its competitiveness both in the EU internal tourism market and in the international tourism market.

The rapid development of incoming and domestic tourism has identified the weak points of the current tourism infrastructure. Evaluating the number of tourist accommodation establishments and the number of people serviced by them in 2004 by planning regions, pronounced concentration of them was observed in Riga planning region with about 57% of all tourist accommodation establishments and 71% of all serviced people. It is also possible to single out the economically active centres Liepāja and Ventspils, where commercial activity of tourism is also becoming more active, but elsewhere in Latvia the tourism development rates are considerably slower, thereby creating differences in overlay, capacity and quality of tourism infrastructure. The poor attendance of regions and the limited capacity to receive a big number of travellers simultaneously strengthens disproportion between Riga and other regions. Latvia has a lot of areas and objects, which are economically underdeveloped but attractive for tourism development and where adequate investments into development of tourism infrastructure could promote development of new, innovative and semi-season tourism products and tourism services on the basis of this infrastructure. Both in the capital and regions (towns and rural areas) there is a shortage of tourist facilities and business tourism infrastructure (in the capital – economy class and business class hotels, conference infrastructure for large-scale congresses; in regions – hotels with 50-200 places and adequate conference infrastructure, camp sites and youth hostels), which could simultaneously receive a big number of tourists and ensure venues for activities of Latvian and international scale. It is a hindering factor for diversion of tourist flow to regions, extension of the length of tourist stay and increase in the number of tourists and the amount of incomes. Statistical data on the number of construction permits for buildings and engineering structures issued during the 1st half of 2005 indicate a considerable increase in the number of permits issued for construction of hotels – 138 against 50 in the respective period of the preceding year. In the future, it can aggravate other essential problem – load of hotels besides the tourism season.

Supply of tourism products and services is still insufficient in Latvia. This is indicated by statistical data that in 2004 the average stay of a tourist in Latvia was 1.7 days (decrease by 9.3% in comparison with 2003). Comparing the current supply of Latvian tourism products with the supply of other EU member states (especially Baltic and Scandinavian states), no special differences are observed. Yet, the Latvian tourism product is offered in a fragmented way, encompasses a wide target audience and has no definite development priorities. Latvia could attract much more tourists if a whole set of diverse tourism products, characterised by high-level quality of services and harmonised with Latvian tourism image (logo, motto and visual concept), which would facilitate planning and choice of a trip, simplify selling of tourism products and extend the length of tourist stay at tourist destination, would be directed into the market purposefully, using modern technologies of information and communications.

Evaluating the current situation and potential of tourism resources, three main priorities can be set for the further period:

- development of tourism infrastructure;
- promotion of development of new, innovative, semi-season tourism products and services;
- strengthening competitiveness of Latvia as a tourist destination.

Measures for improvement of overlay and quality of tourism infrastructure are planned in 2006. Latvian Tourism Development Agency will implement the project “Establishment of parking network and tourism information screens and booths” resulting in essential improvement of quality of tourism infrastructure and accessibility of tourism objects. Investment in tourism infrastructure is also planned by attracting EU financial resources (e.g., the open competition of projects “Effective use of cultural and historical heritage for development of tourism” of the ERDF, Component 3 “Investment in development of natural, historical and cultural heritage” of PHARE 2003 National Programme project “Economic and Social Cohesion Measures in Latvia”, PHARE 2003 Cross-Border Co-operation Programme, development of eco-tourism in Natura 2000 programme areas). The implemented measures for the improvement of tourism infrastructure will also promote the development of new tourism products and services. Competition for the best new product of tourism, competition “Tourism Merchant of the Year ‘2006” and support activities, including the new tourism products and services into informative tourism materials published by the Latvian Tourism Development Agency and involving them into marketing activities in target markets of Latvian tourism are planned as additional stimuli for creation of new tourism products and services and starting their implementation.

Tourism Development Agency will implement marketing activities of Latvian tourism in 2006 (participation in international tourism fairs, advertisement campaign in internet portals, publication of informative tourism materials, organisation of working seminars and visits of foreign tour operators and

journalists), paying special attention to target markets of Latvian tourism – Germany, United Kingdom, Sweden, Finland, Estonia, Lithuania and Russia.

Latvia will also continue co-operation at the international level (taking part in the work of the World Tourism Organisation and its Regional Commission for Europe, and in the work of the European Travel Commission), in the framework of the European Union (participating in the work of the Tourism Advisory Committee and the Tourism Sustainability Group of the European Commission) and in the Baltic Sea region (taking part in the work of the Baltic 21 Tourism Task Force and in the Interreg III B project “AGORA – Network Sustainable Tourism Development in the Baltic Sea Region”), as well as in the implementation of intergovernmental and interministerial agreements.

6.4. Business Environment

The study “Doing Business in 2006: Creating Jobs” conducted by the World Bank Group was published on September 13, 2005. The study reflects the situation on January 31, 2005. Business environment of Latvia takes the 26th place among 155 countries. Latvia is among 12 countries, where reforms have been introduced most actively, and this is a very positive estimation of measures conducted by Latvia for improvement of business environment. However, there are several procedures, where additional measures (e.g., labour legislation) are necessary.

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

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 compliance of Latvian national legislation with the requirements of the European Union directives.

Since 1999 the **Action Plan for Improvement of Business Environment** is worked out annually. 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 *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.

The Cabinet of Ministers has charged the Latvian Investment and Development Agency with supervision of implementation of the *Action Plan* and with institutionalisation of the dialogue between the government and business circles.

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

The most essential achievements since 1999 are: simplification of enterprise registration and tax administration, improvement of inspection activities, measures in customs and border crossing, construction and real estate spheres as well as in improvement of foreigners’ residence and employment procedures, easier access to information is achieved and better protection of investor rights is ensured. The *Action Plan* contained approximately 170 tasks in total, of which 90% are implemented. However, as business survey data show, substantial problems in development of production are created by costs of infrastructure services and certification and environmental requirements.

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 personal income tax;
- setting unified corporate income tax rate at 15% for all business incomes;
- 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. At the top level meetings, the Prime Minister, Ministers of Economics, Foreign Affairs and Finance and other government officials take part. They meet 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 ninth high level meeting between the government of Latvia and FICIL representatives took place on June 2, 2005. Representatives of organisations representing Latvian businesses also take part in these meetings, hence ensuring broader discussion. During the meeting its participants discussed development of Latvian national economy since accession to the EU and its perspectives, development of human resources, tax and customs issues, and regional development. During the meeting the government of Latvia and FICIL agreed to continue co-operation and to plan the next top level meeting in spring of 2006.

In August-December 2005 the Ministry of Economics and the Latvian Investment and Development Agency (LIDA) 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 (already the 4th) **survey to assess the measures of business environment improvement**.

The study consists of three main elements: business survey, self-appraisal of the influence on business environment exerted by national and local government institutions, and report of policy recommendations. The business survey was conducted by the Marketing and Public Opinion Research Centre SKDS, using methodology that was jointly improved by the World Bank/FIAS, Central Statistical Bureau, LIDA and SKDS. 701 company managers in Latvian cities and regions were interviewed in the survey.

The survey covers such spheres as starting business activity, licensing, environmental requirements, foreign trade, observance of working regulations, inspection activities, tax administration, state assistance to business activity and electronic services. The survey contains questions about administrative costs and time spent fulfilling requirements of supervision institutions during entrepreneurs’ daily business activity in phases of start-up, choice of location, and operation.

Results of surveys allow to compare development trends of business environment, to identify spheres, where new reform programmes are needed and to measure effectiveness of various measures for improvement of business environment. The survey helps both to develop measures of assistance to small and medium-sized enterprises and to find out opinion of entrepreneurs about operation of national and local government bodies.

Panel of private sector experts and representatives of business associations is established for independent supervision of the survey and determination of entrepreneurs’ priorities. Representatives of non-governmental organisations (National Economy Council, Council of the Small and Medium-Sized Enterprises and Crafts, Foreign Investors Council in Latvia, Employers’ Confederation of Latvia, Latvian Chamber of Commerce and Industry, Latvian Association of Certified Auditors, Taxpayers’ Rights and Interests Representation Fund, Association of Mechanical Engineering and Metalworking Industries of Latvia, Latvian Association of Business Consultants, Logistics and Customs Brokers Association, Latvian Real Estate Association) and independent experts are represented in the panel of experts.

Appraisal of the influence on business environment exerted by national and local government institutions was made in September of this year. It is based on information furnished by respective institutions and local governments about procedures under their supervision. Questionnaires about each of the most important administrative procedures are used to obtain this information. Questionnaires of procedures reflect information about the institution, statistics on the respective procedure, applicable legal norms, description of the order of procedure performance, and opinion of the chief executive

officer on the procedure. The information in questionnaires will be compared with results obtained in the survey about the influence of administrative procedures on business environment in Latvia.

On the basis of recommendations passed in these studies, additions to the Action Plan for Improvement of Business Environment will be developed.

On the basis of opinion offered by organisations representing entrepreneurs, also several other essential issues were solved, among them the issue of the so called “*cheat fee*” (entrepreneurial risk state fee). The Ministry of Justice prepared the informative report “On the Amount of Entrepreneurial Risk State Fee Included in the Employee Claim Guarantee Fund in 2003 and 2004 and its Utilisation” approved by the Cabinet of Ministers on July 19, 2005.

Concerning the amount of entrepreneurial risk state fee and the residue of employee claim guarantee fund, the government supported the proposed version of the informative report, which prescribes, that entrepreneurial risk state fee for every employee, with whom labour relations are established, is decreased from 0.35 LVL per month to 0.25 LVL per month (by 29 per cent).

In this case, both the guarantee fund’s residue formed in the previous years and a part of entrepreneurial risk state fee revenues will be used to cover employee claims in 2006, 2007 and 2008. It is planned to use the guarantee fund’s residue in such amount that the constant accrual of the guarantee fund would not be less than 1 million LVL. The guarantee fund’s residue formed in the previous years will be used in 3 years.

Gradual transition to partial funding of measures related to insolvency process from the state budget subsidy of general incomes is planned from 2008.

Prepared amendments to the Land Register Law envisage simplification of the number of procedures and documents to be submitted to the **Land Register** offices. They envisage reduction of the number of corroboration applications requiring notarial certification. The draft law provides for opportunities to certify signatures at the same land registry office, which performs fixation of property rights and corroboration and limitation of rights associated herewith at the Land Register without turning to a certified notary or the local court. Signatures of private persons will not require notarial or local court certification in the cases where the application is based on a judgement of court, notarially concluded transaction, restoration of property rights, or in the case of property rights obtained through privatisation of state or local government property.

On August 2, 2005 the Informative Report “On Opportunities to Cancel Use of **Invoices/Bills** for Numbered Goods Acquired from the State” of the Ministry of Finance was approved by the Cabinet of Ministers. Ministry of Finance prepares a draft law on amendments to the Law “On Taxes and Fees”, prescribing:

- duty of taxpayers to use mandatory invoices/bills or source documents, where a number assigned by territorial office of the State Revenue Service is indicated, for calculation and book-keeping of taxes according to procedure prescribed by this law and regulations of the Cabinet of Ministers;
- duty of administration to ensure publicly accessible unified database (register) of numbers of issued mandatory invoices/bills and source documents;
- use of mandatory invoices/bills by taxpayers in transactions involving excise goods (alcoholic beverages, tobacco products and oil products), timber and medicines;
- use of source documents by taxpayers, where a number assigned by territorial office of the State Revenue Service is indicated, and including authority of the Cabinet of Ministers to issue regulations on use of such source documents, where a number assigned by territorial office of the State Revenue Service is indicated;
- permission for taxpayers which do not execute transactions involving excise goods (alcoholic beverages, tobacco products and oil products), medicines and timber, to use mandatory invoice/bill forms at option in official registration of transactions until December 31, 2006. In transactions involving timber, taxpayers use timber transport invoices/bills until December 31, 2006.

According to the Informative Report, taxpayers will have the following gains:

- administrative obstacles to business transactions will be reduced;
- costs associated with the use of source document processed in form chosen and necessary for a taxpayer will diminish;

- after introduction of electronic signature, taxpayers with internet access will not have to personally approach the State Revenue Service to receive source document numbers;
- prescribing specification of requisites determined by normative acts in source documents, procedure of filling out these documents will be facilitated, hence taxpayers will have smaller possibilities to make mistakes in filling out the mentioned documents;
- form of the statement of number utilisation, which has to be submitted to the State Revenue Service, will be simple and easy to fill out.

One of the priority goals of the government is the *reduction of tax burden* and simplification of tax administration procedures (see Box 6.11).

Box 6.11

Tax burden and simplification of its administration procedures

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, who perform small amounts of economic activity. Like in other EU member states, these measures for simplification of tax calculation are not applied to businessmen, who establish capital companies for economic activity, as well as to physical persons, who 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. The concept also offers to introduce tax of 15% for individual businessmen.

As of May 1, 2004, when Latvia became a fully-fledged member state of the European Union and internal borders were removed, products in the internal market circulate without customs control and customs procedures are not applied to supplies of goods from one EU member state to another. A reduced (in the amount of 5%) 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 accommodation, 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 in all fields of the doctoral degree studies;
- 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 mentioned relief is applied to tuition fee, starting from the academic year of 2004/2005 till the academic year of 2009, if an employee has presented a respective statement from a higher educational institution to the employer.

Although tax rates in Latvia are low, special attention must be paid to tax administration issues that are often associated with complicated and long procedures, which require additional time and financial resources from entrepreneurs.

To prevent inefficient and non-incentive penalty system for violations of tax laws, the Ministry of Finance has prepared the report “**On Optimisation of the Penalty System**”. Its aim 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 characteristics of situation, 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. It is envisaged to work conclusions of the report into normative acts thereby improving Latvian tax legislation.

6.5. Research and Innovation

In the National Lisbon Programme of Latvia for 2005-2008 (see Section 6.1) research and innovation is one of the main priorities for promotion of competitiveness of Latvia. Priority directions to increase the national innovation capacity are as follows:

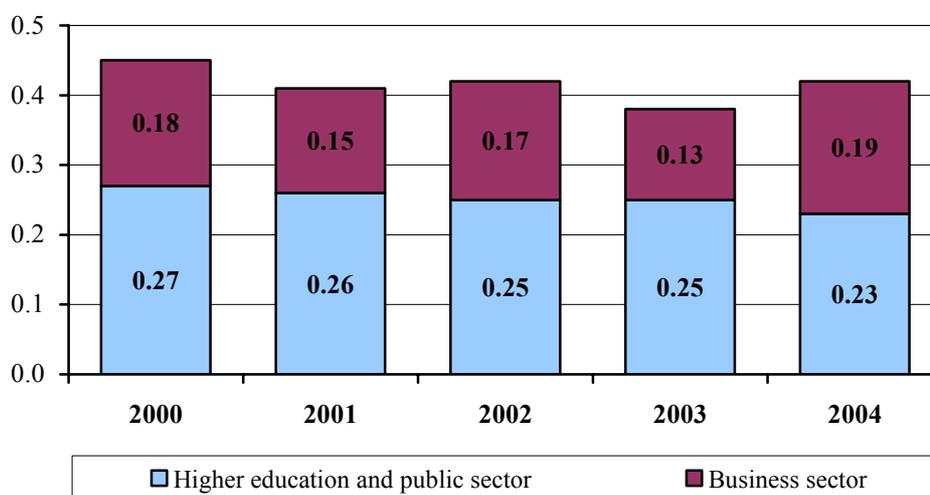
- to create favourable institutional environment for innovative activity;
- to promote co-operation of science, education and the private sector;

- to support transfer of knowledge and technologies;
- to encourage development of new products and technologies, including promotion of entrepreneurs' awareness of the intellectual property and its protection.

Innovation system of Latvia is insufficiently developed at present and does not ensure active participation of commercial companies in processes of research and innovation. Hindrance to development of applied research, commercialisation of research results and development of innovative business in Latvia is constituted by low investment of public and private sector into research and development. In 2004 the total financing for research and development in Latvia equalled to mere 0.42% of GDP (1.93% of GDP in the EU on average). Research financing by the public sector comprised 0.23% 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 research. In 2004 the private sector investment in research equalled to mere 0.19% of GDP (0.73% of GDP in the EU on average).

Figure 6.8

Expenditure on Research and Development in Latvia in 2000-2004
(% of GDP)



Source: CSB

In order to reach the goal set in the framework of the Lisbon Strategy (that EU member states must increase investment in research to 3% of GDP by 2010), the new Law on Scientific Activity included the requirement for the Cabinet of Ministers, in development of the annual law on the state budget, to prescribe increase in financing for scientific activity in the amount not less than 0.15% of GDP. Simultaneously with increase in financing, the system of financing scientific activity should be changed and the planned increase in public financing should be channelled mainly to applied research and innovation. The procedure of granting the financing should be such that ensured involvement of the private sector in identification, development and financing of research areas.

The Ministry of Education and Science has currently started drafting several regulations of the Cabinet of Ministers and regulates the procedure of how the financing for scientific activity is granted. It is envisaged to improve the procedure of assessment and financing of fundamental and applied research projects, procedure of financing the market-oriented research, and rules of granting commercial company support to projects in the framework of the EUREKA programme.

Implementation of several measures included in the National Lisbon Programme of Latvia for 2005-2008 is started. Additional financing was granted to the Ministry of Economics for improvement of technology transfer system by amendments to the law on the state budget for 2005. The Ministry announced invitation to higher educational establishments and scientific institutes to apply for participation in the programme for getting support to establishment of contact points of technology transfer at scientific institutions. Ten project applications were received in the framework of the programme, of which six qualified for getting the financing:

- project of the University of Latvia: “Establishment of Contact Point of Technology Transfer at the University of Latvia”;
- project of the Riga Technical University: “Establishment of Contact Point of Technology Transfer at the Riga Technical University to promote attraction of financing of structural instruments”;
- project of the Latvia University of Agriculture: “Establishment of Contact Point of Technology Transfer at the Latvia University of Agriculture”;
- project of the Riga Technical University: “Production and Quality Assessment of Biodiesel and Diesels Containing Biodiesel”;
- project of the Rēzekne Higher Educational Institution: “Establishment of Contact Point of Environmental Protection Technology Transfer at Rēzekne Higher Educational Institution”;
- project of Ventspils University College: “Establishment of Kurzeme Contact Point of Technology Transfer on the basis of Ventspils University College”.

Contact points of technology transfer are being established in order to promote co-operation of scientists and entrepreneurs and ensure efficient introduction of research results of state research institutions into production. Contact points of technology transfer usually accomplish the following main tasks:

- clarifies opportunities of the respective universities and scientific institutes to provide research and product development services according to the needs of entrepreneurs;
- clarifies demand of companies for research results and co-operation opportunities;
- promotes co-operation of entrepreneurs and scientists in order to attract financing of the private sector for research work;
- ensures patenting for intellectual property, which is created as a result of state financed research, ensures its protection and promotes its usage in the national economy;
- encourages establishment of new high technology companies on the basis of results of research conducted by Latvian scientists.

It is planned to grant 588 thousand LVL for financing of the mentioned projects in three years, including 150 thousand LVL for implementation of these projects in 2005. In the framework of contact points of technology transfer it is planned to prepare 95 commercialisation offers, initiate at least 70 co-operation agreements with entrepreneurs, and prepare 15 patent applications.

In 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. By November 2005 it was decided to grant support to 11 projects in the framework of the programme. It must be noted that 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 in the framework of this programme, and approximately the same amount will be attracted from the private sector.

In 2005 the Ministry of Economics has also implemented several good-practice and informative measures in order to encourage public awareness of the innovation role in promotion of competitiveness. One has to note especially the support to participation of scientific institutes and higher educational establishments in the international exhibition Baltic Industry 2005, which gave an opportunity for scientists and entrepreneurs to get acquainted and discuss possibilities of co-operation.

6.6. Information Society

Information society is a social development phase based on the free mutual exchange of information and developing a knowledge-based economy. Information society consists of the technological base (infrastructure, software), range of information services available to society, and the level of individual skills and knowledge. As a result of development of information and telecommunications technologies, information and knowledge are more and more widely used in work and labour relations, education and everyday life.

With Latvia's accession to the EU, the European Union initiatives with regard to building the information society (see Box 6.12) have become binding for Latvia.

Box 6.12**European Union initiatives in building the information society**

In December 1999 the European Union launched the initiative “*eEurope – an Information Society for All*”. In June 2000 the initiative was harmonised with Lisbon Strategy objectives and the *eEurope 2002 Action Plan* was worked out. The main three goals of this action plan were:

- cheaper, faster, secure internet;
- investing in people and skills;
- stimulate use of the internet.

As a result of implementation of the action plan in EU member states, in 2002 more than 90% of schools and companies had internet connection and more than half of all population used internet on a regular basis. However, the majority of individual users used dial-up access that is an Internet connection with small speed. Therefore, the main goal in the *eEurope 2005 Action Plan* is a wide distribution of broadband data transfer in networks, which by 2010 should embrace at least 50% of all networks. The goals of the *eEurope 2005 Action Plan* are:

- development of public online services;
- development of e-government (broadband connections; interoperability; interactive public services; public procurement; public Internet access points; culture and tourism; good practice framework);
- development of e-learning (broadband connections; eLearning Programmes; virtual campuses for all students; university and research computer-supported co-operation system; life-long learning; exchange of best practice);
- development of e-health (health cards; health information networks; online health services; interoperability);
- development of e-business (legislation; SME; e-Skills; interoperability; trust and confidence; the “.eu company”; M-payments; Digital Rights Management);
- promotion of e-inclusion;
- fostering security (cyber security task force; culture of security; secure communications between public services);
- distribution of broadband data transfer (spectrum policy; broadband access in less favourable regions; reduce barriers to broadband development; multi-platform content; digital switchover; national broadband strategies; introduction of the new Internet Protocol IPv6);
- benchmarking (adoption of indicators and methodology; evaluation of eEurope 2002 results; evaluation of eEurope 2005 results);
- funding of activities (European Commission programme e-Ten; European Commission strategic initiative IDA; cyber security programmes Promise / Modinis and ENISA; e-Learning programme; market-oriented programme eContent; market-oriented programme eContent plus; Safer Internet Action Plan);
- evaluation and review (contribution to Lisbon Strategy goals).

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 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 the whole Latvia, implementing regulation of activity of dominant enterprises;

2) ensure rational and efficient use of limited national resources (radio frequency spectrum, numbering and addressing);

3) encourage education of 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 the 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 the ISB and started working as 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 the 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 6.13).

Box 6.13

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 area, 95 merchants operating or planning to operate in international voice telephony services area, 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 a subsidiary of Danish telecommunications company “TDC” for 6.707 million LVL. The state still retains controlling share (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 44% had ever used internet.

According to Eurostat data, 42% of households in Latvia had internet access at the beginning of 2005. The share of inhabitants that had ever used internet during the last 3 months was 49% in the middle of 2005, while 36% of inhabitants used internet on a regular basis.

At the beginning of 2004/2005 academic year, all higher educational establishments and colleges, 98.1% of professional education establishments and 99.9% of comprehensive schools had computers, while all higher educational establishments and colleges, 97.1% of professional education establishments and 93.4% of comprehensive schools had internet connection. Number of computers per 100 students was 5.4, while the number of internet connections amounted to 3.7 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 academic 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”, teaching staff consider the insufficient number of computers and the lack of funding as the main obstacles to integration of ICT into education, while the interest of teachers and the state support are mentioned as contributing factors. In the last years no finances from the 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 regarding 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 had 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.

“*Global e-government Readiness report 2005*” of the UN Department of Economic and Social Affairs shows that Latvia in terms of e-government development ranks the 32nd among 179 countries. Leaders in this regard are the United States, Denmark, Sweden, the United Kingdom, and South Korea. Estonia ranks the 19th, while Lithuania takes the 40th place.

Box 6.13 continued**e-health**

In December 2003 only 22% of general practitioners (GPs) had computers in their consulting rooms and only 12% had internet access in these rooms, 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 hindering development of e-health.

e-commerce

In the middle of 2005, only 6.2% of Latvia's inhabitants shopped online. At the same time, the number of credit cards in Latvia exceeded 1 million in 2005, and 15.6% of population used e-banking services. This points to the huge potential for development of e-commerce, which remains unused because online payments are offered and made by relatively small number of Latvian companies – 3.8% of companies have purchased online, while only 3.3% received online payments. In January 2004 approximately 13.3% of Latvian companies selling online sold to other companies through specialised internet market places.

Building the information society is set as a priority in the National Lisbon Programme of Latvia for 2005-2008 (see Section 6.1). The main planned activities for promotion of ICT and building the information society are the following:

- to encourage widespread use of ICT in public services, SMEs and households;
- to ensure the security of networks and information, as well as convergence and interoperability in order to establish an information area without frontiers;
- to encourage the deployment of broadband networks, including the poorly served regions, in order to develop the knowledge economy.

On May 10, 2005 the Cabinet of Ministers approved the By-law of the Latvian e-Government Co-ordination Council, where promotion of updating the e-government strategic guidelines and fostering implementation of e-government projects are set as the main task of the Council. The functions of the Council also include providing information to state and local government institutions about activities in the area of e-government. According to the by-law, the Council will give opinions and recommendations on issues related to e-government to state administration bodies that are implementing e-government and will prepare proposals for solution of issues related to e-government.

On September 29, 2005 the Cabinet of Ministers approved the “Electronic Government Development Programme for 2005-2009”. The goal of the Programme is, through introduction of information technologies and optimisation of processes in the public administration:

- to improve quality and accessibility of state administration services and to reduce the administrative and financial burden on the society;
- to create an efficient and economic state administration;
- to form an open and democratic administration enjoying confidence of population and involving them in its work.

On May 3, 2005 the government approved the schedule of activities for introduction of safe electronic signature, which envisages the start for issuing the first e-signature certificates as from March 2006.

On October 18, 2005 the Cabinet of Ministers approved the draft concept on selection of the bearer of safe electronic signature and on introduction of safe electronic signature in Latvia submitted by the Secretariat of the Special Tasks Minister for e-Government Affairs. The concept envisages that smart card is chosen as the bearer of safe electronic signature in Latvia. Secretariat of the Special Tasks Minister for e-Government Affairs has started developing criteria and proposals for distribution of 50 000 safe electronic signature certificates to employees of state and local government bodies, and has started activities required for carrying out the procedure of procurement of safe electronic signature certificates.

In parallel with the establishment of safe electronic signature infrastructure, it is planned to create electronic services that would allow to implement circulation of electronic documents both in the private and the public sector, ensuring wide use of them. Great attention is paid to integration of safe electronic signature with the intended electronic services.

Electronic procurement is one of the electronic services. Cabinet of Ministers has approved the following documents for implementation of electronic procurement (e-procurement) system in Latvia:

- on January 29, 2004, the concept “Use of Information Technologies in Improvement of Public Procurement System”, which envisaged to implement pilot project of centralised procurement (development and putting into operation of e-catalogue infrastructure);
- on October 5, 2005, the Concept of Electronic Procurement System, envisaging to establish an electronic procurement state agency in order to separate the functions of centralised procurement institution (provider of e-procurement system) from the supervisory functions of the Procurement Supervision Bureau;
- on December 6, 2005, the instruction on establishment of electronic procurement state agency and the by-law of this agency. The main goals of the agency are to ensure for state and local government institutions an opportunity to use system for carrying out procurement of standardised goods and services, organise activities in order to conclude general agreement on participation in procurement of standardised goods and services, and supervise fulfilment of general agreements.

Establishment of e-procurement system is aimed at improvement of the public procurement system by using information technologies in order to:

- reduce bureaucracy and risk of corruption;
- increase efficiency of utilisation of budget resources;
- raise level of transparency and access to information.

On December 27, 2005 the Cabinet of Ministers adopted Instruction No. 839 “On the Concept “Broadband Network Development Strategy for 2006-2012””, supporting the concept’s A option, which envisages by 2012 to provide opportunity of broadband access to all target audience (for example, physical persons, state administration institutions, merchants, schools, hospitals, health centres) for acceptable price, embracing 85-95% of the territory of the country. Providing opportunity of broadband access includes improvement of the current electronic communication infrastructure, building the required infrastructure, and maintenance of infrastructure.

On August 17, 2005 the Cabinet of Ministers approved the Basic Guidelines “e-Health in Latvia”. The Basic Guidelines is a single strategic document for different e-health projects. The Basic Guidelines envisage, by using IT opportunities, to ensure operative exchange of healthcare information between the society, patient, healthcare specialists and policy builders and implementers, improve efficiency of healthcare services provision, and ensure credibility and safety of healthcare data.

On November 10, 2005 the Saeima adopted the Law “Amendments to the Law on Information Society Services”. The goal of the Law is to define what the electronic mail is as well as specify the ban on sending a commercial message, providing that it is banned to use (for sending a commercial message) automatic dialling (terminal) systems operating without human participation (automatic call equipment), electronic mail or fax machines (facsimiles) whose usage makes feasible an individual contact with service provider if the service recipient has not given a free and unambiguous agreement beforehand.

The Law designated the Data State Inspection as additional supervision institution for practical supervision of observance of norms of the Law on Information Society Services.

On December 2, 2005 the Memorandum of Understanding with the European Community to administer organisation of the conference “Information and Communication Technologies for Inclusive Europe” was signed. It is envisaged to organise the conference in Riga on June 11-13, 2006. The main goal of the conference is to encourage development of EU information society policy, which is closely linked with inclusion initiative in the framework of the new EU strategy “i2010”. It is anticipated that approximately 500 delegates of EU member states will take part in the conference.

6.7. Small and Medium-Sized Enterprises

Small and medium-sized enterprises (SME) comprise a major part of national economy and play a significant role in the GDP growth and employment in Latvia like elsewhere in Europe (see Box 6.14).

Box 6.14**Number of small and medium-sized enterprises in Latvia**

According to provisional data, there were 53 000 economically active businessmen and commercial companies in Latvia in the 1st half of 2005 (excluding agricultural and fishing farms and self-employed persons, which perform economic activity), of which 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 EU member states: 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.

Essential indicator characterising economic activity is the number of economically active businessmen and commercial companies per 1000 inhabitants. The indicator in Latvia has constantly grown in the last 5 years from 17 in 2001 to 23 in 2005.

It is of the same importance to accentuate the number of performers of individual piece-work (self-employed persons), which amounted to 36 344 in 2004 (16 per 1000 inhabitants), and the number of agricultural and fishing farms, which equalled to 13 850 in 2004 (6 per 1000 inhabitants). Taking into consideration the fact, that among EU member states there is no single methodological practice for calculation of such indicator characterising economic activity as the number of enterprises per 1000 inhabitants, it is difficult to conduct objective comparative analysis of this indicator. The current practice of responsible EU institutions shows that calculation of the number of enterprises per 1000 inhabitants includes not only businessmen and commercial companies, but also performers of individual piece-work, agricultural and fishing farms etc. Accordingly applying an analogous practice, Latvia had 44 performers of economic activity per 1000 inhabitants in 2004, which is close to the EU average.

Statistical data of the recent years indicate positive trends in growth of the number of newly founded enterprises. Lursoft data show that 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. It is also forecasted that the number of newly founded enterprises in 2005 will grow by 10% in comparison with 2004, which on the whole indicates efficiency of measures taken to ensure improvement of business environment and promotion of business development.

Assistance to SME in Latvia is regulated by the Law on Control of Aid for Commercial Activity, which is in force as from January 1, 2003.

Box 6.15**Definition of SME**

The **Law on Control of Aid for Commercial Activity** lays down the definition of small and medium-sized enterprises (according to the European Commission Regulation No. 70/2001 and amendments to the European Commission Regulation No. 364/2004):

Medium-sized enterprises:

- number of employees from 50 to 249;
- annual turnover does not exceed 50 million EUR;
- total balance sheet value is under 43 million EUR.

Small enterprises:

- number of employees from 10 to 49;
- annual turnover does not exceed 10 million EUR;
- total balance sheet value is under 10 million EUR.

Micro enterprises:

- number of employees from 1 to 9;
- annual turnover does not exceed 2 million EUR;
- total balance sheet value is under 2 million EUR.

The main problems hindering SME development in Latvia are the following:

1. Business environment. Competitiveness of SME sector cannot develop without environment, which is 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, as well as 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 small and medium-sized enterprises and among business beginners. Guarantee and investment funds are insufficiently 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 the choice of personnel: insufficient business management skills, knowledge on management and business and technical knowledge, to be able to develop business plans of high quality and value; insufficient level of knowledge about financial and money flow management; and poor culture of business organisation while working in a 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 topical issue. 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 has created increased differences between cities and rural areas as well as between the central part and periphery of the country. Integrated development of rural areas, including development of non-agricultural business activity, is a necessary precondition for balanced development of the country.

6. Administrative capacity of public and non-governmental organisations for development and implementation of SME policy and for absorption of the EU Structural Funds is insufficient at present. The main 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, and to promote stability and efficiency 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 practices of companies of the developed countries, in accordance with the activities outlined in the European Charter for Small Enterprises, at the same time 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 for utilisation of the financial resources from the EU Structural Funds.

For the majority of the entrepreneurial activity assistance measures envisaged in the *Programme*, attraction of **co-financing from the EU Structural Funds** is planned (see Section 6.2.1). It is possible for Latvian businessmen to submit their projects to the following state support programmes for 2004-2006 administered by the Latvian Investment and Development Agency:

1. support to consultations and participation of commercial companies in international exhibitions, fairs and trade missions;
2. support to development of new products and technologies;
3. support to modernisation of commercial activity infrastructure;
4. support to raising qualification of employees, their retraining and further education.

More comprehensive information on state support programmes, as well as on the 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* (MLBL) plays an important role in the SME support system. Since 2000 MLBL helps to introduce and implement the **Programme of Crediting Latvian SME Development**. The insofar implementation of the programme has substantially promoted accessibility of capital to SME and has encouraged more active involvement of commercial banks in offering loans to SME.

On November 26, 2002 the Cabinet of Ministers approved the Programme of Crediting Latvian SME Development (second phase) for the next three years, foreseeing state guarantees in the amount of 20 million LVL to MLBL in order to enable the bank to borrow the necessary resources for crediting SME in the financial market. On January 21, 2004 MLBL started crediting in the framework of the Programme of Crediting Latvian SME Development (second phase). Funding projects of specific SME (business beginners, rapidly growing SME, SME in regions requiring special assistance, and female SME) supported in the framework of EU programmes is continued in the frames of the Programme of Crediting Latvian SME Development (second phase).

By April 1, 2005 more than 1699 new jobs were created and 97 new enterprises were established in the framework of the Programme of Crediting Latvian SME Development (second phase). Total amount of loans granted in 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 für 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 the 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 2003 a full-fledged work is being done by the *Latvian Guarantee Agency* (LGA). LGA is a state-supported institution with a goal to support development of business activities of small and medium-sized enterprises (commercial companies) registered in Latvia by promoting availability of credit resources and issuing medium-term and long-term loan guarantees in its name to financial institutions registered in Latvia or abroad, which are financing these enterprises. In 2004 the LGA has issued 20 guarantees for the total amount of 0.66 million LVL.

In 2005, EU Structural Funds are attracted to the Latvian Guarantee Agency for guarantee and risk capital programmes (10.28 million LVL per every programme separately, which are envisaged to use by the middle of 2008). Work is being done to start operation of risk capital funds, thereby entrepreneurs will have access to additional financial support instrument in cases, where receiving other loans for improvement of their activity is difficult.

As of November 1, 2005, LGA has issued 16 loan guarantees for the total amount of 522 600 LVL. Average amount of guarantee issued this year per one project comprised approximately 50% of the loan. In the framework of the state support programme “LGA Loan Guarantee Support Programme”, load of equity capital of guarantees with issued loan guarantees comprised about 24% as of November 1, 2005. In 2005 the biggest support from LGA was received by enterprises, which operate in the following sectors: manufacturing industry (37%), social and individual services (19%), hotels and catering (15 %).

Measures planned by LGA for 2006 are:

- to expand the range of the existing services:
 - 1) in the framework of loan guarantees,
 - 2) offering new guarantee products in co-operation with other financial instruments (leasing guarantees);
- to improve the scheme of compensatory payment in case of unsuccessful projects. The changes are aimed at decrease of the banks’ losses,
- to conduct study about demand of the financial market for new guarantee products.

Training of businessmen and business beginners and their providing with information about issues topical to them was continued in 2005, organising informative seminars on availability of

financial instruments for SME and the business forum “Day of Knowledge for Entrepreneurs 2005” in Riga and regions. Surveys about identification of administrative procedures hindering SME development and identification of tax burden were conducted, indicating the development-hindering factors in this area. Comparative analysis of application of taxes in EU member states was done. Analysis of business development was performed, broken down by years. Support is given to consultations rendered to entrepreneurs of Latgale about preparing applications for finances from the Structural Funds, preparing project applications and submitting them to the Latvian Investment and Development Agency.

In order to encourage more active involvement of women in business activities, research and analysis of situation in development of female business activity in Latvia were performed, conducting the study “Woman in Business Activity”. As a result of this study, problems in development of female business activity were detected and defined, possible solutions of these problems were indicated, and introduction of the Mentoring Programme to Encourage Female Entrepreneurship in Latvia was supported.

Latvia joined the **European Charter for Small Enterprises** (see Box 6.16) by signing the Maribor Declaration on April 23, 2002. In September 2002 Latvia also joined the Multiannual Programme for Enterprise and Entrepreneurship, and in particular for Small and Medium-Sized Enterprises (2001-2005). In the framework of the Multiannual Programme, a range of integrated activities were performed in Latvia within the mentioned three lines of action thereby efficiently overcoming obstacles to development of small and medium-sized business in Latvia.

Box 6.16

European Charter for Small Enterprises.

On June 19-20, 2000 the European Council meeting in Feira approved the **European Charter for Small Enterprises**, thereby its member states affirmed their commitment to work according to 10 lines of action of the Charter by integrated promotion of establishment of conditions and factors, which determine development of business activity. These lines of action are:

1. education and training for entrepreneurship;
2. cheaper and faster establishment of enterprises;
3. more efficient legislation and regulation;
4. availability of training;
5. improving internet access;
6. gaining more out of the Single Market;
7. taxation and financial matters;
8. strengthening the technological capacity of small enterprises;
9. making use of successful e-business models and developing top-class small business support;
10. developing stronger, more effective representation of the interests of small enterprises at the EU and national level.

For practical implementation of the Charter, on December 20, 2000 the European Council adopted (by Decision No. 2000/819/EC) the **fourth Multiannual Programme for Enterprise and Entrepreneurship, and in particular for Small and Medium-Sized Enterprises (2001-2005)**. This Programme is an action plan with the following objectives:

- to enhance the growth and competitiveness of enterprises in a knowledge-based 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 for business, especially SME;
- to give business an easier access to Community support services, programmes and networks and to improve co-ordination of these facilities.

In that way the Programme is directly focused on solution of the principal SME development problems – inaccessibility of seed 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.

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 contains information on the Multiannual Programme and the projects implemented in 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

The main goals of Latvia's competition policy are to ensure equal competition between market participants as well as development and protection of competition in all sectors of national economy. The Saeima adopted the Competition Law in 1997. The Competition Law stipulates responsibility of market participants for violation of prohibited agreements, abuse of dominant position and violation of prohibition of unfair competition in activities of market participants. Possible sanctions for violations of competition rules in Latvian legislation are considerable. Penalty for a prohibited agreement or an abuse of dominant position may reach 10% of the respective company's net turnover for a financial year.

The Competition Council carries out supervision of Competition Law norms and investigation of possible violations.

The competition supervision body also performs assessment and takes decisions in relation to planned mergers of market participants. The Competition Council is entitled to take decision prohibiting merger if this merger creates or strengthens a dominant position. Since May 1, 2005, a merger of market participants may be restricted also in the case, if such merger can significantly lessen competition in every particular market.

The Competition Council, within scope of its mandate, assesses possible violations of the Advertising Law, when advertisement distributed by a market participator is misleading in terms of its content, design or presentation and may do some harm to a competitor and when advertisement distributed by a market participator identifies a competitor directly or indirectly, i.e., there is a comparative advertisement not complying with conditions set for comparative advertising. Changes in the Code of Administrative Violations of Latvia have provided to the Competition Council an opportunity to apply penalties for established violations of the Advertising Law. According to the amendments to the Code of Administrative Violations of Latvia, which are in force as of April 15, 2005, the Competition Council is entitled to take decision on application of administrative penalty, i.e., impose fine of up to 10 000 LVL to legal persons for provision or distribution of advertisement prohibited by a the law.

In 2005 the Competition Council has taken 68 final decisions and established 16 violations of the Competition Law and the Advertising Law. 36 cases of possible violations are still under examination, including 12 self-initiated cases. The Competition Council has assessed the information indicated in 42 applications, giving conclusion or opinion or sending the application to other competent institution. The Competition Council has investigated possible violations, for example, in medical gas distribution market, oil product market, market for provision of airport services, press distribution market, market of pharmaceutical services, wholesale paper market, market for document finishing and copying services, etc.

In 2005 the competition supervision body has imposed fines for established violations in the total amount of 104 384.96 LVL, which has to be transferred into the state budget. The biggest fine was imposed for established violation of prohibited agreement in activities of construction service enterprises while participating in price questionnaire organised by a local government (see Box 6.17).

Box 6.17**Competition Council establishes violation of prohibited agreement in activities of construction service enterprises**

The Competition Council received report of the Procurement Supervision Bureau about possible violations of the Competition Law in the activities of several business companies participating in the price questionnaire “Construction work in the local government agency “Jūrmalas sociālās aprūpes centrs” (Jūrmala Social Care Centre)” organised by Jūrmala city council (hereinafter – Price Questionnaire).

There were suspicions that four companies (LLC “Stats”, LLC “Alti A”, LLC “Info Serviss” and LLC “Balsts-R”), which participated in the price questionnaire for construction work in the Jūrmala Social Care Centre have exchanged information and coordinated their actions in this competition.

In the framework of this case the Competition Council conducted checks at work premises of the companies and found evidence that confirmed existence of agreement between three companies during preparation of tenders for the price questionnaire. The market participants exchanged information both on prices and technical tender hence influencing competition conditions in the particular Price Questionnaire.

The Competition Law prohibits agreements between the market participants, which have as their purpose or consequence the hindrance, restriction or distortion of competition in the territory of Latvia, including agreements regarding the participation or non-participation in the competitions or auctions or regarding the provisions for such actions (inactions). Exception is made for cases, when the competitors have publicly announced their joint tender and the purpose of such a tender is not to hinder, restrict or distort competition.

The Competition Council established that from February 7, 2005 till February 17, 2005 the limited liability companies “Stats”, “Alti A” and “Info Serviss” were involved in prohibited activities, which manifested as a concerted action of market participants, in the framework of which an exchange of information about prices took place as well as participation in the competition and provisions for such action were concerted. The Competition Council decided to impose on the market participants implicated in the violation a fine in the total amount of 76 672 LVL for violation of prohibited agreement.

The Competition Council points out that exchange with commercial activity plans and other information between competitors in commercial activity is inadmissible. Prohibited agreement is established, when its parties come to a consensus or a plan that limits or tends to limit their commercial freedom, setting joint provisions for activity of the parties, and do not observe that every business company has to determine its commercial policy independently. The mentioned requirement does not allow direct or indirect contacts between business companies, which have as their purpose or consequence the coordination of the market actions of competitors and exertion of influence on these actions.

The full text of the Decision No. ED2-41 adopted by the Competition Council on September 14, 2005 is published on the Competition Council’s website www.competition.lv.

Along with investigation of possible violations of the Competition Law and the Advertising Law, the Competition Council has also conducted several market studies or supervision cases, analysing development trends in the aspect of competition. In 2005 a great attention was paid to the retail sector, which develops very rapidly in the current years (see Box 6.18).

Box 6.18**Competition trends in the retail market of goods**

Retail market of daily consumption goods in Latvia is characterised by a structure, where two big market participants dominate and other participants may be characterised as market niche participants. The existing short-term problem is the marked oligopoly and its form duopoly in particular, i.e., the market is controlled by the two biggest market participants, which considerably prevail over smaller market participants.

Retail trade of food products in Latvia is carried out by shops of different formats that differ both functionally and qualitatively. The special status of supermarkets and their irreplaceability with other retail formats, such as kiosks and markets, are indicated by several qualitative criteria – area, number of assortment items and their filling, opportunity to shop “under one roof” and park a car, as well as various supplementary services. Hypermarkets, supermarkets and low-price or discount shops are positioned so as to be able to satisfy people of different levels of income. As levels of income in Riga, the biggest cities and the rest of Latvia are different, development of low-price shops in regions is expected in particular during the following years.

The number of inhabitants shopping in hypermarkets, supermarkets and low-price shops has substantially increased in the current years while the number of inhabitants shopping in traditional shops and markets has gone down. With increased supply in the retail sector, segmentation of consumers occurs, namely, consumers have an opportunity to choose the retail shop most suited to their lifestyle and needs. One-stop shopping that takes place once a week during the weekends becomes increasingly characteristic for the population in Latvia.

The Competition Council forecasts that the number of traditional shops will decrease even further, but those remaining in the market will perform functions of specialised shops or orient to sale the daily essential goods. It is expected that in parallel to the construction of supermarkets the low-price shops will develop rapidly, because this niche of the Latvian market offers good prospects. Entry of strong participant in the market will result in re-division of the market, and particular weaker participants will have to leave the market or to merge for increased efficiency (effect of volume, logistics and other advantages). The number of market participants will inevitably decrease in the future both as a result of merge of smaller participants and due to particular market participants leaving the market. However, it does not mean automatic decrease in competition, because with the entry of strong participants in the market, the rate of market concentration (indicator for evaluation of competition situation, reflecting the amount of market shares of the biggest participants and their share in the total market) will go down and the competition will be more efficient in comparison with the current situation in the market. Aggravation of competition will be particularly apparent in the market share controlled by the two market participants, where the most essential changes of the market shares are forecasted. It will certainly lessen the market problem existing in the short-term (duopoly) and will increase competition in the retail trade and gains of consumers.

For more efficient accomplishment of Competition Council tasks, work is being done constantly to improve the legal base and co-operation with other Latvian and foreign institutions. Essential role in the protection of competition rights is played by international co-operation directed to promotion of market participants' protection against unfair competition in the interstate trade and to improvement of competition legislation and investigation techniques. The Competition Council takes part in the work of the Organisation of Economic Co-operation and Development (OECD) and other international organisations. Co-operation with the European Commission and competition supervision bodies of EU member states is continued. In the framework of development projects the Competition Council also strengthens co-operation with the Federal Antimonopoly Service of the Russian Federation and the competition protection body of Ukraine.

Future plans of the Competition Council are related not only to the improvement of investigation activities. The Competition Council will focus more to the competition support function, promoting decreased state regulation in sectors, where obstacles to development of competition exist. Along with the basic activity in the law supervision area, assessment of the draft normative acts and policy documents in the field of competition protection and development will be ensured. It is also necessary to encourage consumer motivation to respond more flexibly to the price changes, i.e., change their shopping habits and frequently choose substitutes for particular goods and services hence strengthening the competition pressure on prices of goods and services.

As the competition policy is made by a set of normative acts and policy instruments implemented by the state, which prescribe the protection of market participants and consumers against activities restricting competition as well as the state action for stimulation of the supply party through opening the markets to free competition, the promotion of competition greatly depends on availability of resources and on division of tasks between institutions responsible for the economic policy.

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 the 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 heat supply (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 Public Utilities 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;
- sets tariff calculation methodologies;
- sets service tariffs if special laws of the sector do not prescribe other procedure of tariff setting;
- carries out extra-judicial dispute settlement.

Amendments to the Law “On Regulators of Public Utilities” came into effect on January 4, 2005. The amendments also apply to the Paragraph 2 of Article 7 of the Law, which (in the wording presently in force) prescribes that “the Commission is a secondary public entity supervised by the Minister of Economics”. Thereby the Commission has obtained the status of a secondary public entity, which affects its rights to issue external normative acts. Before that the Commission did not have the mentioned special status. Thereby, in accordance with the law On Coming into Force of the Law on Administrative Procedure, the external normative acts issued by the Commission are to be regarded as equal to Regulations of the Cabinet of Ministers, and the previously issued normative acts lapse on January 1, 2006.

On November 14, 2005 the Concept for the improvement of public utilities regulation model in Latvia was accepted by the committee of the Cabinet of Ministers. In order to reach this goal, it is planned to centralise regulation of public utilities in Latvia. The Concept envisages establishment of a unified system for regulation of public utilities, where decisions are taken by the Board of the Public Utilities Commission, while the necessary obtaining and assessment of information, preparation of decisions and control over their execution will be ensured by executive body, which will include regional branches of the regulator. Regional branches will be formed on the basis of already existing regional regulators, taking over specialists in this field and optimising the number of branches. Also operation of the centralised Public Utilities Commission will be financed by revenues gained through collection of state duty for regulation of public utilities.

The situation and policies in the regulated sectors

Energy sector

In the energy sector, electricity supply and gas supply are regulated by the state. The dominant role in the electricity supply is played by the JSC “Latvenergo”, which generates more than 90% of electricity generated in Latvia, ensures import of electricity, its transmission, distribution and delivery to users. In addition to “Latvenergo”, there are more than one hundred small power plants and 10 licensed companies of distribution and/or sales of electricity. Supply of natural gas in Latvia is ensured by vertically integrated JSC “Latvijas Gāze”, while about 70 companies compete in supply of liquefied gas.

Since July 1, 2004 all electricity users, with the exception of households, have the opportunity to choose alternative suppliers of electricity. However, practically no qualified user has changed supplier of electricity. Relatively low imported electricity prices do not encourage entry of new independent energy generators into market. In the recent years the electricity generation in Latvia has undergone development only in the sectors, where state support prices are ensured – combined heat and power, small hydropower plants and wind power stations.

The Electricity Market Law was adopted on May 25, 2005, which envisages setting legal regulation for opening the electricity market and is developed in conformity with normative acts of the European Community, which prescribe norms regulating market access, operation and criteria of systems, and the procedure applicable to receive permission for production, transmission, distribution and sales of electricity. The law also prescribes that, by January 1, 2006, the Commission will adopt several normative acts: requirements for independence of system operators, normative acts related to operation of public trader, requirements for reports of system operators. On June 8, 2005 the Commission issued a licence to the JSC “Augstsprieguma tīkli”, which started functioning as an independent transmission system operator as of September 1, 2005, and granted the public trader status to the JSC “Latvenergo” on September 28, 2005.

On June 8, 2005 the Commission approved new tariffs for natural gas. The increase of tariffs was determined by the upsurge in the price of natural gas received from “Gazprom”, which followed the growth of oil and oil product prices in the world.

Electronic communications and post

The biggest market participators in the field of electronic communications are the fixed network operator LLC “Lattelekom” and mobile communications operators LLC “LMT” and LLC “Tele2”. 380 companies are registered in the field of electronic communications (360 are registered in compliance with the Electronic Communications Law), of which 106 companies operate or plan operating in the field of domestic/local voice telephony services, 118 companies operate or plan operating in the field of international voice telephony services, 126 companies plan to provide leased line services, 330

companies will offer Internet and data transmission services, 15 companies will offer payphone services, 19 companies will offer radio communication services, and 53 companies will offer television and sound distribution services.

Development of secondary legislation in the field of electronic services continued in the 2nd half of 2005, because, in accordance with the Electronic Communications Law, the Commission has to work out the normative acts prescribed by the law by December 1, 2005.

The Commission performs the analysis of electronic communications market in 2005 in accordance with the Electronic Communications Law and observing market analysis guidelines of the European Commission. As a result of the analysis, it will be determined whether efficient competition exists and the current list of electronic communications companies with significant market power will be reviewed. Application of special requirements to these companies will allow preventing the detected competition problems. On August 31, 2005 the Commission approved the Rules on Amount of Information Necessary for Market Analysis and on Procedure of its Submission, and market analysis questionnaires were sent out to electronic communications companies in early September.

On June 8, 2005 the Commission's Board adopted decision to set the upper limit of tariffs for interconnection services provided by LLC "Lattelekom" (at 0.8 santims per minute) and limited liability companies "LMT" and "Tele2" (at 6.2 santims per minute). The main goal for setting the upper limit of tariffs for interconnection services is the reduction of end tariffs for users. Application of lower interconnection tariffs will activate provision of services of carrier selection and carrier pre-selection, increasing competition and creating preconditions for reduction of tariffs for calls in Lattelekom, LMT and Tele2 networks. The operators appealed the Commission's decision in the Administrative District Court and asked to suspend the decision until review of the case on the merits. The Administrative District Court decided to suspend the decision of the Commission, but the Commission appealed this court judgement and the Administrative Regional Court decided to repeal this judgement and not to suspend the disputed decision of the Commission.

In the postal sector, the SJSC "Latvijas Pasts" provides general postal services, while more than 30 service providers operate actively in the field of express mail.

In accordance with amendments to the Postal Law, as of May 1, 2004 the postal market is open to competition for provision of general postal services – accepting, sending and distributing domestic and international mail correspondence (letters, postcards, and small parcels) in Latvia. In accordance with the Postal Law, the amount of monopoly rights of the SJSC "Latvijas Pasts" is reduced as of January 1, 2006 – the SJSC "Latvijas Pasts" will have monopoly rights to accept, send and distribute domestic and international mail correspondence weighing no more than 50 grams within the country borders.

In the postal sector, on November 2, 2005 the Commission approved the tariffs for general postal services submitted by "Latvijas Pasts", which will come into force on January 1, 2006. Since the previous setting of tariffs in October 1998, operation costs of the company (especially personnel costs and expenses for fuel) have significantly increased. In June 2005 the Cabinet of Ministers determined division of domestic mail items into class A and class B, and tariffs for domestic mail of class A had not been set before. In order to ensure that introduction of class A priority mail will not deteriorate quality of the existing services, the Commission proposed to set stronger requirements for the quality of mail delivery. Introduction of class A domestic mail and setting its tariffs will provide an opportunity for postal service users to choose mail items of different quality for different tariffs.

In 2006 it is envisaged to develop a new Postal Law that will determine unified regulation for all participants of the postal services market.

Railway

In the railway sector, SJSC "Latvijas Dzelzceļš" ensures maintenance of public railway infrastructure as well as carries out cargo transportation and international passenger transportation. Domestic passenger transportation is carried out by JSC "Pasažieru vilciens" and LLC "Gulbenes-Alūksnes bānītis". In the field of cargo transportation, several operators independent from SJSC "Latvijas Dzelzceļš" operate actively.

Reorganisation of SJSC "Latvijas Dzelzceļš" is in process, following the market economy conditions and requirements of EU Directives. At the end of 2002 the JSC "Pasažieru vilciens" was founded, while in 2003 joint stock companies "Starptautiskie pasažieru pārvadājumi", "Vagonu remonta centrs", "Lokomotīvu remonta centrs", "VRC "Zasulauks"" and LLC "Apsardze" were established. By the end of 2005 it is envisaged to establish new daughter companies "LDz Cargo", which will handle

cargo transportation, and “LDz infrastruktūra”, which will be the administrator of the railway infrastructure, thereby completing restructuring of the sector.

In relation to restructuring, the Saeima has adopted amendments to the Railway Law, which prescribe that setting the infrastructure usage charge is not allowed not only to the commercial company itself, which provides transportation services (as until now), but also to any other administrator, which is related to the respective institution on a contractual basis. Thereby the Commission will set the railway infrastructure usage charge also in the future.

6.10. Export Promotion Policy

The main problems in export are closely linked to the implementation of educational, industrial business and innovation policies, as well as development of transport sector and infrastructure. At present, the main problems are as follows:

- even though the number of student places financed by the state budget funds in engineering study programmes is growing, the shortage of skilled labour force in production becomes increasingly acute and substantially hinders faster increase in export volumes; manufacturing enterprises are short of skilled marketing specialists; knowledge of foreign languages is insufficient; migration of the labour force to the foreign countries is taking place; insufficient marketing of the leading sectors of national economy in schools of Latvia, aimed at encouraging the influx of young labour force into production, and information of the Latvian society about the importance of production in development of national economy;
- lack of co-operation between Latvian enterprises, and the scientific potential, insufficient information on possibilities to create and develop innovative products and on opportunities of co-operation with Latvian scientists; low activity of enterprises in absorption of the financing available from the EU Structural Funds for development of new products and technologies;
- products of low added value make up 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 the lack of current assets;
- Latvia as a country is still little recognisable outside the Baltic Sea region, a single image (brand) of Latvia is not yet developed;
- 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 forming the basic activity of the enterprise (for example, logistics) are performed. Supplies by 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 the main ports of Latvia.

As the mentioned problems embrace wide range of issues, they have to be solved in an integrated way.

Objectives and main tasks of the export promotion policy and the results to be achieved are determined by the **Latvian Export Promotion Programme for 2005-2009** (hereinafter – LEPP).

The objective of LEPP is to actively promote international competitiveness of Latvian enterprises and to foster entry into new markets and consolidation in the current ones.

The main lines of action of LEPP 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 in the entry into new markets;
- financial instruments for export promotion.

To provide assistance to Latvian enterprises in export promotion in accordance with LEPP lines of action, several measures are envisaged, which are being implemented within the framework of the annual LEPP action plan.

The **Export Promotion Council** chaired by the Minister of Economics supervises the implementation of LEPP. The Council is made up of representatives of public institutions and sectoral associations as well as social partners. Several meetings of the Council took place in 2005, during which discussions were held on priorities and the necessary measures for promotion of international competitiveness of Latvian enterprises and for export promotion.

During the Council's meeting on October 27, 2005 a draft work plan for 2006 was reviewed. Suggestions of sectoral associations for export promotion were taken into account in development of the draft. Among the most essential issues raised by sectoral associations were the necessity to get information about foreign markets, seminars on export skills related to entry into external markets, and support to participation of enterprises in the national stands at international exhibitions.

The Ministry of Economics, consulted by sectoral associations with a view to improving and simplifying, is elaborating state support programme "Support to Consultations and Participation of Commercial Companies at International Exhibitions, Fairs and Trade Missions" in order to ensure that sectoral associations and enterprise associations can apply for participation at international exhibitions and missions in 2006, organising participation of enterprises in joint stands at the exhibitions. Application for individual participation at exhibitions is often too expensive for small and medium-sized enterprises, hence the financing from EU Structural Funds for this programme is not fully used.

The link to the **Development Concept of Foreign Economic Representative Offices of Latvia** is essential for LEPP. Implementation of the Concept substantially contributes to strengthened competitiveness of Latvian entrepreneurs in the global market, especially in the EU internal market. With establishment of a network of foreign economic representative offices abroad and consolidation of Latvian Investment and Development Agency (hereinafter – LIDA) as its support institution in Latvia, Latvian entrepreneurs are provided with the help and services similar to those received by their competitors and partners in the EU member states. International trade, including export, is a significant part of the Lisbon Strategy. Without the state support infrastructure, Latvian entrepreneurs would not be able to fulfil the goals and requirements defined in the Lisbon Strategy.

At present, nine foreign economic representative offices of Latvia operate abroad (in Germany, United Kingdom, Sweden, France, Russia, Kazakhstan, Netherlands, Norway and Denmark). It is planned to open a representative office in the US at the beginning of 2006.

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. Capacity of representative offices was increased in 2005, ensuring 2 employees in the offices with the most intensive flow of investment/export demands and supplies and the largest amount of work, e.g., in the United Kingdom, Germany, etc.

Operation of representative services takes place in the three main directions: identification and channelling of the potential investment and export projects, services for Latvian enterprises, distribution of information to foreign companies on the economic situation and business environment of Latvia.

The Ministry of Economics and the LIDA have organised two forums for Latvian entrepreneurs in 2005, where leaders of all 9 representative offices took part. Within the framework of the forum on June 16-17, 2005, more than 200 enterprises were acquainted with opportunities for co-operation with Norway, Denmark and France, and individual meetings with the leaders of representative offices also took place. Within the framework of the forum on December 8-9, 2005, the enterprises were acquainted with German, Swedish and Japanese markets, specific market requirements and useful business contacts. The enterprises also had an opportunity to meet individually the leaders of all representative offices.

External marketing is one of the main export promotion instruments. The Ministry of Economics in co-operation with LIDA and other institutions carries out several external marketing measures. Foreign visits of state officials with participation of Latvian business delegations constitute one of them. In 2005, visits to the Netherlands, France, Switzerland, Norway, the US, Sweden, Turkey, Germany, United Kingdom, Italy, Georgia, Azerbaijan, Armenia and other countries took place. In total, more than 300 enterprise representatives have participated in these visits.

Participation of Latvian enterprises in LIDA stands at 5 international exhibitions, which play a leading role in the respective sectors has been organised with a higher quality this year. 35 enterprises participated in

the joint stands of LIDA and enterprises. LIDA in co-operation with representative offices organised campaigns of direct marketing before these exhibitions, addressing and inviting potential co-operation partners of Latvian enterprises to the stand and thereby ensuring good attendance of the stands and high-quality business contacts. Contact exchanges of enterprises and seminars on the potential of Latvian sectors were additionally organised within the framework of several exhibitions.

Several trade missions abroad of Latvian enterprises were organised in 2005. In their framework, an individual business programme is prepared for each entrepreneur. The range of consultations rendered by LIDA to Latvian enterprises was expanded 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 about Latvian sectors and their leading enterprises, marketing brochures have been issued in machine building and production of horizontal beams, and it is planned to issue marketing brochures in food industry, electronics, textile industry, chemistry and pharmacy by the end of the year.

Box 6.19

“The most export-capable product of Latvia” competition

In the LEPP framework, the Ministry of Economics has started a new tradition, establishing the annual award “The most export-capable product of Latvia” awarded to Latvian enterprises for their achievements in export. The aim of this award is to promote competitiveness of Latvian enterprises in foreign markets, as well as increase in volume and quality of product and service exports, assessing enterprise performance during the past year and appreciating the most successful export products and services.

The award is given on the results of an open competition in three categories – product/service with the most rapid increase in export volume; the new export product/service; the most innovative solution of product/service export.

In 2005, 33 enterprises from the whole Latvia applied for “**The most export-capable product of Latvia 2004**” competition that was organised by the Ministry of Economics in co-operation with the Latvian Investment and Development Agency. All sectors were represented, namely, food production, wood-processing, IT, chemistry and pharmacy, machine building, and metal processing. **Winners of the 1st place** in the three categories of this competition are: JSC “Grindeks” (“Mildronāts” medicine, for the **most rapid increase in export volume**); LLC “BFDF” (“PYTHON” chair as the **new export product**); LLC “Varis Toys” (“VARIS” wooden toys as the **most innovative export solution**).

It is planned to announce application of enterprises for the “Latvian most export-capable product 2005” award at the beginning of 2006.

6.11. Protection of Consumer Interests and Market Surveillance

The system of consumer rights protection in Latvia gradually strengthens and develops during the recent years (see Box 6.20). Regular drafting and acceptance of normative acts regulating rights and duties and relations between consumers and producers, sellers, service providers and other stakeholders, as well as normative acts stipulating requirements for goods and services and procedure of labelling is an on-going process. At the same time, a lot of efforts are focussed on the institutional capacity building to ensure adequate market surveillance and supervision of consumer rights protection.

Development of several normative acts in the area of consumer rights protection is taking place in the European Commission, and the Ministry of Economics has engaged in this process.

On October 7, 2004 the European Council adopted the Regulation of the European Parliament and the Council on co-operation between national authorities which are responsible for enforcement of legal acts in consumer rights protection (Regulation on Consumer Protection Co-operation). This regulation prescribes conditions according to which the member states’ competent authorities that are indicated as responsible for enforcement of consumer protection acts co-operate between themselves and with the Commission in order to ensure observance of the legal acts mentioned in the regulation and successful operation of the internal market and to strengthen protection of 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 provides information at its disposal and investigates the case. The competent authority has to take compulsive measures for prevention of consumer rights violations and ensuring observance of normative acts. Thus a solution of cross-border problems will be provided in cases when a businessman from one member state has committed a violation in other member state. The regulation will come fully into force in 2006.

Directive of the European Parliament and the Council on unfair commercial practices against consumers in the internal market has been adopted. The directive determines uniform regulation for commercial practices in the EU and harmonises EU requirements in relation to unfair commercial practices between business and consumer, preventing barriers created by different national regulations. It is aimed at facilitation of cross-border trade and clarification of consumer rights.

Box 6.20

Policy planning and development of normative base

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 as follows:

- protection of consumer health and safety;
- protection of economic interests of consumers;
- opportunity for consumers fulfil their rights, including the opportunity to receive reimbursement;
- consumers' opportunity to receive information and consumer education in schools;
- opportunity for consumers to represent their interests by organising consumer groups and taking part in decision-making processes.

This policy is aimed at ensuring high-level consumer rights protection, by accentuating consumer rights in the developed normative acts and including consumer rights protection issues into other policies, and at 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:

- 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' awareness related to 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, the Cabinet of Ministers approved **Consumer Rights Protection Programme for 2005-2007** on April 27, 2005, and the programme will be developed for 2008-2010 as well.

The programme 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.

Amendments to the **Consumer Rights Protection Law** were developed in 2005, which specify the definition of a "consumer" and prescribe consumer rights and responsibility of the plastic card issuer in all cases where consumer's plastic card has been used unlawfully.

Supervision of consumer rights

The Consumer Rights Protection Centre (hereinafter – 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 and 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 normative acts, gives consultations on consumer rights protection legislation and compliance of goods, and co-operates with international consumer rights protection bodies and national institutions of other countries. The Centre is actively engaged in providing information to consumers, preparing and disseminating reminders on consumer rights protection issues, giving interviews and comments to mass media, delivering lectures to students of comprehensive schools and placing publications in regional press on these issues. Information on the Centre's website www.ptac.gov.lv is updated regularly as well as on the website www.pateretajacelvedis.lv of non-governmental organisations of consumer protection. These websites contain information on the consumer rights protection legislation in force, various goods and services, and opportunities to protect legitimate rights of a consumer.

In 10 months of 2005 the Centre carried out 3581 inspection visits to trade and service companies (sites), provided 2751 consultations to entrepreneurs and 16 100 consultations to consumers, reviewed 1131 cases of administrative offences in the area of consumer rights protection and 810 applications and

complaints of consumers, 411 of which were settled in favour of consumers, while 203 applications and benefits proved to be unfounded. During that period of time 1207 inquiries of entrepreneurs with a request to announce experts for examination of goods and services were reviewed. Carrying out inspection visits to 2317 trade companies, 580 service provision sites and 684 public catering companies, the Centre recognized 2768 offences. As a result of the review of consumer applications, consumers got refunds of money paid for goods or services that do not comply with the agreement. Total amount of refunded money comprised 79 532 LVL. In their applications, consumers have presented claims about:

- non-observance of the principle of legal equality of contracting parties – 18 times,
- provision of incomplete information – 37 times,
- incorrectly set payment for purchase and weight or measure – 21 times,
- violations of review of claims – 341 times,
- non-issuance of documents attesting to the transaction, and other offences – 116 times,
- services that do not comply with the agreement – 237 times,
- goods that do not comply with the agreement – 400 times.

Consumer applications mostly include complaints about footwear, electric appliances, mobile phones, textiles, and recently also complaints about terms of credit agreements.

During review of applications and complaints, employees of the Centre actively co-operate with employees of other state institutions (State Revenue Service, Public Utilities Commission, Food and Veterinary Service, Rent Board, Latvian National Metrology Centre, etc.), asking to give opinion and assessment in specific consumer cases. On June 16, 2005 an agreement of co-operation in market surveillance and consumer rights protection between the Consumer Rights Protection Centre of the Republic of Latvia, Consumer Protection Board of Estonia, Estonian Technical Inspectorate and State Non-Food Products Inspectorate of Lithuania was concluded. Successful co-operation has developed and joint projects for 2006 are being planned.

Until November 2005 the Centre issued 24 administrative acts on unfair terms of an agreement, demanding to cease fulfilment of the unfair terms of agreements concluded with a particular consumer and agreements concluded with other consumers, and to alter draft agreements offered to consumers. Four of these administrative acts are issued on unfair terms of agreement in consumer crediting agreements, and four are issued on unfair terms in real estate purchase agreements. In order to prevent deception of consumers concerning credit costs, in November and December the Centre assesses draft credit agreements offered to consumers, including whether in these draft agreements loan providers have indicated annual interest rates calculated in accordance with the Cabinet of Ministers Regulation No. 257 “*Regulations Regarding Consumer Credit Agreement*” adopted on June 13, 1999.

The most frequent unfair terms in agreements with consumers are as follows:

- terms prescribe settlement of disputes only by the court of arbitration;
- prescribe disproportionately big penalty to be paid by a consumer in case of non-fulfilment or inadequate fulfilment of contractual obligations;
- infringe upon legitimate rights of consumers;
- prescribe service provider’s rights to alter terms of agreement unilaterally.

The Centre has also issued 20 administrative acts regarding fulfilment of legitimate demands of consumers and 8 executive instructions which allowed forced fulfilment of administrative acts regarding legitimate demands of consumers.

In the framework of legal assistance 160 consultations were provided to consumers, decisions to fulfil legitimate demands of consumers were taken and 4 references were given.

Carrying out the supervision of advertising, 6592 advertisements were assessed and 14 applications and complaints about advertising were reviewed by November 2005.

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, European Consumer Centre of Latvia was established at the Centre on July 18, 2005. European Consumer Centre of Latvia:

- provides information about legislation and legal practice of EU member states;
- gives adequate informative support to start solving conflict situations between individuals;
- provides information about judicial procedures and possibilities to take legal proceedings;

- co-ordinates possibilities of settling consumer disputes out of court;
- gives opportunity for consumers to settle cross-border disputes rapidly and effectively, especially in cases where practical problems arise, e.g., providing translation;
- helps consumers in addressing their complaints so that this addressing is done in accordance with the established out-of-court procedures.

From July 18, 2005 to November 1, 2005, European Consumer Centre of Latvia reviewed 22 consumer applications and gave consultations regarding them. The biggest number of received complaints was about passenger rights pertaining to air transportation. It is possible to contact European Consumer Centre employees by e-mail info@ecclatvia.lv.

On October 4, 2005 a Bureau Veritas certificate was issued to the Centre, ascertaining that the management system is audited and acknowledged as complying with requirements of ISO 9001:2000 standard in the area of review of consumer complaints and provision of information to consumers.

Market surveillance

In order 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 also includes actions taken by the Centre 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 order to ensure effectiveness of carried out inspection visits, the Centre carries out joint inspection visits with other institutions involved in market surveillance. The main co-operation partners in market surveillance are the State Construction Inspection, State Labour Inspectorate and SJSC “Elektronisko sakaru direkcija” (Electronic Communications Office). In July and August 2005 inspectors of the Centre together with representatives of the Latvian National Association of Consumer Protection carried out inspection visits to toy trade sites and selected samples of toys in the framework of the project “Strengthening Consumer Confidence in Safety of Large Range of Products”. The selected samples of toys were brought to the state LLC “Latvijas Sertifikācijas centrs” (Latvian Certification Centre) for examination in order to determine their conformity to safety requirements. According to conclusions, only one sample conformed to the established safety requirements (final results will be summarised at the beginning of 2006).

On May 31, 2005 the Cabinet of Ministers approved Regulation No. 350 – a new composition of the Market Surveillance Council, which ensures exchange of information and opinions between market surveillance authorities and promotes uniform approach to market surveillance in all institutions.

In order to ensure co-operation of goods’ producers and distributors and service providers with market surveillance and control authorities and thereby to achieve a higher level of consumer rights protection, preventing entry of goods which are unsafe and hazardous to consumer health into market, and to promote fair competition, the Cabinet of Ministers at the end of the year 2005 adopted Regulation “Procedure by which Market Surveillance Authorities Inform the Consumer Rights Protection Centre about the Performed Measures which Restrict or Prohibit Putting Goods into Circulation, and 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 the Regulation “Procedure by which a Goods Producer, Distributor or Service Provider Informs Appropriate State Supervision and Control Authorities about Goods or Services which Create Risk Non-Compliant with General Safety Requirements” was developed and submitted to the Cabinet of Ministers for approval.

International co-operation also plays an important role in consumer rights protection. The Centre participates in the Rapid Information Exchange System (RAPEX) that operates between EU member states. From this system the Centre receives information on dangerous goods sold in other EU member

states. On the basis of this information, strengthened control measures are carried out, and this information is released to consumers by mass media.

PHARE 2002 project “Market surveillance in non-food area” of the EU is being implemented in Latvia (see Box 6.21). This project is generally aimed at achieving free movement of goods in non-food area (except medical goods) in order to strengthen capacity of market surveillance authorities in all areas except ones related to food, pharmaceutical products and medical goods.

Box 6.21

EU PHARE 2002 project “Market surveillance in non-food area”

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 of this year, and during implementation of this project a profound analysis of the 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 completed in September 2005. In its framework the following main goals were achieved:

- information exchange system between market surveillance authorities (L-Rapex) was created;
- database system was developed;
- quality management system was introduced at the Centre;
- training on risk assessment system and professional training in specific areas were ensured for employees of market surveillance authorities;
- information on issues related to market surveillance was provided to consumers and businesses through mass media, TV advertisements and widely accessible informative materials – brochures and booklets. Informative campaign “Get acquainted with your commodity!” was carried out in August 2005.

In the framework of the 3rd component “Supply contract”, technical equipment is being purchased for market surveillance authorities.

As a result of the project, the market surveillance system is being strengthened on a whole and high level of consumer protection is being ensured in the area of non-food products in Latvia.

6.12. Quality Assurance

6.12.1. Quality Structural Policy

The main task in the area of quality assurance includes promoting observance of requirements of normative acts in the regulated and non-regulated sphere as well as improving the legislative base, hence encouraging increased competitiveness of entrepreneurs and ensuring compliance of products and services in use and in the market with national and EU requirements.

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 several regulations of the Cabinet of Ministers.

The main directions of the policy are:

- 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, promote growth of competitiveness of entrepreneurs and reliability of products and services provided by Latvian entrepreneurs;
- improvement of the informative base in order to inform inhabitants and entrepreneurs of Latvia on the newest requirements of national and EU normative acts;
- participation of national institutions of accreditation, standardisation and metrology in international organisations, ensuring their recognition at international level and thereby also adjustment of compliance of Latvian quality assurance system to international requirements;

- maintenance and international comparison of the national base of standards in order to ensure the necessary traceability of measurements and protect the society from inaccurately conducted measurements;
- maintenance of Latvian national standards and other related documents, development of Latvian national standards and adaptation of international standards in order to ensure equal requirements for all concerned parties both in regulated and non-regulated spheres, at the same time facilitating and promoting conduction of business activity within the framework of the European Community market;
- encouraging introduction of quality management system, environmental and other voluntary quality systems within enterprises in order to ensure manufacturing of higher-quality products and provision of higher-quality services as well as competitiveness of Latvian companies in international markets;
- improvement of market surveillance system in order to provide equal conditions for all market participants and protect consumers from actions performed by entrepreneurs.

In order to foster development of Latvian national economy and of the sector, the following activities have been carried out in the first 3 quarters 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”;
- draft regulations on national accreditation, standardisation and metrology councils have been worked out 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 newspaper) and their notification to the European Commission and other EU member states as well as publication of EU conformity assessment institutions in “Latvijas Vēstnesis” in accordance with requirements of the Law “On Conformity Assessment” were ensured;
- adaptation of standards regulating conformity assessment area was ensured;
- supervision of measuring instruments offered in the 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 throughout EU, including protection of Latvia’s interests.

In order to improve legislative and informative base as well as infrastructure of the quality assurance system, it is planned to carry out the following activities in 2006:

- draft normative acts in the field of metrology in order to fully harmonise national requirements with EU requirements and amendments to the Law “On Uniformity of Measurements”, thereby aligning the legal environment of business and metrology supervision;
- ensure transition to notification of conformity assessment institutions accredited in the regulated sphere to the European Commission and other EU member states in the electronic form;
- develop the informative report in order to improve society’s understanding about unclear issues in the area of standardisation;
- inform the society about topicalities in the field of quality assurance in order to deepen society’s understanding of these issues;
- organise the annual international quality conference and the Latvian Quality Award 2006 in co-operation with the Latvian Association for Quality in order to popularise quality assurance as a way for raising the business competitiveness.

6.12.2. 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 on 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 base 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 work of these committees. Producers, users, organisations of consumer interests' protection, certification, testing, accreditation, control and supervision, and other parties related to the use of standards are considered the concerned parties.

16 168 standards have been registered as Latvian national standards as of November 1, 2005, among them 1347 European standards were adapted during the first 10 months of 2005. Standardisation information services were provided to 7650 legal and physical persons in the first 10 months of 2005.

Metrology. The LLC “Latvijas Nacionālais metroloģijas centrs” (LNMC) is the national metrology institution that ensures uniformity of measurements in the Republic of Latvia and international traceability and recognition of measurements conducted in Latvia, in this way encouraging international trade and confidence in conformity assessment of goods carried out in Latvia, in order to exclude necessity of repeated conformity assessment procedures.

The main objective of LNMC 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 LNMC are:

- to maintain national measurement standards at appropriate level;
- to provide metrological services corresponding to Latvian national economy interests (calibration and verification of measuring instruments);
- to co-operate with international metrology institutions and national metrology institutions of other EU member states.

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.

Activities of laboratories to ensure international recognition of calibration and measuring capabilities (CMC) are continued, and in their framework the CMC of LNMC were recognised by the Technical Board of EUROMET and included in the inter-laboratory Key Comparison Database (KCDB) of the International Bureau of Weights and Measures (BIPM) (geometric measurements – on March 22, 2005, and mass measurements – on October 11, 2005).

Active participation in the working groups of the European Co-operation in Legal Metrology (WELMEC) takes place in the area of regulated metrology.

321 270 measuring instruments were checked in the first 10 months of 2005, among them 300 384 instruments verified and 20 886 instruments calibrated.

State metrological supervision. The state metrological supervision in Latvia is carried out by the State Metrological Inspection (SMI), which is a direct administration body under authority of the Ministry of Economics and operates according to the Regulation No. 174 “Statute of the State Metrological Inspection” adopted by the Cabinet of Ministers on March 8, 2005.

The aim of SMI operation is to ensure accuracy and credibility of measurements in areas that affect human life and health, environmental health and safety as well as consumer rights protection.

SMI controls and supervises compliance with requirements set in normative acts of measuring instruments offered in the market in the regulated sphere, performs state metrological supervision of measuring instruments handed over for use and carries out metrological control of pre-packed goods in line with the Law “On Uniformity of Measurements”. Latvia as EU member state has to guarantee that the actual content of the package of “e”-marked goods produced in Latvia conforms to requirements of

the respective EU directives and related national legislation. Achievement of this goal requires periodic and efficient control in enterprises producing pre-packed goods. SMI officials are authorised to draw up reports regarding administrative violations and impose administrative penalties for non-observance of metrological requirements, in accordance with provisions of the Code of Administrative Violations of Latvia.

In the first 10 months of 2005, SMI has carried out checks in 2502 enterprises, subjecting 33.8 thousand measuring instruments to state metrological supervision. Control of pre-packed goods was performed in 30 enterprises.

SMI constantly co-operates with metrological supervision institutions of other countries and participates in the European Co-operation in the Legal Metrology (WELMEC) working groups WG4 "Legal Metrology", WG5 "Metrological Supervision" and WG8 "Implementation of Measuring Instruments Directive 2004/22/EC".

Accreditation. The state agency Latvian National Accreditation Bureau (LATAK) is the supervisory authority of the Ministry of Economics and operates on the basis of the Law "On Conformity Assessment", the Cabinet of Ministers Regulation No. 689 "Regulations on Accreditation and Supervision of Testing and Calibration Laboratories, Certification and Inspection Institutions and Environmental Verifiers" adopted on August 3, 2004, and the Cabinet of Ministers Regulation No. 498 "Statute of the State Agency "Latvian National Accreditation Bureau"" adopted on September 2, 2003.

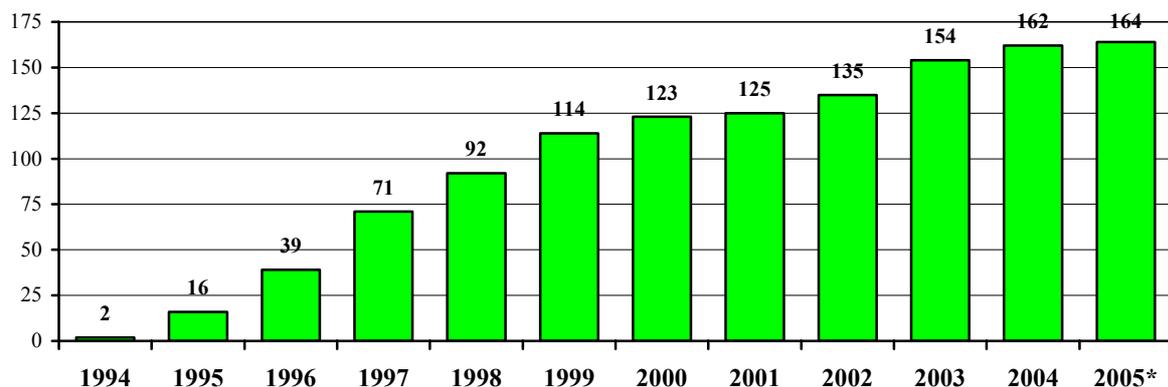
According to the Law "On Conformity Assessment", the main LATAK functions are:

- to evaluate, accredit and supervise testing and calibration laboratories and certification and inspection institutions in conformity with the prescribed requirements of Latvian national standards, normative acts, and European or international standards;
- to organise and co-ordinate inter-laboratory comparative testing in compliance with Latvian, EU and international requirements;
- to represent Latvia at international accreditation organisations;
- to maintain and update the informative base of accredited institutions.

Number of accredited institutions has increased by 2 institutions in 2005 in comparison with 2004 (see Figure 6.9). Accreditation was maintained for 164 conformity assessment institutions in total. In 2005, 13 institutions were accredited, accreditation was cancelled for 11 institutions, 23 institutions were reaccredited, 92 supervision visits took place, and 9 accreditations for assessment of sphere expansion were performed.

Figure 6.9

Development Dynamics of the National Accreditation System



* as of October 1, 2005

LATAK has developed a modular training system for LATAK experts, assessors and leading assessors in accordance with recommendations of the European Co-operation for Accreditation (EA) and the International Laboratory Accreditation Co-operation (ILAC). 14 seminars were organised and 161 participants attended training in 2005.

In 2005 LATAK organised 32 bilateral proficiency tests for 22 laboratories and 2 inter-laboratory comparative testing programmes for 5 laboratories, co-ordinated 2 proficiency testing programmes and participated in several committees and working groups – EA Laboratory Committee, meeting of the Multilateral Recognition Agreement (MLA) – EA MAC Committee, EA Inspection – Certification Technical Committee, meeting of the working group of EUROMET-EUROCHE, meeting of the working group on Good Laboratory Practice (GLP), working group meeting “Influence of the Principles of the Kyoto Protocol on the Baltic States – Opportunities in Energy Sector and in Trade of Emission Quotas”, etc. Co-operation with accreditation organisations of other countries continues.

LATAK also provides accreditation services abroad. At present, one testing laboratory and one personnel certification institution are accredited by LATAK in Ukraine.

6.13. Privatisation

After Latvia regained its independence, it became vital for the national economy interests to make the transition from a planned economy to a market economy based on private property and private initiative. In order to achieve this goal, rehabilitation of the ownership rights (denationalisation) and mass privatisation of properties owned by the state or 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 properties;
- secondly, 75% of gross domestic product is made up by the private sector, which employed 74% of Latvia’s economically active population at the end of 2005.

Taking into account the results of the reform, rearrangement from the creation of private entrepreneurship to its development was important from the aspect of Latvian national economy.

According to the Declaration on the planned activities of the Cabinet of Ministers headed by Aigars Kalvītis, transition from privatisation to the procedure of alienation 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 the 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 normative acts, and the issue of privatisation certificates will be stopped.

For this purpose, the “Law on Completion of the State and Local Government Property Privatisation and Use of Privatisation Certificates” (hereinafter – Privatisation Completion Law) and the respective amendments to other laws related to the status of permanent user of the state land, procedure of redemption determined by the land reform laws, procedure of privatisation and alienation of the state and local government property, and issue and use of privatisation certificates were developed and adopted by the Saeima. The Privatisation Completion Law came into force on September 1, 2005.

The Law stipulates that persons may submit a proposal on privatisation or land redemption of the respective state or local government property by August 31, 2006. It also determines the procedure and terms, by which the Cabinet of Ministers and the local government council review the privatisation proposal and adopts a definite decision. Privatisation certificates do not have an expiry term anymore but their use is limited in the framework of privatisation and land reform.

At the same time the Law stipulates that shares of such state joint stock companies important to national economy and the society 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 the state-owned property units

Privatisation of the 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 the 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 or 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 December 1, 2005, privatisation rules have been approved in the statutory procedure for 2162 state property units (except land), including tax payment capitalisation (159 units), and 2732 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 sales of shares created as a result of capitalisation (98 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 were 1.75 billion LVL, including 1.262 billion LVL for privatisation certificates. New owners took over obligations of privatised state companies (enterprises) for more than 176 million LVL. The amount of the specified investments was 130 million LVL while the amount of investments actually invested reached 252 million LVL.

Privatisation Agency carries out privatisation of the state-owned lands since 1997. 3442 state-owned lands (78.5% of all land put up for privatisation) with the total area of 5501.1 hectares have been privatised (purchase agreements signed) by December 1, 2005. Total sales price for the privatised state lands 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 the local government property

Privatisation of the 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, province). According to the provisions of the Law “On Privatisation of Property Units Owned by the State and Local Governments”, it is the responsibility of the Ministry of Economics to supervise the work of these commissions (ascertain compliance of privatisation projects and rules with normative acts).

From February 17, 1994 till December 1, 2005 the Ministry of Economics has reviewed and accepted for information 2939 privatisation projects for the total relative price of 92.6 million LVL (including payments in certificates for the nominal value of 55.8 million LVL).

From January 1, 1997 till December 1, 2005 the Ministry of Economics has reviewed and accepted privatisation rules in respect of 1503 built-up and vacant local government lands with the total value of 17.8 million LVL (of which 12.4 million LVL have to be paid in property compensation certificates).

Privatisation of the apartment houses

Privatisation of the apartment houses in Latvia was started in 1995. By December 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” 28 201 state and local government apartment houses with 492 037 apartments or 99.08% of the total number of apartments (496 588). 193 703 apartments have been handed over to private owners by a resolution preceding privatisation of the apartment house.

There are 405 206 state and local government apartments privatised (purchase agreements signed) in Latvia by December 1, 2005, making up 81.6% of the total number of apartments. Apartment owners so far have taken over management of 8611 apartment houses, including 5301 local government apartment houses and 3310 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: 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, 324 CSAOs have been founded in Latvia, including 216 CSAOs in seven biggest cities and 108 CSAOs in various districts of Latvia. So far the biggest number of CSAOs have been founded in cities of Rīga and Ventspils and in Kuldīga and Valmiera districts. Authorisation agreements for house management have been signed for 2591 apartment houses.

Land reform

State land reforms include restoration of property rights, privatisation of the state and local government land properties and allocation of free land cognizable to the state for permanent use, and redemption of the allocated land. Land redemption and privatisation of lands is being carried out in relation to the rural and urban land reform under way in the country.

The reform of the rural and urban land cognizable to the state is close to completion. All claims for the urban land have been reviewed and decisions made about granting ownership to land for pay, but conclusion of purchase agreements is continuing (1019 agreements in the first 3 quarters 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, the JSC “Latvijas Hipotēku un zemes banka” (Mortgage and Land Bank of Latvia) has signed a total of 259 400 land purchase agreements (8695 in the first 3 quarters of 2005) for sale of 1.448 million hectares of land (59 167 hectares in the first 3 quarters of 2005).

As of January 1, 2005, the free (unclaimed) state land area amounted to 16.6 thousand hectares, and 666 thousand hectares of land cognizable to the state were given to 117 thousand physical persons for permanent use.

Privatisation certificates

Privatisation certificates are being issued and used according to the Law “On Privatisation Certificates”. By November 1, 2005 a total amount of 103.9 million privatisation certificates have been issued to 2.45 million people for the time they have lived in Latvia, including 789.2 thousand certificates granted to 40.8 thousand politically repressed persons. 7.84 million property compensation certificates have been issued to 114.2 thousand former owners or their heirs, including 691.7 thousand certificates for property appropriated for state needs at the privatised specialised state agricultural enterprises, 4785.2 thousand for land in rural areas, 948.1 thousand for house ownership, 783.6 thousand for urban land, 460.5 thousand for companies and other property units, 89.8 thousand for property taken away from politically repressed persons, and 81.8 thousand for property alienated in illegal manner.

In the 3rd quarter of 2005 a total of 75.5 thousand property compensation certificates have been granted to 1.5 thousand former owners or their heirs.

According to the Law “On Privatisation of Land in Rural Areas”, 11 067 decisions have been made by November 1, 2005 about payment of cash compensations for former land ownership in rural areas. Compensations in the total amount of 17.45 million LVL have been paid to 8408 persons, cancelling 0.62 million property compensation certificates.

Table 6.3

Use of Privatisation Certificates

(by November 1, 2005)

Type of property	Number	Number of privatisation certificates (million)	incl. property compensation certificates (thousand)
Apartment houses	425 thousand privatised housing units	35.07	582.1
Companies and other properties	accurate data not available	7.11	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 lands	15.19	5089.1
Total:		101.77	6734.8
% of total certificates issued		91.1%	85.9%

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 by November 1, 2005.

101.77 million certificates or 91.1% of the total number of issued certificates have been used for privatisation of state and local government property units by November 1, 2005 (see Table 6.3).

As of November 1, 2005 a total amount of 3.88 million certificates or 3.4% of the total number of certificates issued, including 0.29 million property compensation certificates, were on accounts of 440 thousand physical persons.

Accounts of legal persons held 3.95 million privatisation certificates, including 0.16 million property compensation certificates, as of November 1, 2005.

Holders of privatisation certificates in November 2005 could use services of 20 licensed intermediary capital companies. Total monthly transactions with privatisation certificates (selling and buying from physical persons) carried out by intermediary companies in 2005 fluctuated from 0.14 million certificates in January to 0.29 million in September.

6.14. Public Private Partnership

Public private partnership (PPP) is a co-operation between a state or local government institution and an entrepreneur from the private sector whereby a public service or object is being transferred over to the private entrepreneur for a certain period of time and certain conditions on the basis of agreement in order to ensure public services, such as provision of drinking water, waste management, construction of road, etc. The state or the local government has traditionally provided these services using its own initiative and resources, while in PPP the private capital is involved in provision of these services, accordingly dividing financial and competence contributions, risks and gains.

In the “old” EU member states PPP has already become a traditional mechanism for implementation of public investment projects, allowing the public sector to carry out a substantial number of infrastructure projects.

PPP policy development

On January 20, 2000 the Saeima adopted the Concessions Law. However, PPP has not been widely used so far, and mere 14 comparatively small concession agreements are registered in the Register of Concessions, which is a very low indicator taking into account the huge need for investment projects in Latvia. There are several reasons, why the spread of PPP projects in the national economy is small, and the most essential of these reasons are the lack of experience in implementation of such projects and the general lack of knowledge on PPP.

To increase transaction potential of PPP, the Cabinet of Ministers approved the Concept on Promotion of Concessions (Attraction of Private Capital to Perform State Functions) in April 2002.

Through the implementation of the conception, the following most essential problems for the use of PPP mechanism were identified:

- public investment plans do not envisage an opportunity to develop public infrastructure and services through the use of the private capital, thereby both a successful PPP development is hindered and the opportunities, which could be provided by PPP are not used;
- lack of instruments supporting the PPP process, as 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 reduce administrative costs of preparation of the project, which sometimes comprise from 5 to 12% of the total costs of the project¹;
- lack of PPP projects conforming to the best international practice;
- lack of general knowledge on PPP mechanism.

In order to prevent these problems, on March 22, 2005 the Cabinet of Ministers approved the policy planning document “Basic Guidelines of Latvian Public Private Partnership Promotion” (hereinafter – Guidelines), which determine government policy, basic principles, targets and priorities in promotion of the use of public private partnership.

¹ Michael Klein (ed.): *Concessions for infrastructure. A guide to their design and award*, World Bank, www.worldbank.org.

Taking into account the Guidelines, on November 16, 2005 the Cabinet of Ministers approved the Action Plan for Implementation of the Basic Guidelines of Latvian Public Private Partnership Promotion for 2006-2009, setting the following lines of action for PPP promotion:

- 1) co-ordinated activity of institutions and organisations involved in the PPP process:
 - to establish advisory council of PPP,
 - to analyse responsibility and role of public administration institutions in the framework of the PPP process;
- 2) examination of PPP by sectors:
 - to conduct analysis of national economy sectors from the PPP aspect, identifying the most suitable sectors for carrying out PPP projects and the suitability of PPP model in the regional development context;
- 3) creation of instruments promoting the PPP process:
 - in 2006-2009 to carry out preliminary examination of potential PPP projects for assessment of suitability of PPP financing model,
 - to work out methodology of PPP project management cycle and update it on a regular basis,
 - to develop a standard contract of PPP project;
- 4) alignment of legislative framework:
 - to work out and submit to the Cabinet of Ministers the Concessions Law and binding Cabinet of Ministers Regulations, which would comply with EU directives,
 - to develop informative material about the new Law on Granting of Concessions,
 - to prepare annually and submit to the Ministry of Economics a report on the identified administrative obstacles to implementation of PPP projects and on normative acts' imperfections (by sectors) hindering implementation of such projects;
 - to prepare information about influence of PPP projects on the state budget and debt;
- 5) improvement of the knowledge and understanding of PPP:
 - to create a unified internet website about PPP, which would contain all required information – explanatory materials, normative acts, methodology and guidelines, standard documents, topicalities, executive update, information from abroad, most current links,
 - to organise informative seminars for public institutions about methodology of PPP project management cycle and standard documents required for preparation of PPP projects,
 - to develop a PPP communications strategy,
 - in accordance to provisions of the PPP communications strategy, to start fulfilment of tasks mentioned in the PPP communications strategy.

Improvement of legal environment

The Ministry of Economics has drafted the Concessions Law. New requirements of the Directive 2004/17/EC of the European Parliament and of the Council co-ordinating the procurement procedures on entities operating in the water, energy, transport and postal services sectors, and requirements of the Directive 2004/18/EC of the European Parliament and of the Council on the co-ordination of procedures for the award of public works contracts, public supply contracts and public service contracts have been transposed into the draft.

International consultants, the Swedish international legal consulting company “Manheimer Swartling”, have also been involved in the development of this draft law.

The draft was developed, also taking into account the United Nations Commission on International Trade Law (UNCITRAL) *Model Legislative Provisions on Privately Financed Infrastructure Projects* (adopted by the UN General Assembly Resolution of September 9, 2003), practice of international law, and experience of other EU member states (Lithuania, Czech Republic).

The drafted normative act prescribes creation of favourable environment for attraction of private capital to ensure public infrastructure and services, and a more transparent and more equal procedure for granting of concessions. The draft law was submitted to the Cabinet of Ministers in December 2005.

Support to implementation of potential pilot projects of public private partnership

The Latvian Investment and Development Agency (LIDA) in co-operation with the Ministry of Economics has started PPP promotion in two directions:

1) promotion of understanding of PPP;

The Ministry of Economics in co-operation with LIDA has carried out several activities to expand understanding on issues related to PPP. Specialists of the Ministry of Economics and LIDA have participated in and organised several activities, among them:

- a) passing knowledge on PPP to a wider society;
- b) development of methodical support instruments;
 - developed project of PPP project cycle manual including such issues as preparation, financial management, procurement, supervision of PPP projects,
 - developed methods “Procedure of how the financial and economic calculations are done to take decision on starting the procedure of obtaining rights to conclude concession agreement”.

2) direct work with PPP projects.

LIDA and the Ministry of Economics give advisory support to implementers of potential PPP projects, informing them about:

- a) the applicable type of PPP transaction;
- b) the applied conduction of procurement procedure;
- c) financial and economic calculations and procedure of doing them;
- d) the possible legal solutions of the project agreement;
- e) other PPP issues.

On October 13, 2005, five co-operation agreements with four local governments were signed at LIDA on starting the development of PPP projects in the state and local government sector. In a tender procedure, pilot projects submitted by local governments and involving possible use of PPP in their implementation were selected, namely, construction of dwellings with social housing in Salaspils, construction of new pre-school educational establishment in Cēsis, reconstruction of heat supply system in Jēkabpils, reconstruction and repair of town streets in Cēsis, and renovation of art school in Ogre. It is expected that after examination of these potential PPP projects the local governments will get reply whether it would be more useful to finance the public investment project in a traditional way or by attracting the private capital.

6.15. Advisory Councils of the Ministry of Economics

The National Economy Council of the Ministry of Economics (hereinafter NEC) was established in 1999 and operates as an advisory institution of the Ministry of Economics.

Founders of the NEC are the Ministry of Economics, Latvian Chamber of Commerce and Industry, Employers' Confederation of Latvia, Industrial Confederation of Latvia, Free Trade Union Confederation of Latvia, and Latvian Association of Local and Regional Governments.

NEC consists of the Minister of Economics and 21 experts designated by founders of the NEC, including representatives of entrepreneurs, public institutions and other organisations. Representatives of the Council of the Small and Medium Sized Enterprises and Crafts of the Ministry of Economics and of the Foreign Investors Council in Latvia participate in 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 per month. The meetings are chaired by the Chairman elected by the NEC Steering Committee (representatives of the NEC founders). NEC invites the industrial sector associations as observers to participate in the meetings.

Box 6.22**Action Plan of the National Economy Council**

The following important issues have been reviewed by the NEC in the period from June 2005 until December 2005:

- Action Plan of public private partnership policy for 2005-2009;
- National Lisbon Programme of Latvia;
- development of strategy of the National Development Plan;
- licensing procedure of the Higher Education programme;
- Market surveillance strategy;
- Latvian labour market problems;
- development of Latvian transport infrastructure.

In between the NEC meetings the recommending decisions of the NEC are taken by the NEC Steering Committee, which consists of six representatives of the NEC founders. Work of the NEC is organised by the Secretariat of the National Economy Council.

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 promulgated by the SSM.

NEC also co-operates with the Saeima, ministries and other public institutions in order to incorporate NEC's proposals into regulatory documents aimed at improvement of the business environment.

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 to the increase of the tax revenues. Experts of the NEC work actively with the working group of the Ministry of Finance dealing with assessment of the national taxation policy in order to reduce the tax burden on businesses and to enhance business development in Latvia.

NEC has unambiguously expressed the opinion, that successful absorption of the EU Structural Funds requires creation of procedures as simple as possible so that maximum number of projects submitted by the small and medium sized commercial companies of Latvia are implemented.

To promote the creation of the favourable environment for 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's implementation, studies have been conducted in the following four areas: analysis of the needs of enterprises in relation to innovations; capacity of innovations in the 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 the new innovation promotion and support programmes as part of the National Innovation Programme's (NIP) action plan for 2005-2006.

In order to ensure the professional representation of the interests of industries between the Ministry of Economics, NEC, other business organisations and public institutions, a model of co-operation with industries has been set up by the Ministry of Economics, whereby a **protocol of agreement on co-operation with the councils of experts of industries** and the industry associations, which correspond most of all to the functions of the Ministry of Economics and account for the biggest part of Latvian GDP, has been signed.

The Ministry of Economics and the NEC have signed such protocol with the following councils of experts (CE) of industries: CE of Machine Building and Metal Processing Industry, CE of Chemical and Pharmaceutical Industry, CE of Light Industry, CE of Construction Materials Producers, CE of Timber Industry, CE of Food Industry, CE of Construction Industry, CE of Passenger Carrier Industry, CE of Business Education and Management Advisers, CE of Tourism, and CE of Printing and Publishing Industry.

On signing the protocol of agreement, the parties agreed to unite their resources for development of programmatic documents, 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, with the aim to discuss implementation of the co-operation mechanism and problem issues.

The Council of the Small and Medium-Sized Enterprises and Crafts of the Ministry of Economics (hereinafter CSMEC) is an advisory institution of the Ministry of Economics.

CSMEC consists of representatives delegated by 28 non-governmental organisations representing small and medium-sized enterprises (SME) and business people (organisations of various sectors of economy and regional organisations of SME). The Ministry of Economics participates with an observer status.

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 has an aim to involve the non-governmental organisations of SME and the industry associations into development and implementation of the 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, which influence operation and development of SME.

CSMEC meetings are held once per month on average.

In between the meetings of the CSMEC, 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 operation the CSMEC has launched a positive and efficient dialogue with institutions representing businesses, the Ministry of Economics, the Latvian Investment and Development Agency and public institutions responsible for improvement of business environment in Latvia. The trend 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 their adoption by the Cabinet of Ministers, is positive.

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.

The council actively participated in finding the solutions to the issues related to improvement of the taxation policy.

For more detailed acquaintance with business environment in Latvian regions, the CSMEC organises visiting sessions on a regular basis. During these sessions, meetings with municipal leaders and specialists as well as businesses of the respective region are held, problems and needs of businesses are being discovered and solutions are being found collectively. In 2005, visiting sessions of the council have taken place in Liepāja and Ogre.

In the visiting sessions the main topics of discussion are business environment and development prospects in the respective region, municipal support for businesses, opportunities of businesses to use financing from the EU Structural Funds, as well as hindering factors.

In order to strengthen the role of the CSMEC in improvement of business environment and to ensure that the non-governmental sector is competently represented in absorption of the EU Structural Funds and aid programmes, the CSMEC members and representatives of its participating organisations are delegated for participation in the following councils, committees and working groups:

- EU Structural Funds Supervision Committee at the Ministry of Finance;
- Working group of the EU Structural Funds Steering Committee at the Ministry of Finance;
- National Information Society Council;
- Export Promotion Council at the Ministry of Economics;
- Advisory Council of the Latvian Investment and Development Agency;

- Working group for development of the National Development Plan for 2007–2013;
- Working group for national taxation policy assessment at the Ministry of Finance;
- European Economic and Social Committee (EESC) in Brussels.

Box 6.23**In 2005 the CSMEC has reviewed the following important issues at its sessions:**

- entrepreneurship risk state fee;
- problems of fictional business activity and their solutions;
- measures implemented in 2004 in the framework of the SME development programme and planned measures for promotion of the SME development in 2005;
- support to small food producers;
- information of the Food and Veterinary Service (FVS) about the procedure for performing control and listing its results and taking decision about publication of test results;
- procedure of simplified accounting in businesses and methodological materials to be used;
- cashier's checks that can be used as VAT accounts;
- draft informative report developed by the Ministry of Finance on opportunities to cancel use of invoices/bills for numbered goods acquired from the state;
- proposals for improvement of labour legislation;
- process of absorption of the EU Structural Funds, identified problems and their solutions, planned changes in state aid programmes;
- copyright issues regarding commercial activity;
- report on activity of Latvian experts in projects taking place 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;
- draft Cabinet of Ministers regulations "Regulations on Conditions for Providing Commercial Activity Support to State Aid Programme "Support for the Modernisation of Commercial Activity Infrastructure"" prepared by the Ministry of Economics and draft law "Law on Management of the Structural Funds of the European Union" prepared by the Ministry of Finance;
- draft directive of the European Parliament and the Council on services in the internal market, its impact on Latvian business environment;
- Action Plan of Export Promotion Programme for 2005;
- public private partnership policy;
- European Economic Area (EEA) and Norwegian financial instrument;
- process of optimisation of the penalty system;
- decision-making process in the European Union;
- amount of untaxed minimum in calculation of the personal income tax;
- basic principles of the National Development Plan for 2007-2013 and the process of its development;
- opportunities for absorption of financing from the EU Structural Funds and other funds in the planning period of 2007-2013 and setting priorities for increase of business activity competitiveness;
- draft National Lisbon Programme of Latvia for 2005-2008.

7. Recommendations

To ensure continued growth also in the future, it is necessary to maintain stable macroeconomic environment and promote competition, as well as continue implementation of structural reforms to increase productivity, improving business environment and infrastructure, raising efficiency, quality and accessibility of the educational and teaching system as well as its ability to respond to the labour market needs, and promoting science and research and innovation.

In our opinion, the most important and urgent objectives of the economic policy are as follows:

- **to limit inflation more actively**, considering possibilities to restrict accessibility of credit resources and reduce particular indirect taxes as well as stimulating entry of new market participators in those sectors, where competition is insufficient;
- **to ensure gradual decrease of the public budget deficit**. A public budget deficit in the amount of more than 1.5% of GDP is inadmissible in 2006, while in the following years one would consider possibilities to implement a more restrictive fiscal policy;
- **to introduce more consequently the strategic planning in ministries and medium-term budget planning**, thereby encouraging purposeful, far-sighted, co-ordinated, transparent and result-oriented use of available resources as well as a link of the *Single Strategy of National Economy*, the *National Lisbon Programme of Latvia* and strategic plans of ministries with the budget;
- **to continue the reform of public administration**, including introduction of a unified system of wages and strengthening the current public administration bodies so that Latvia in the EU would be able to operate as a full-fledged EU member state both fulfilling the new duties and using the opportunities and rights given to Latvia;
- **to use and get maximum benefit from EU funds**. Management process of the EU structural instruments has to be improved, focusing in particular on high-quality development of planning documents and establishment of an efficient system for absorption and supervision of EU funds. Special training programmes for Latvian officials and users of these funds have to be created;
- **to strengthen supervision of competition and encourage development of competition** to public benefit in all national economy sectors, timely identifying the risk sectors, where violations of competition law are possible, limiting administrative and other obstacles to competition. Along the *ex post* application of competition protection instruments, when market distortions are identified and investigation is under way in the framework of particular cases, to focus more actively on the use of *ex ante* preventive measures in order to prevent a possibility of such distortions;
- **to consequently implement opening of monopoly markets (electronic communications (telecommunications), electricity and gas supply, post and railway markets) to competition**. Transposing EU requirements on further opening of energy sector, electronic communications and post 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 increase choice opportunities for consumers, **connection of economically based infrastructure networks with networks of other EU member states 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 create conditions favourable to business activities and encourage rise of business culture**. *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. In improvement of business environment, it is necessary to envisage improvement of tax administration, lifting compulsory invoices for goods, 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 ease the legislative burden on business activity**, promoting simplicity, clarity, mutual harmonisation and transparency of the legislative process. Following the EU initiative for better legislation, active dialogue at EU legislation level has to be maintained and preconditions for introduction of better legislation at national level have to be explored;
- **to encourage development of local governments and ensure rise of their capacity**. It is especially important to implement the administrative territorial reform by local elections of 2009 in order to establish optimum administrative and organisational structure of local governments and promote their capacity;
- **to promote research and development (R&D) and innovation, especially in the private sector**. Measures have to be developed and carried out to promote co-operation between educational, research and national economy sectors, ensuring transfer of knowledge and technologies. National research programmes and principles for distribution of grants need to be improved. State assistance must be provided to innovative enterprises and infrastructure for development of research and knowledge centres, technological centres, business incubators and knowledge-intensive technology enterprises. Technologies Agency has to be established with the main goal to promote private sector investment in applied research, encourage transfer of technologies and ensure introduction of efficient research results in production;
- **to promote building the information society more actively**, raising availability of internet and introducing e-government of the state. It is especially important to accelerate introduction of electronic signature that is a precondition to ensure development of e-government;
- **to improve access to financing for SMEs**, promoting availability of credit resources, issuing guarantees for medium-term and long-term loans, ensuring allocation of finances for business development in early stage (measures for access to seed capital) and opportunities to receive preferential loans, promoting access to finances in the form of SME risk capital, as well as **ensure informative and advisory support to SMEs**;
- **to improve efficiency, capacity and quality of the educational and training system and its compliance with long-term labour market demands**. Co-operation between public administration bodies, educational establishments and employers in correction of educational system supply in accordance with labour market needs has to be strengthened, and cost efficiency in all stages and forms of education has to be raised;
- **to raise the level of technological skills and knowledge of natural science on the whole**, improve the system of professional orientation and ensure availability of professional orientation services for all population in the context of life-long learning;
- **to carry out the export promotion policy**, fostering expansion into new markets and consolidation in the existing ones. It is essential to provide the institutional base of export promotion and rise of its capacity, development of foreign economic representative offices, access to financial instruments and support to companies in export marketing. In order to strengthen international competitiveness of Latvian companies, it is necessary to ensure that border-crossing procedures (tariff and non-tariff barriers) do not raise unjustifiably the costs of raw materials, inter-consumption goods and services for Latvian companies and to promote bigger market access for exporters in third countries, especially in rapidly growing markets (Russia, China, India);
- **to promote introduction of quality assurance systems**. To support and foster introduction of such quality systems 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 improve and adapt to technical progress the established conformity assessment system**, co-ordinating the standardisation policy, ensuring international traceability of conducted measurements and promoting use of adequate measuring instruments, as well as promoting accreditation of conformity assessment institutions in the regulated sphere. Applying these conformity assessment instruments, Latvian companies and their products/services will have additional credibility also in other EU member states;
- **to ensure high level of consumer rights protection** through continued improvement of legislation, among other things, including consumer interest protection into other policies and strengthening the mechanism of its observance supervision. Special attention has to be

- focused on safety of goods and services, protection of economic interests of consumers, and informedness of consumers and entrepreneurs on consumer rights;
- **to encourage functioning of the EU internal market**, ensuring control over transposition and implementation of EU directives and preventing administrative restrictions, which hinder free movement of services;
 - **to manage efficiently the state-owned properties**, promoting alienability of state-owned real estate and capital shares that are not required 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 continue fight against corruption and money laundering as well as opportunities to operate in shady 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 the changes in EU normative acts and implementing preconditions for electronisation of the procurement process. Opportunities to prevent money laundering, which are prescribed by normative acts, have to be used more efficiently. It is essential to ensure access to information about public administration functions delegated to commercial companies, their implementation and legal control. This would promote more efficient use of funds and lessen possibility of corruption. Transparency of construction has to be ensured, establishing a publicly accessible single information system on construction, which would also include decisions of local governments in regard to construction.
 - **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 businessmen to understand and start using an entirely new instrument in provision of public services, thereby 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 for preparation and administration of PPP have to be made;
 - **to implement policy, which would lessen the socio-economic disproportion**. The primary task is to reduce unemployment, as it is the main cause for poverty and social exclusion. Special attention has to be paid to incentives for development of less developed regions. Real levers and instruments have to be created in order to stimulate entrepreneurs to invest in the depressive regions. It is important to create such system, where a person which receives benefit would become a taxpayer;
 - **to solve structural problems of employment**, supporting efforts to get adequate and higher skills in accordance with labour market needs and facilitating the labour mobility, especially through improvement of transport infrastructure;
 - **to reduce undeclared employment**, raising the minimum wages and increasing the non-taxable minimum in order to lessen the tax burden on low-paid wages, and raising administrative capacities of the State Labour Inspectorate, attracting additional personnel, improving control over observance of labour law norms, raising the level of society's awareness about labour law issues, and strengthening the role of trade unions and employer associations in business, encouraging entrepreneurs to unite in entrepreneurial organisations in order to create favourable environment for increased reputation of socially responsible business activity.

Consequently implemented economic policy, which is directed to the increase of productivity and to establishment of knowledge-based economy, will promote the convergence process and increase standard of living of population. However, it is essential to realise that successful development and economic growth of Latvia will depend not only on the work of public institutions, but also everyone's personal initiative in any location of Latvia in conditions of mutual understanding and dialogue within the society.