Ministry of Finance of the Republic of Latvia

Convergence Programme of the Republic of Latvia 2004-2007

December 2004

Contents

1. Overall Policy Framework and Objectives

The updated Convergence Programme clearly reflects the objective of Latvia's government to ensure compliance of the fiscal policy with the Stability and Growth Pact and to become a full-fledged member state of the Economic and Monetary Union.

The economic strategy of the government has a goal to ensure an improvement of the welfare of the population by achieving convergence with the average EU level within a foreseeable period.

In order to attain the above, Latvia needs to preserve robust and sustainable economic growth. The main basic directions of the economic policy to attain those objectives are:

- ensuring the macroeconomic stability;
- creation of business-friendly and economic functioning-friendly conditions;
- stimulating the establishment of an effective and competitive sectoral structure;
- reduction of socio-economic disparities and ensuring sustainable development.

One of significant instruments of the government to promote the economic development is implementation of a stable fiscal policy. The Cabinet of Ministers has undertaken to review the national fiscal and budgetary policy concepts, ensuring effective and transparent central government budget spending. In order to ensure the effectiveness of spending, the suitability of the existing resources for the operational priorities established by the government is analysed, the efficiency of the previous spending is evaluated and effective utilisation of the budgetary funds is ensured.

Declaration on the Planned Activities of the Cabinet of Ministers defines the following medium-term fiscal policy objectives:

- implement a fiscal policy, aimed at stable macroeconomic growth and low inflation. Ensure a gradual improvement of the fiscal situation in the next years;
- consistently ensure compliance with the Maastricht criteria in Latvia;
- introduce medium-term (3–5 years) budget planning. In order to ensure targeted development and effective spending of the budgetary funds, introduce strategic planning in ministries and, in line with the above, base the budget formulation on financing policy objectives and outcomes;
- implement clear and transparent tax policy, create an accurate legislative framework of taxation, without allowing varying interpretation possibilities for the legislative acts;
- reduce the overall tax burden by raising the non-taxable income not subject to the personal income tax and tax reliefs for dependants, at the same time improving tax collection;
- in cooperation with the Bank of Latvia ensure successful integration of Latvia in the euro area.

2. Economic Situation

2.1. Current Economic Development

Reforms implemented by the government and further integration into the European Union have facilitated the economic development. Latvia has become one of the economically fastest growing European countries. Average annual growth of Latvian gross domestic product (GDP) within the period from 1996 to 2003 was 6%. In 2003, the growth of Latvia's GDP reached 7.5 percent at constant prices, whereas in the first half of 2004 it reached 8.2 percent.

Latvia's economic growth in the previous years was primarily determined by high domestic demand, especially private consumption and investment, as well as the ability of Latvian businesses to expand the exports market. The first half of 2004 was marked by a steep acceleration of the economic activity related to the accession to the European Union, characterised by buoyant expansion of investment and external trade. The growth of exports was facilitated by an increase in the euro exchange rate. A steep rise in imports and investment was driven by one-off and large volume transactions and investment made shortly before the accession to the European Union as well as the lending expansion and domestic demand. Private consumption, promoted by the growth of lending and improvement of the purchasing power of the population, also contributed significantly to the economic growth. The growth rate of real wages and salaries was slower than the productivity growth; therefore, the overall competitiveness of the economy was not undermined. The rapid expansion of lending was encouraged by stability of the financial system, increasing lending opportunities at relatively low interest rates and sentiment toward economic growth prospects.

In the first half of 2004, the economy developed in a balanced way and there was growth in all the major sectors. Similarly as in the previous years, the largest contributors to the GDP growth were trade, transport and communication, manufacturing and construction. Trade (including retail trade) and construction expanded due to the growing private consumption and development of lending. Large growth was experienced in construction of industrial, residential and infrastructure buildings, whereas the construction of trade building has shrunk.

Manufacturing has been demonstrating steady development rates for a longer period of time, and in the first half of 2004 it was facilitated by appreciation of the euro, which strengthened the export competitiveness of the sector on the EU market. The expansion of industrial output exports also to other countries outside the euro area points to overall improvement of the competitiveness of the sector.

Private services constituted 58% of the gross value added and increased by 15.1% in the first half of 2004. This sector envelops such important services as trade, transport and communication and business activities. The growth of transport and communication was characterised by differentiation in cargo types and steep increase in passenger transportation, especially by air. The development of business activities was driven by higher overall activity of the business environment and real estate market.

Employment increased by 1.3% in the first half of 2004. Latvia's unemployment rate is characterised by the share of jobseekers (unemployment according to the ILO definition) approaching the officially registered unemployment rate, which points to a higher willingness to obtain the official status of an unemployed person and, consequently, to engage in active job seeking. Thus, the number of jobseekers was 9.9% of the economically active population in the second quarter of 2004, which is a historical low, while the officially registered unemployment rate did not improve significantly. Considerable differences concerning the unemployment rates in various districts and cities still prevail in Latvia, with the lowest rate being in Riga at about 4.5% and the highest in separate regions of Latgale, where it exceeds 20%.

The first half of 2004 was marked by higher external trade activity related to the accession to the European Union. Imports of goods and services grew by 25.8%, while exports expanded by 14.8%. The sharp rise in imports was driven by the intensive imports of investment goods (transport vehicles, cars, mechanical appliances and equipment) shortly before the accession. In the remaining months of the year, no extreme growth rates have been observed, nor can be expected. Foreign trade turnover in 2004 was influenced by the high euro exchange rate that, on the one hand, improved the competitiveness of Latvian producer exports to the euro area countries, while, on the other hand, made imports more expensive.

As a result of that, the negative balance of trade and services and the deficit of the current account of the balance of payments increased. The growth of the current account deficit of the balance of payments was driven by an increase in deficit of the goods and income account and a decrease in surplus of the services account. The current account deficit was covered by portfolio investment, direct foreign investment and other investment, and the foreign reserves of the Bank of Latvia grew.

In 2004, consumer prices continued to grow, and the highest annual inflation was reached at 7.8% in August. Currently, further inflation growth has stopped and there are some signs of decline. Consumer price rise was determined by a set of several one-off factors — an increase in administratively regulated prices as well as tax rates harmonisation with the European Union requirements, and euro appreciation and upturn in oil prices as well as weather conditions unfavourable for agriculture.

2.2. Macroeconomic scenario

Macroeconomic development scenario envisages stable economic growth. The forecast average annual GDP growth rate in the medium-term is 6.5%. In 2004 and 2005, the economic development will be fostered by the expected recovery of the EU economy and Latvia's accession to the EU, and the forecast growth of GDP will be 8.1% and 6.7% respectively.

Table 1. Growth and associated factors.

Percent (if not specified otherwise)	ESA code	**2003**	**2004**	**2005**	**2006**	**2007**
1. GDP growth at constant prices	B1g	7.5	8.1	6.7	6.5	6.5
2. GDP level at current prices (mln. euro)	B1g	9802	10894	11819	12963	14181
3. GDP deflator		3.4	6.8	4.7	3.0	2.7
4. CPI (average annual) change		2.9	6.2	4.3	3.0	3.0
5. Employment growth*		1.8	1.0	1.0	0.5	0.5
6. Labour productivity growth**		5.5	7.0	5.6	6.0	5.9
GDP by expenditure: changes at constant prices, %						
8. Private consumption	P3	8.6	9.0	8.2	7.0	6.5
9. Government consumption expenditure	P3	1.9	2.0	2.0	2.0	2.0
10. Gross fixed capital formation	P51	10.9	19.2	11.3	9.9	9.1
11. Changes in inventories and net acquisition of valuables (% of GDP)	P52+P53	3.7	3.1	1.9	1.2	0.8
12. Exports of goods and services	P6	5.0	9.3	8.4	8.2	7.9
13. Imports of goods and services	P7	13.0	12.0	8.4	7.5	7.1
Contribution to GDP growth						
14. Final domestic demand		8.7	11.4	9.1	8.0	7.6
15. Changes in inventories and net acquisition of valuables	P52+P53	3.4	-0.6	-1.1	-0.7	-0.3

Percent (if not specified otherwise)	ESA code	**2003**	**2004**	**2005**	**2006**	**2007**
16. External balance of goods and services	B11	-4.6	-2.8	-1.3	-0.9	-0.7

** Number of employed, national definition*

*** Increase in the ratio of GDP at constant prices against the number of employed*

2.2.1. Real sector

In the medium-term, the economic development will be driven by improvement of the external economic environment and high domestic demand. The global economy will preserve positive development trends; nevertheless, it may be influenced by the high oil prices and risks associated with the US external sector imbalances and the threats of the Chinese economy overheating. Domestic demand will continue to be fostered by the still high private consumption as well as the rise in gross fixed capital formation.

GDP by expenditure

In the last years, **private consumption** was a significant contributor to GDP growth and will remain the main driving force of economic development in the medium-term as well. Private consumption will pick up primarily on account of increasing wages and salaries. As compared to the growth of productivity, this increase will be lower; nevertheless, comparatively high, due to the expected steep productivity growth. Private consumption will also be fostered by stable employment rates and development of lending, with household borrowing remaining at a high level. Within the nearest years, increase in consumption will be offset by the price rises, tighter fiscal and monetary policy.

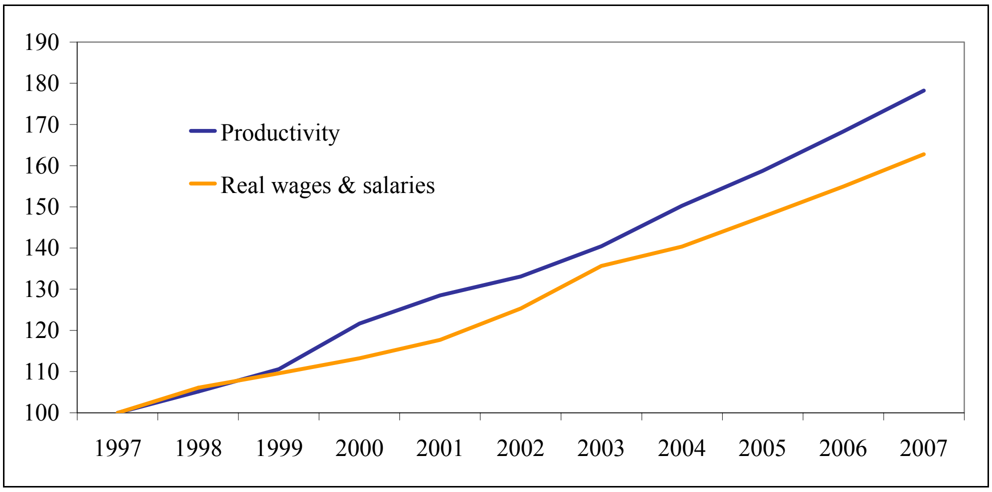

Figure 1. Growth of productivity and real wages and salaries, 1997=100.

Due to implementation of a tight national fiscal policy, the increase of the central government budget expenditure and **public consumption** will be moderate in the medium-term and will reach 2% at constant prices.

Growth of GDP will be significantly affected by expanding **gross fixed capital formation**. Macroeconomic development scenario provides that investment will grow at a quicker pace than the GDP. In the medium-term, investment will be encouraged by stable macroeconomic environment and increased economic activity. Both foreign and domestic private and public investment in businesses and infrastructure will pick up. Expansion of investment will be stimulated by the opportunities to draw from the EU funds and the economic policy measures of the government aimed at promoting business development as well as the development of lending. During the recent years, involvement of the banking sector in providing loans to local companies has been on a constant rise. Further increase in lending is expected in the future, with the share of consumer credit diminishing. Investment is to a large extent dependent also on the level of domestic savings. It is anticipated that the increase in savings in the medium-term will be promoted by the development of deposit insurance, pension system reform as well as the development of the securities market.

Macroeconomic development scenario envisages a constant growth of the foreign trade turnover. It is expected that the growth of **exports** in the medium-term (annual average of 8.0% at constant prices) will exceed that of the imports (7.4%). During the previous periods, several sectors have received significant investment (e.g., manufacturing, transport and communication); therefore, there is hope that productivity and, consequently, also competitiveness will grow considerably. High share of capital goods in the structure of Latvian imports is also a sign of the expected productivity growth. Macroeconomic development scenario envisages that the productivity will grow faster than the real wages and salaries; therefore, Latvian businesses will be able to preserve and increase their competitiveness on the domestic and external markets. During the last years, Latvian businesses have always found new markets, and it is expected that they will continue conquering new markets and strengthening their position in the existing ones in the medium-term. Growth of exports will be encouraged by the opportunities for businesses to operate in the EU domestic market and the economic policy measures of the government aimed at promotion of exports. It is anticipated that in the medium-term the structure of Latvian exports will diversify and the share of wood in it will decrease, whereas the share of higher value added goods will grow.

Growth rates of **imports** will remain comparatively high. Demand for imports will be partly restricted by the increase in real wages and salaries that will be lower than the growth of GDP and productivity. Significant slowdown in the growth of imports, however, is not expected, because the structure of imports is dominated by goods that are not produced in Latvia (various equipment and machinery, raw materials) and that are required for further modernisation of production and economic development. It is expected that the share of machinery and investment goods in the structure of imports will continue increasing in the medium-term.

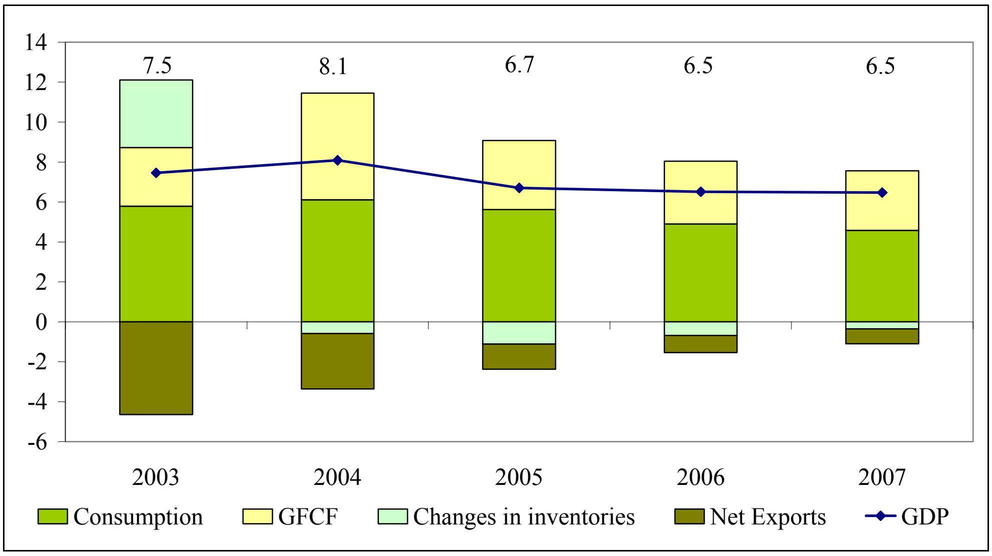

Figure 2. Contribution to GDP growth, %.

GDP by sector

During the last years, ***industry*** has experienced dynamic development and it is expected that it will be one of the fastest growing sectors also in the medium-term. It is anticipated that the growth of industry during the next years will to a large extent be driven by the growth of manufacturing, mainly light industry, food industry, woodworking and metal working. Further investment in production modernisation, including through attracting the EU funding, will raise the productivity and competitiveness of the sector. Development of the branches of industry will be facilitated by various governmental economic policy measures aimed at developing the capacity of businesses, production of higher value added goods and promotion of innovations.

Medium-term macroeconomic development scenario does not envisage any significant growth in the ***energy*** sector, since no development of high energy-consuming sectors can be expected. Sectoral development will be affected by reduced losses and increased efficiency as well as a gradual growth of the industry sector.

During the last years, comparatively high growth has been observed in ***construction*** and it can be expected that it will remain one of the most dynamic sectors also in the medium-term. Development of mortgage lending, economic activity growth and expanding investment point to a significant boost in the volume of construction also in the future. Sectoral development will be marked also by implementation of the EU funds-financed projects and demand for construction of residential buildings.

The development of ***agriculture*** will depend on several factors, including an increase in private consumption, adjustment of agricultural holdings and products to the EU standards and quality criteria, and external demand. Sectoral development will be promoted by fairer competition on the domestic EU market and the support drawn from the EU funds for modernisation and operational diversification. With the sectoral reforms continuing, an economically independent rural business model will develop, the number of persons employed in agriculture will decrease, rural infrastructure will improve and productivity and wages and salaries in the sector will grow. Nevertheless, the increase in the volume of agriculture and fishery will be restricted by production and fishing quotas. More moderate growth of the sector will be also determined by slower growth of forestry, as the optimum volume of timber cutting has been almost reached and further development of the sector will be driven by increasing efficiency. Ageing and depopulation tendencies in the rural areas may reduce the potential of agriculture and are a serious obstacle to further development.

It can be expected that ***private services*** will be one of the fastest growing sectors in the medium-term. An increase in the share of the private services in the structure of GDP can be also predicted. The development of the private services will be driven by the development of various services sectors.

Transport and communication, in particular, the oil transit from Russia, are largely dependent on politically governed factors; nevertheless, the further infrastructure development and diversification of services in the future envisages a growth in the freight transportation volume. Sectoral development will be fostered by both growing foreign trade of Latvia as well as the development of the exports to the CIS countries and global trade.

Commercial and financial services can expect high growth rates. There is a growth potential also in tourism. Increase in communication will be significantly fostered by the liberalisation of the telecommunications market.

With the rise in population incomes and expansion of consumer credit, further growth in trade can be expected (especially for non-food); however, the growth rates will be lower than before because of market overfilling and it will be impossible to preserve the same high growth rates in the medium-term.

Comparatively low growth of about 2.0% per annum can be expected in ***public services***.

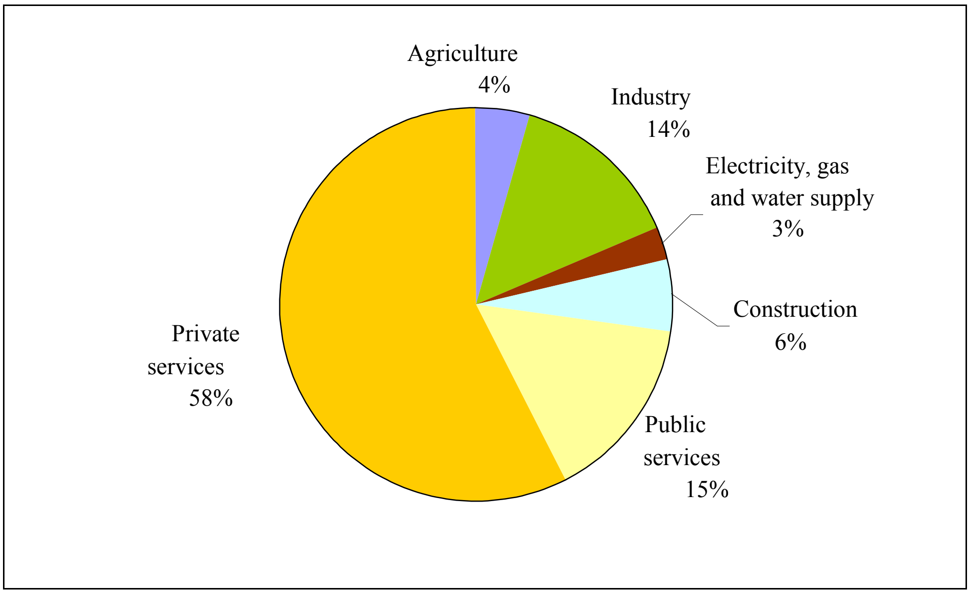

Figure 3. GDP by sector in 2003, %.

Employment

As a result of low birth rates, comparatively high death rates and negative net migration, population in Latvia will gradually decrease by 0.5%-0.7% per annum. Nevertheless, no aggravation of the demographic burden due to the low birth rates and increased retirement age is expected in the next years. Moreover, analysing the demographic trends, a relatively stable number of economically active population can be predicted up to 2010. By that time large cohorts of young, well-educated people born in 1980s will join the labour market.

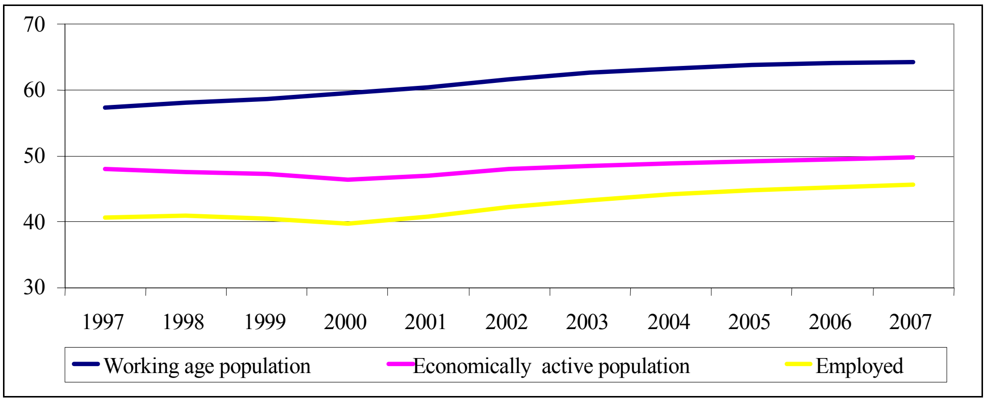

Figure 4. Working age, economically active and employed population to total population, %.

Currently, the labour market development is characterised by several positive tendencies – growth of the economic activity and employment, reduction of unemployment. National economic growth and the ongoing regional, labour market and other reforms, including those financed from the EU Structural Funds, will enable gradual coping with the problems of the existing labour market.

Based on that, the macroeconomic development scenario envisages a gradual decline in job-seekers (unemployment according to the ILO definition) to 8.4% in 2007 and a sustainable employment growth in the medium-term.

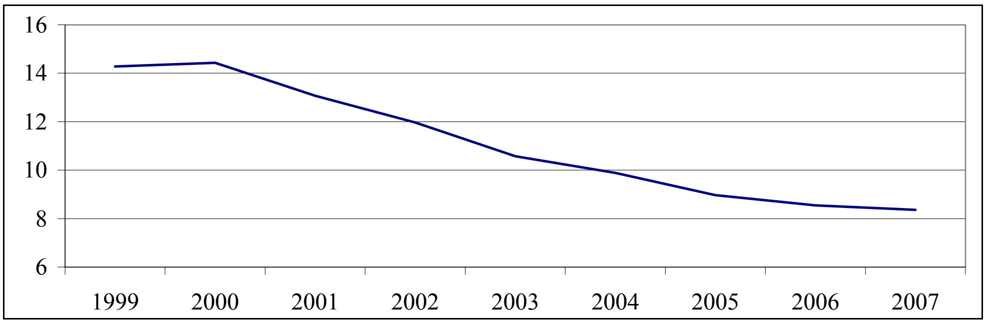

Figure 5. Jobseekers , % of economically active population.

2.2.2. Inflation

In 2004, the consumer price growth was twice as high as in the previous years. The expected annual inflation for 2004 is 6.2%, which is the highest level since 1999. Looking at a 12 months period, there was an overall inflation growth throughout the year, reaching the maximum in August and then stabilising and even slightly declining.

Such a growth of inflation was driven by interaction of several factors, mainly on the supply side. As 2004 was marked by a notable rise in administratively regulated prices (electricity, natural gas, utilities etc.), the level of prices was also affected by measures to harmonise indirect taxes with the EU standards, when excise on tobacco products and fuel was raised and the VAT base expanded, as well as other institutional changes related to the EU accession. The rise in agricultural products, alongside with a general increase in costs, was affected also by the new market situation, with Latvia joining the Common Agricultural Policy, as well as by unfavourable weather conditions. The global situation was also unfavourable; rapidly rising oil prices and euro appreciation fuelled a further growth of inflation by making imports from the euro area more expensive. Pre-accession inflation expectations can be mentioned as one of 2004 factors that underpinned a rise in demand for potentially “EU influenced” products, causing a premature and steep increase in their prices.

In the last years, good economic growth, lending expansion and sustainable increase in the real income of population ensured that the demand side did not pose any immediate and sudden restrictions on cost inflation. Nevertheless, with the inflation rising, the increase in the real wages and salaries has become smaller in course of the year. The fiscal situation, which provided the central government budget surplus for the major part of the year, including in the months that were the most critical for inflation, as well as the restrictive measures of the monetary policy (raising of the refinancing rate by 1 percentage point and the minimum reserve ratio 1 percentage point overall), diminished the contribution of the demand side to the inflation development.

In 2004, the increase of producer prices was also considerably higher than in the previous years, and in the third quarter of 2004 it was 11.2% higher in manufacturing, and 8.9% higher in construction year-on-year. Moreover, the price rise for export production was slightly higher than for the production sold on the domestic market, as a result of the euro exchange rate, favourable for exports. The most significant and higher than average price rise was experienced in sectors where consumption is dominated by oil products, base metals and articles of base metals.

In 2005, the price increase will continue to be affected by an increase of administratively regulated prices, indirect taxes harmonisation measures (VAT on heating, excise on fuel, tobacco etc.); nevertheless, the annual average inflation will gradually decline to 4.3%, basically driven by the shrinking core inflation. Price development will be positively affected also by rising competition, as a result of further business development in Latvia as well as closer integration in the EU common market. Within the future years, the inflation will gradually return to the previous level and will not exceed 3% in 2006 and 2007. Assumptions underlying the forecasts take into account that the influence of the exchange rate will lessen due to pegging the lats to the euro starting from January 1, 2005, as well as assume that inflation in the EU countries as well as the global oil prices will be stable.

Table 2. Changes in consumer prices.

	2003	2004	2005	2006	2007
	actual	forecast			
CPI changes (year-on-year)	2.9	6.2	4.3	3.0	3.0

2.2.3. Monetary and Exchange Rate Policy

Latvia's monetary and exchange rate policy in the medium-term is closely related to the monetary integration plans. The status of the new member states provides that until the adoption of the euro they have to implement such an exchange rate strategy that is in line with the interests of all the European Union member states. Moving towards the adoption of the euro, it eventually means joining the exchange rate mechanism II (ERM II) and pegging the national currency to the euro with the fluctuation band of +/-15%, which would both ensure the required level of flexibility and promote the stability of the macroeconomic policy, hence creating pre-requisites for the adoption of the euro.

Overall, Latvia's strategy for integration into the Economic and Monetary Union (EMU) has remained unchanged. In accordance with the integration plans, the Bank of Latvia plans to change the lats peg from the SDR currency basket to the euro on 1 January 2005. The decision of Board of the Bank of Latvia of November 11, 2004 states that lats will be pegged to euro according to euro reference exchange rate of European Central Bank of December 30, 2004, SDR exchange rate formula and existing practice of pegging to SDR currency basket with +/-1% exchange rate fluctuation corridor.

Coming to an agreement with the participants of the Eurosystem, the Bank of Latvia plans to join the ERM II at the beginning of 2005, soon after changing the peg of the national currency, in order to fulfil the requirements for participation in the EMU. As regards the fluctuation band, the Bank of Latvia plans to propose an agreement on a unilateral commitment to ensure a +/-1% exchange rate fluctuation corridor around the central parity rate within the framework of ERM II.

It has to be noted that pegging of the national currency to the euro is justified not only by the formal need to meet the set criteria but also changes in economic conditions that are best characterised by the significant increase in the role of the euro in foreign trade settlements from 22% in 1994 to 54% in 2003. It can be expected that, with the continuing economic integration, the role of the euro in Latvia's economy will continue to grow in the next years as well. Therefore, changing the currency peg is adequate from the perspective of the main Bank of Latvia's objective as well, i.e. ensuring the price stability, because considering the small size of the Latvian economy and high degree of openness, the fluctuation band plays an important role in the price formation process; hence, a fixed exchange rate policy is suitable for Latvia's economy.

In order to prevent shocks in the financial sector, the Bank of Latvia adjusts the monetary policy implementation instruments to those used by the European Central Bank. The Bank of Latvia uses the same indirect, market-based monetary policy instruments that are used by the European Central Bank, the only thing required being a review of their importance and procedural elements.

Duration of participation in ERM II will depend on the ability of the Latvian economy to meet the convergence criteria and the evaluation of the involved institutions of Latvia's readiness to join the EMU. Joining the ERM II that has been planned for the beginning of 2005, Latvia's economic development and growing economic integration in the euro area suggest that Latvia is capable of fulfilling the pre-conditions for joining the EMU in 2007. At the same, time, the expected benefits to the Latvian economy relating to joining a stable monetary union urge the Bank of Latvia to launch the required measures for potential introduction of the euro on January 1, 2008.

2.2.4. External sector

Table 3. Key indicators of the balance of payments (% of GDP)

	2001	2002	2003	2004	2005	2006	2007
Current account	-7.6	-6.7	-8.2	-10.3	-9.5	-9.1	-8.9
Direct investment	1.4	2.7	2.4	3.4	3.6	3.9	4.0
Changes in reserve assets*	-3.7	0.0	-0.6	-4.3	-1.4	-1.2	-1.2
Changes in other assets:							
Net portfolio and other investment (including statistical errors and omissions)	9.9	4.0	6.4	11.2	7.3	6.4	6.1

** A minus sign points to an increase in reserve assets*

In the last years, the current account of Latvia's balance of payments has been comparatively high, mainly pointing to insufficient domestic savings to ensure investment relating to restructuring and modernisation of the economy. This is confirmed by the growing imports of investment goods. In 2003, the imports of capital goods and intermediate consumption goods increased by 22.3% and reached 68.4% of total imports.

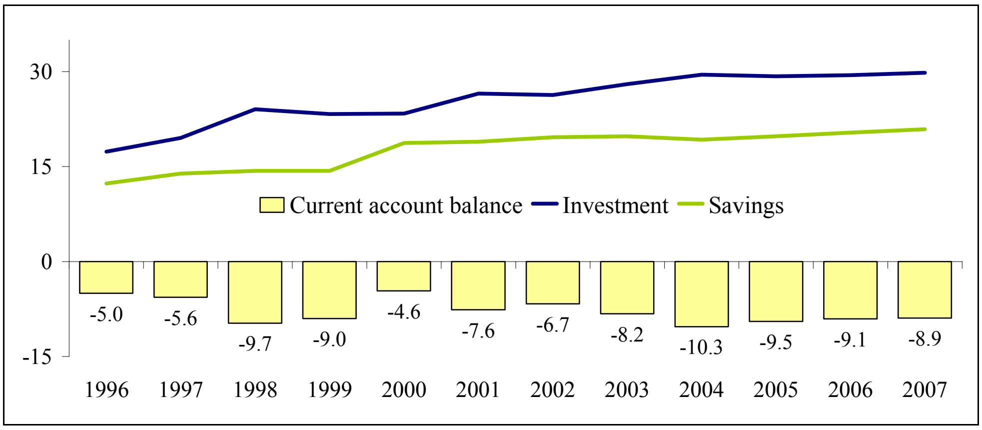

Figure 6. Investment and savings balance (% of GDP).

In 2003, the current account deficit stood at 8.2% of GDP, whereas in the first half of 2004 it climbed to 13.6% of GDP. The main factor fuelling the high current account deficit is the continuously increasing external trade deficit. In 2004, the exports growth rates remained high, reflecting the sustained competitiveness of the Latvian goods on the foreign markets, favourable terms of trade and growing external demand. However, the growing domestic demand in the first half of 2004 resulted in an untraditionally rapid expansion of imports of goods. The rise in imports was primarily driven by larger inventories made by businesses prior to Latvia joining the European Union with regard to the expected changes in import tariffs and terms of trade with the third countries, as well as some significant one-off investment projects implemented in this period. If those factors were excluded, the current account deficit would be just slightly higher year-on-year in the first half of 2004. That the impact of those factors is only short-lived is confirmed also by the external trade data for the first ten months of 2004, where the annual growth rate of exports at 26.1% is higher than that of the imports at 23.9%.

Although the services provided in 2003 and the first half of 2004 expanded, as a result of the more rapid growth of imported services, the surplus of services did not grow and even slightly declined this year. The surplus of transportation services shrank; mainly transportation by sea was affected, due to a decline in ship charter rates and number of operated ships. The growth in the surplus of other services and decrease in the deficit of travel balance could not offset the drop in the surplus of transportation services. In the first half of 2004, income deficit continued to grow, with non-resident income gained in Latvia increasing. The surplus of current transfers continues to grow, primarily as a result of availability of the EU Structural Funds financing and cash inflows from foreign private funds.

The purchase of some one-off investment goods and formation of inventory stocks prior to the EU accession will mainly underpin a rise in the current account deficit of the balance of payments to 10,3% of GDP in 2004. Although a sustainable demand on behalf of the main trade partner states can be anticipated and the exports of goods will maintain high growth rates, the overall high imports component in exports and drawing from the EU Funds will underlay a rise in imports, which does not warrant to forecast a sizeable improvement of the trade balance within the nearest years. Consequently, only a slight decline in the current account deficit of the balance of payments to 9.5% of GDP can be expected in 2005.

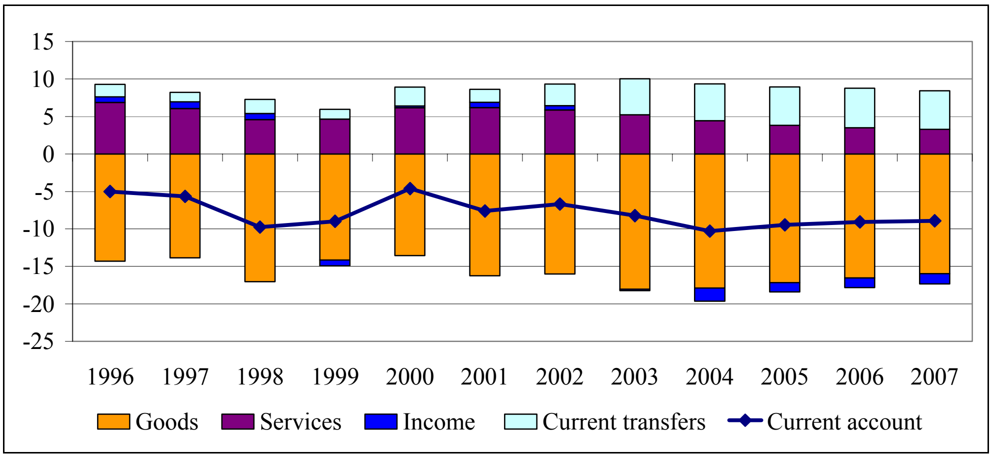

Figure 7. Current account of the balance of payments, % of GDP.

In the medium-term, the trade balance will improve, with the exports of goods growing faster than the imports. That will be determined by the already ongoing growth of higher value added goods in the structure of exports as well as significant investment inflows in the exporting sectors which will improve the competitiveness of goods. An improvement of the services balance can also be expected due to the increase in provided services. That will be mainly driven by expansion of transportation services as a result of renewal of the Latvian Shipping fleet and development of tourism services in Latvia, with significant growth of non-financial investment in the sector. Therefore, a gradual decline in the current account deficit can be forecast in the medium-term.

The financing structure of the current account deficit confirms the foreign investors' trust in further economic development and the national policy implemented in Latvia. The sustainable economic growth and the EU accession promoted inflows of foreign direct investment into Latvia. In the first half of 2004, the foreign direct investment inflows into Latvia grew significantly, by 52.7% year-on-year, reaching 5.3% of GDP. Within this period, the long-term capital covered ¾ of the current account deficit, the most important being foreign direct investment as well as banking sector loans (primarily as financing extended by parent banks), long-term borrowing of enterprises and the government sector. Net foreign reserves of the Bank of Latvia continue to grow and provide full backing for the issued national currency.

Latvia is a small and open economy, and its risks are mainly connected with the external economic environment. Latvia's main risk relates to the big current account deficit, and there are several risk factors that could result in the deficit not decreasing significantly or even increasing in the medium-term.

Significant risks relate to demand from the external trade partners, especially the economic development in the principal exports markets of the European Union and CIS countries. A decrease in the external demand may exert pressure on the lats, diminish the economic activity, reduce the budgetary revenue and create instability in the financial sector. With the deterioration of the external economic environment, the ability of Latvia to raise its competitiveness, find new exports markets, as well as diversify the structure of exports will be important.

Latvia's current account deficit can be adversely impacted also by steep changes in the prices of main Latvian imports or exports goods on the global market. Falling prices of wood, which is the main Latvian exports, may decrease the value of exports, and the growing oil and energy prices may increase the value of imports, hence considerably pushing up the current account deficit. The balance of payments can be also affected by one-off transactions that are considered large according to Latvia's scale (e.g., purchase of ships).

Current account deficit is financed by capital flows. Short-term capital flows are very volatile and hard to forecast, and their significant fall may create problems with the balance of payments; therefore, Latvia has to encourage inflows of long-term capital (foreign direct investment). With the foreign capital flows diminishing, the foreign reserves of the Bank of Latvia may shrink and that could cause a decrease in money supply and increase of domestic interest rates, negatively impacting on the economic development.

3. General government balance and debt

3.1. Fiscal policy and general government budget balance

The fiscal policy of the government is aimed at a stable macroeconomic growth and low inflation, ensuring a gradual improvement of the fiscal situation, thus, securing the implementation of the recommendations of the Council of Europe. An important task of the national fiscal policy is to create a balanced budget.

It is forecast that the general government budget deficit will gradually shrink in the medium-term. To implement those objectives successfully, ministries introduce the strategic planning, formulating a budget oriented at financing policy objectives and outcomes.

The 2005 budget is aimed at improving the welfare of the population, investment and use of the EU Funds financing, at the same time balancing the public support to the social needs of the community. An important budget priority is the funding designated as the national co-financing for the EU Funds as well as the funding for ensuring the administrative capacity in relation to the administrative, technical, financial management and control of the EU projects. Effective and efficient spending of the EU Funds will ensure a considerable support to business development, and development and improvement of public infrastructure.

Starting from 2005, it is planned to commence alignment of the healthcare system, envisaging to dedicate 34.5 million lats to address the most acute problems. The Government's Declaration states that it is necessary to establish a functional and accessible health protection system, envisaging that in the medium-term the annual increase of the public financing for healthcare would be 10–15%.

The government regards an improvement of the quality of education and science as an important pre-requisite for sustainable economic development and ensuring the competitiveness of Latvia; therefore, a significant rise is planned in the 2005 budget for financing the development of scientific fundamental research and development in universities (2.3 million lats) as well as raising the pedagogue salaries to improve the prestige of the profession and attract new specialists (29 million lats).

The government also plans to use the 2005 budget to achieve an overall improvement of support to Latvia's residents in the social sphere. The social budget expenditure will increase by 59 million lats, ensuring significant pension indexation in 2005. Moreover, to improve the demographic situation in Latvia, 10 million lats have been channelled to a notable increase of childbirth and childcare benefits.

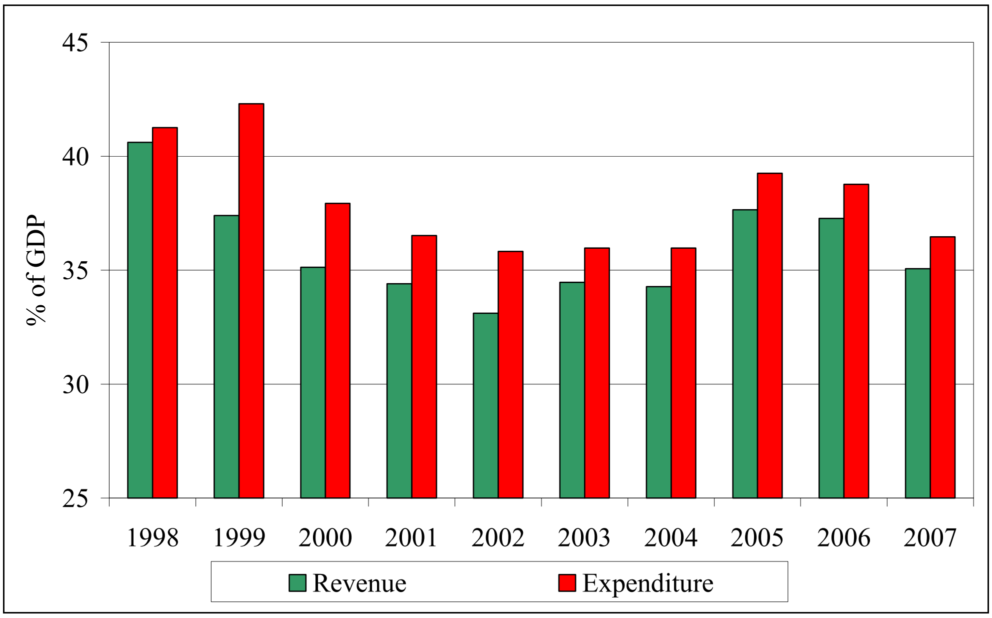

Figure 8. General government revenue and expenditure, % of GDP.

In 2004, the general government deficit is forecast at 1.7% of GDP.

Table 4. General government budget (millions of lats)

	2003	2004	2005	2006	2007
	actual	estimate	forecast		
Revenue	2179.2	2501.4	3070.6	3333.3	3430.7
Expenditure	2274.1	2625.5	3201.1	3467.5	3567.7
Balance	-94.9	-124.1	-130.5	-134.2	-137.0

Overall general government budget deficit in 2004 and in the medium-term will be determined by the central government budget deficit. In line with the forecasts, the central government budget deficit in the medium-term will gradually decline from 2.1% of GDP in 2004 to 1.8% of GDP in 2007. A gradual decline of the central government budget deficit is forecast, because:

- it is necessary to ensure co-financing for drawing funding from the EU Funds, agricultural policy, rural development and the EC programmes and initiatives and for pre-financing;
- additional financing will be channelled to the healthcare system reform;
- in the time period up to 2008, expenditure in the amount of 2% of GDP will be ensured in the central government budget for the national defence, security and participation in the NATO.

Latvia has prepared the **Development Plan** (Single Programming Document) for drawing financing from the EU Structural Funds, setting forth the operational strategy and measures for using the Structural Funds financing in Latvia. Implementation of priorities started in 2004 continues in the 2005 budget in line with the objectives provided in the Development Plan – support to business development, development and improvement of public infrastructure, environmental adjustment, human resources development and promotion of employment, promotion of agricultural and rural development, development of sustainable fisheries.

In comparison with the previous years, the fiscal position of the local government budget improved considerably in 2003, and, as a result of that, the deficit declined from 0.9%

of GDP to 0.2% of GDP. It is forecast that in the next years the deficit of the local government budget will remain at 0.2% of GDP, as the local governments need to continue the improvement of local infrastructure, renovation of cultural and educational establishments as well as to ensure pre-financing for the EU Funds financing. It has to be noted that the local government amalgamation process has not yet been fully completed. If the local governments amalgamate more intensively, creating local governments more capable of economic development and financially stronger, then the financial development of the local governments in the next years could be more rapid, as formation of larger local governments enables more efficient use of the existing funds and attraction of additional financing.

In 2004, there was a surplus in the amount of 0.6% of GDP in the social security budget. A surplus in this budget is also forecast in the medium-term, provided that the social security system is not changed radically.

Amendments to the law “On State Pensions”, effective from March 10, 2004, state that until January 31, 2005 all state pensions below five-fold state social security benefit have to be reviewed annually, and if the annual inflation exceeds 3% - semi-annually, based on the actual consumer price index and the real increase index of social contribution wage as follows:

- all state pensions below three-fold state social security benefit will be reviewed, based on the actual consumer price index and no less that 50% of the real increase percentage of the social contribution wage;
- all state pensions exceeding three-fold state social security benefit but below five-fold state social security benefit will be reviewed based on the actual consumer price index.

In accordance with the law “On State Pensions”, from January 1, 2006 to December 31, 2010 all state pensions below five-fold state social security benefit have to be reviewed annually, based on the actual consumer price index and no less than 25% of the real increase percentage of the social contribution wage.

Taking into account that a decline of inflation is forecast in the medium-term, lower expenditure to ensure pension indexation is also forecast in the medium-term. The reduction of expenditure in the social security budget will be also determined by an increase in retirement age by 2008.

Table 5. General government budgetary developments.

% of GDP	ESA code	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Net lending (B9) by sub-sector	**S 13**						
1. General government	S 1311	-2.7	-1.5	-1.7	-1.6	-1.5	-1.4
2. Central government	S 1312	-1.9	-2.0	-2.1	-2.0	-1.9	-1.8
3. State government	S 1313						
4. Local government	S 1314	-0.9	-0.2	-0.2	-0.2	-0.2	-0.2
5. Social security funds	S 1315	0.1	0.7	0.6	0.6	0.6	0.6
General government (S13)							
6. Total receipts	ESA	33.1	34.5	34.3	37.7	37.3	35.1
7. Total expenditures	ESA	35.8	36.0	36.0	39.3	38.8	36.5
8. Budget balance	B 9	-2.7	-1.5	-1.7	-1.6	-1.5	-1.4
9. Net interest payments	D 41	0.8	0.8	0.8	0.7	0.7	0.7
10. Primary balance		-1.9	-0.7	-0.9	-0.9	-0.8	-0.7
Revenue components							
11. Taxes	D2 + D5	19.4	19.9	19.4	19.4	19.3	19.1
12. Social contributions	D 61	9.6	9.2	8.9	8.7	8.7	8.4
13. Other		4.2	5.4	5.9	9.5	9.3	7.6
14. Total revenue	ESA	33.1	34.5	34.3	37.7	37.3	35.1

Expenditure components							
15. Collective consumption	P 32	10.7	11.0	11.0	11.3	11.4	11.8
16. Social transfers in kind	D 63	0.6	0.7	0.6	0.6	0.6	0.5
17. Social transfers other than in kind	D 62	10.9	9.6	8.7	8.6	8.4	7.9
18. Interest payments	D 41	0.8	0.8	0.8	0.8	0.7	0.7
19. Subsidies	D 3	0.7	0.8	0.8	0.7	0.8	0.8
20. Gross fixed capital formation	P 51	1.3	1.5	1.6	1.8	1.9	1.9
21. Other		10.7	11.6	12.5	15.5	15.0	14.1
22. Total expenditures	ESA	35.8	36.0	36.0	39.3	38.8	36.5

3.2. Structural balance

Cyclically adjusted central government budget balance was calculated in accordance with the methodologies developed by the European Commission, using the macroeconomic and fiscal development policy scenario discussed in the Convergence Programme. The potential GDP was calculated using the Cobb-Douglas production function and quarterly macroeconomic data from 1995 to the third quarter of 2004. The ratio of elasticity of the central government budget to cyclical business fluctuations was established based on tax revenue elasticities. Revenue from five main taxes comprises about 80% of total budget revenue, and the average central government budget elasticity to GDP is 0.7. The cyclic part of the budgetary expenditure (unemployment benefits) constitutes only a small part of the total budgetary expenditure and do not have a significant impact on the central government budget deficit.

The development of cyclically adjusted budget balance is driven by the difference between the potential GDP growth estimate and the actual and forecast economic development. In the last years, and particularly this year, the economic growth is higher than the average of the previous decade. These positive development trends are factored in also in the potential GDP estimate, which displays a higher economic growth in the medium-term than in the previous forecasts. Therefore, the medium-term is marked by an increase in the difference between the potential and forecast GDP.

The analysis of the potential GDP allows concluding that under adequate circumstances a higher than forecast GDP growth can be expected in the medium-term. The medium-term estimate of the cyclically adjusted budget balance approaches a balanced position and, taking into account the economic growth potential, economic policies may be used that would approximate the actual growth to the potential one.

The recent changes in the national accounts statistics have adjusted the potential GDP estimate as well, as compared to the previous Convergence Programme. The potential GDP growth estimate can be adjusted once a more complete statistical information becomes available, including the above-mentioned changes in the national accounts data.

Table 6. Cyclical developments.

% of GDP	ESA code	**2003**	**2004**	**2005**	**2006**	**2007**
1. GDP growth at constant prices	B1g	7.5	8.1	6.7	6.5	6.5
2. Actual budget deficit	B9	-1.5	-1.7	-1.6	-1.5	-1.4
3. Interest payments	D41	0.8	0.8	0.7	0.7	0.7
4. Potential GDP growth		7.7	7.9	8.2	7.7	7.5
5. Output gap		-0.2	0.0	-1.5	-2.6	-3.5
6. Cyclic budgetary component		0.0	0.0	-0.3	-0.6	-0.8
7. Cyclically adjusted balance (2-6)		-1.5	-1.7	-1.3	-0.9	-0.6
8. Cyclically adjusted primary balance (7-3)		-0.6	-0.9	-0.5	-0.2	0.1

3.3. Government debt

The objective of the government debt management policy is to ensure the financing required for the purpose of financing the central government budget deficit and refinancing of the government's debt commitments at the lowest possible costs and advantageous terms by hedging the financial risks and taking into account the development of the Latvian state capital market and the overall financial system.

The management objectives, basic principles and tasks of the government debt portfolio and borrowing within the framework of the government debt management in the medium-term are established by the Latvian national debt management strategy (hereinafter – Strategy) approved by the Minister of Finance. In accordance with the Strategy, the management of the government's debt portfolio is prudent and oriented at hedging and prevention of financial risks, allowing for the use of financial derivatives listed within the Strategy only for the purpose of ensuring risk management. Approach to the management of the government's borrowing, in turn, is oriented at ensuring borrowing opportunities, liquidity, beneficial terms and conditions and economical use of the available financial resources. Types of the financial instruments that may be used in the government debt management and attraction of the resources required for financing and selection of terms and conditions is prescribed by the guidelines approved within the Strategy, providing for adherence to optimum indicators concerning the debt portfolio of the government as regards the currency profile of the debt, maturity profile, average maturities of the debt and the share of fixed interest rate in the debt portfolio. The measures planned for ensuring the resources required to finance the central government budget deficit and debt commitments within the current year and the selection of the most appropriate instruments is prescribed by the annual Plan for attracting resources approved by the Minister of Finance which is developed based on the guidelines established in the Strategy and is agreed with the Bank of Latvia.

Within the time period of up to 2007, it is expected that the financial resources required for financing of the central government budget deficit and refinancing the government's debt commitments will be attracted both on the domestic as well as external financial market. Although due to complying with the fiscal criteria established in the Maastricht agreement and with the government implementing tight fiscal policy the planned deficit of the central government budget will gradually reduce in the medium-term, the limits of new borrowing depend also on the maturity profile of the existing government debt commitments and their repayments in the next years.

Latvia's government debt management has been historically aimed at development of the government securities market ensuring favourable terms and conditions for attracting resources at relatively low costs. Nevertheless, it can be expected that in the nearest years, taking into account the planned pegging of the lats to the euro, the financing strategy could change, with the volume of government securities in circulation gradually declining. In addition to short-term Treasury bills, medium-term instruments well known on the market of the government securities could be used for financing from 2005 to 2007, at the same time possibly giving up issuance of new long-term government bonds. If necessary, short-term loans and credit facilities offered by domestic financial institutions will be used to ensure short-term financial liquidity.

In addition to financing attracted from the domestic market, attraction of financing from the external financial market can be also anticipated by using borrowing from international financial institutions, private or public security issues and credit facilities of foreign commercial banks. Issue of eurobonds is the most effective instrument for attracting significant resources, by increasing the volume of the existing issues or issuing new liquid securities; therefore, the possibilities for using the Eurobond instrument between 2005 and

2007 are being investigated. The volume and maturity of borrowing, however, will depend on the central government budget performance, the situation on the financial market, government debt portfolio indicators and other influencing factors. In accordance with the concluded agreements, use of the borrowing from international financial institutions to finance central and local government projects will continue, and it is also expected that the borrowing possibilities offered by the European Investment Bank for the purpose of implementing measures co-financed from the European Union policy instruments will also be used.

Latvia 's government debt is one of the lowest among the new European Union member states and it is expected that it will remain well below the Maastricht agreement criterion for the total government debt (60% of GDP) in the medium-term.

Table 7. General government debt developments.

% of GDP	ESA code	2003	2004	2005	2006	2007
Gross debt level		14.4	14.2	14.5	15.8	15.0
Change in gross debt		0.28	-0.15	0.25	0.32	0.22
Contribution to change in gross debt						
Primary balance		0.7	0.9	0.9	0.8	0.7
Interest payments	D41	0.8	0.8	0.7	0.7	0.7
Nominal GDP growth	B1g	-1.4	-1.9	-1.5	-1.3	-1.3
Other factors		0.2	0.1	0.1	0.1	0.1
Of which: privatisation revenue		-0.1	-0.1	-0.1	-0.1	-0.1
p.m. implicit interest rate on debt		7.5	6.5	6.1	5.6	5.4

4. Sensitivity analysis and comparison with the previous programme

4.1. Sensitivity analysis

Sensitivity analysis establishes the impact of economic development changes on the public finance position. The sensitivity analysis is carried out for the 2005 central government budget discussed in the Convergence Programme and the medium-term budget perspective. In addition to the base macroeconomic scenario, which is the basis for developing the central government budget 2005 and the medium-term budget forecasts, optimistic and pessimistic scenarios are modelled where the medium-term GDP growth rates are forecast 1 percentage point higher and lower, respectively. The key factors impacting on the GDP growth in the optimistic and pessimistic scenarios are changes in the external market situation, private consumption as well as the amount of investment.

Macroeconomic scenarios have been developed, assuming that the price indexes remain unchanged. The volume of public consumption in all scenarios has been preserved unchanged as well.

The optimistic scenario assumes that a more robust external demand will facilitate higher Latvian exports and production growth rates. A higher domestic economic activity will create an additional demand for labour, and a higher labour productivity will enable more rapid growth rates for wages and salaries. The increase in the number of employed and decline of unemployment as well as improvement of the purchasing power of the population will promote stronger private consumption. The growth of domestic demand will be supported by the expansion of investment as well, driven by high productivity growth rates and greater optimism concerning the domestic and external economic environment developments.

With the economic activity increasing, it is forecast that basically the personal income tax and social security contributions revenue could grow at a quicker pace, because the collections of those two taxes are primarily determined by a rise in wages and salaries and employment. As a result of a more rapid economic development, the income tax revenue (D.5) could grow by about 5 million lats, whereas the increase in the actual social security contributions (D.611) could reach 6 to 7 million lats. It has to be noted that the tax increase rates are relatively high already at the moment; therefore, no exceptionally steep increase is forecast.

Table 8. Macroeconomic indicators of the optimistic scenario

		2005	2006	2007
GDP	increase, %	7.7	7.5	7.5
Private consumption	increase, %	8.6	8.3	8.3
Gross fixed capital formation	increase, (%)	11.1	10.4	10.4
Exports of goods and services	increase, %	8.4	8.4	8.5
Imports of goods and services	increase, %	8.3	7.9	8.0
Number of employed in national economy	increase, %	1.4	0.8	0.8
Unemployment rate	%	7.9	7.3	6.7
Average wage and salary in Latvia	increase, %	10.2	8.9	8.9
Current account	% of GDP	-9.6	-9.3	-9.1

In the pessimistic scenario, depending on deterioration of the external economic environment, the macroeconomic processes operate opposite to what happens in the optimistic scenario. Nevertheless, lower economic activity would enable an improvement of the trade balance. This points to the significant impact of the domestic demand on the development of the economy and the external sector.

Deceleration of the imports growth rates could adversely affect the value added tax revenue. Alongside with lower growth rates of wages and salaries, the domestic demand will also shrink, which is considered to be one of the most important macroeconomic indicators determining the value added tax revenue. As a result of decelerated economic growth rates, basically the production and imports taxes (D.2) could decline. Overall it is forecast that the decline could reach about 10 million lats.

Table 9. Macroeconomic indicators of pessimistic scenario.

		2005	2006	2007
GDP	increase, %	5.7	5.5	5.5
Private consumption	increase, %	6.6	6.5	6.4
Gross fixed capital formation	increase, (%)	8.6	7.6	7.4
Exports of goods and services	increase, %	5.5	5.5	5.5
Imports of goods and services	increase, %	5.4	5.2	5.2
Number of employed in national economy	increase, %	0.6	0.2	0.2
Unemployment rate	%	8.5	8.4	8.4
Average wage and salary in Latvia	increase, %	9.1	7.7	7.6
Current account	% of GDP	-9.4	-9.1	-8.9

The economic development trends are analysed regularly and an assessment of the potential impact on the central government budget revenue is prepared. Nevertheless, it has to be clear that a slow economic growth causes a situation where the revenue shrinks, but the central government budget expenditure remains unchanged. Taking into account the potentially adverse impact of the slow economic development, a special procedure has been established in the Latvian legislation. In accordance with Part Two of Article 25 of the Law on Budget and Financial Management, the Minister of Finance reports on the required suspension or reduction of expenditure allocations, if it is expected that the central government budget deficit will exceed the level of deficit approved in the annual law on state budget. Within seven working days of receiving the report, the Cabinet of Ministers makes a decision on suspending or reducing allocations and no later than within three working days submits recommendations for amendments to the annual law on state budget to the Saeima (Parliament).

4.2. Comparison with May 2004 Convergence Programme

Table 10. Comparison with May 2004 Convergence Programme.

	ESA code	**2003**	**2004**	**2005**	**2006**	**2007**
GDP growth (%)	B1g					
May 2004		7.5	6.7	6.7	6.5	6.5
December 2004		7.5	8.1	6.7	6.5	6.5
Changes		0.0	1.4	0.0	0.0	0.0
Actual budget balance (% of GDP)	B9					
May 2004		-1.8	-2.1	-2.2	-2.0	-2.0
December 2004		-1.5	-1.7	-1.6	-1.5	-1.4
Changes		0.3	0.4	0.6	0.5	0.6
Gross debt levels (% of GDP)						
May 2004		15.3	16.2	16.8	17.3	17.7
December 2004		14.4	14.2	14.5	14.8	15.0
Changes		-0.9	-2.0	-2.3	-2.5	-2.7

In 2004, economic development was more positive than was initially forecast, allowing to revise the GDP annual growth estimate upwards by 1.4 percentage points in comparison with the spring forecasts.

In June 2004, the Central Statistical Bureau of Latvia published the adjusted gross domestic product data, in order to achieve more complete harmonisation of its estimates with the requirements of ESA 95. The most significant adjustments were introduced to data on fixed asset depreciation in the sectors of general government and non-profit institutions servicing households, and the imputed rentals for housing inhabited by the owners themselves was included in the GDP estimate. As a result of this adjustment, the GDP at current prices increased, without any significant changes at constant prices.

When preparing the 2004 autumn Fiscal notification, great attention was paid to compliance with all ESA 95 requirements. In order to ensure that, the list of institutions to be included in the general government sector was reviewed, the application of accruals method in calculation of tax and interest income was adjusted and other measures were carried out. Alignment of methodology and adjustments made by the CSB determined a decrease of the budgetary deficit and government debt to GDP in 2003, in comparison with what was stated in the May 2004 Convergence Programme.

In the spring Convergence Programme, the budget deficit of 2004 was forecast at 2.1% of GDP. A decrease against the previously planned figure is determined by a lower than before deficit in the central government budget. A lower than planned central government budget deficit caused also a decline in the planned government debt increase in the next years.

5. Quality of public finances

5.1. Budgetary revenue of the general government

The tax policy implemented by Latvia's government in the previous years has been primarily aimed at reducing the tax burden on businesses, at the same time paying great attention to improvement of tax collection. To implement this policy, one of the most important measures has been a reduction of the rate of corporate income tax from 25% in 2001 to 15% in 2004.

In the medium-term, the tax policy will be more aimed at reducing the tax burden on population. The currently effective personal income tax-free threshold has been applied since 1997. From 1995 to 2003, the total burden of the personal income tax and state social security contributions on the average wage and salary has increased from 18.9% to 28.6%. In order to avoid a further decline in income of low-income population, a decision has been made to gradually increase the personal income tax-free threshold and tax reliefs for dependants.

Table 11. Tax revenue of the general government. (millions of lats)

	Code (ESA 95)	**2003**	**2004**	**2005**	**2006**	**2007**
		actual	estimate	forecast		
Total tax revenue:		**1840.7**	**2068.6**	**2293.6**	**2503.2**	**2687.9**
1. 1.Production and imports taxes	D.2	725.2	797.0	905.7	999.9	1102.6
2. Income taxes	D.5	536.1	622.5	676.0	723.4	766.8
3. Social contributions	D.61	579.4	649.1	712.0	779.8	818.5
of which actual social contributions	*D.611*	*566.5*	*636.1*	*698.8*	*766.4*	*804.9*

The following medium-term changes in the government's tax policy have been planned:

- In order to reduce the tax burden on population and introduce the European Commission recommendation for 2004 amendments to the Broad Economic Policy Guidelines for Member States and Community (2003–2005), the personal income tax-free threshold will be increased to 26 LVL per month in 2005, 32 LVL per month in 2006 and 40LVL per month in 2007, as well as tax reliefs for dependants will be increased to 18 LVL per month in 2005, 22 LVL per month in 2006 and 28 LVL per month in 2007. Although a rise in the wages and salaries and number of employed in the national economy is expected in the next years, taking into account the planned changes, the tax growth rates will decelerate.
- In order to further improve the quality of domestic public transport and ensure a routes network adequate to the consumers' needs, starting from January 1, 2005, a 5% value added tax instead of the current 18% will be applied to domestic public transport services. It is forecast that the reduction of the value added tax rate will partly offset the increase in oil prices that will limit a further row of the transportation tariffs. Although the application of a reduced rate will cause a drop in the value added tax revenue, overall the value added tax revenue will continue to grow, as it is forecast that a stable domestic demand growth will prevail in the medium-term as well; moreover, the increase of tax revenue will be also driven by the expected application of the EU Funds financing, because the value added tax will be applied to services and purchases of goods.
- Starting from January 1, 2005, the excise tax rates on oil products will be increased. This increase of rates will ensure that the rates of excise tax on oil

products will be harmonised with the minimum rates established by the EU. It is forecast that in 2005, as a result of the changed rates, the revenue from excise tax on oil products will grow by 16.5 million lats, which is to be considered a one-off fiscal effect. In the next years, the rate will remain unchanged; nevertheless, at the same time a gradual increase in consumption is forecast.

- Up to January 1, 2010, the excise tax rate on tobacco products will be gradually increased. This increase of rates will ensure that the rates of excise tax on tobacco products will be harmonised with the minimum rates established by the EU. With the increase of excise tax rate on tobacco products, the prices of cigarettes will grow accordingly, and that is forecast to result in a decline in cigarette consumption. Nevertheless, the revenue from excise tax on tobacco products is expected to increase, as the higher rates will compensate the drop in consumption. It is forecast that in 2005, as a result of the changed rates, the revenue from excise tax on tobacco products will grow by 6.0 million lats.
- Starting from January 1, 2007, constructions will no longer be taxed with the real estate tax; therefore, the real estate tax could shrink by 10 million lats.

In accordance with the ESA 95 provisions, social security contributions to the state funded pension scheme are not considered to be general government revenue. Starting from January 1, 2007, 4% instead of the current 2% of the contribution object will be transferred to the state funded pension scheme. It is forecast that the social security contributions to the state funded pension scheme will comprise 71.3 million lats in 2007.

The tax reduction as a result of changes tax policies will be largely offset by a stable and high increase in corporate income tax revenue. Despite the reduced tax rate, a very steep rise in the corporate income tax revenue was observed in 2004, driven by improvement of corporate profit. Overall it is forecast that the corporate income tax revenue in 2004 will exceed the 2003 collections by 34.8%.

Table 12. Fiscal impact of changes in the main taxes policy, % of GDP

	2005	**2006**	**2007**
Excise tax (increased rate on oil products)	+0.2		
Excise tax (increased rate on tobacco products)	+0.1	+0.1	+0.1
Personal income tax (increase of non-taxable minimum and relief for dependants)	-0.2	-0.2	-0.2
Real estate tax (change in the tax base)			-0.1
Value added tax (application of a reduced 5% rate to public transport services)	-0.1		

5.2. Budgetary expenditure of the general government

Latvian government has adopted Medium-term key concepts for macroeconomic development and fiscal policy 2005–2009, which is a report on the management of the public resources in the medium-term, with clearly identified priority measures. The key concepts state the expenditure of the priority measures of the central government budget, total central government budget revenue and maximum allowable level of the deficit in the central government budget.

The main priorities of the government – development of competitiveness and promotion of employment, human resources development and infrastructure development remain unchanged in the medium-term.

Taking into account that Latvia has become a full-fledged member of the EU and NATO, the Cabinet of Ministers has established the following main priorities in the central government budget 2005:

- alignment of the healthcare system, improving the quality of medical services and their accessibility to the population, and, as a result of that, creating a functional healthcare system;
- integration in the EU and NATO, making full use of the opportunities provided and successfully defending the national interests;
- use the EU policy instrument funding granted to Latvia in full and effectively, ensuring the national development and growth;
- development of the scientific potential.

One of the most important fields for the government's action in 2005 is ensuring acceleration of the growth rates of the national economy, paying a special attention to maximum use of opportunities provided by the European Union and development of knowledge-consuming sectors. Implementing those objectives, the government has made provisions for the national financing required to draw the EU funds and well as to ensure the administrative, technical and financial management and control of the projects. For the purpose of scientific development and raising the quality of education, additional financing in the amount of 29 million lats has been planned for pedagogue salaries and a 2.3 million lats increase of spending for financing scientific fundamental research and scientific development in universities.

Allocations in the amount of 34.5 million lats have been planned in the 2005 budget for alignment of the healthcare system, enabling to launch reforms in the area of healthcare, aimed at improvement of the quality of provided services and efficient use of the available resources.

With joining the NATO, Latvia has become a full-fledged member of the alliance, ensuring the security to Latvia's population. The Law on National Defence Financing stipulates that the central government budget financing in the amount of 2% of GDP shall be provided to national protection, security and NATO integration up to 2008 (inclusive). This amount of financing is necessary to implement the reform of the National Armed Forces and fulfil NATO integration related requirements. In 2005, it is planned to spend 153.3 million lats (including an additional allocation in the amount of 29.4 million lats) on national defence, security and NATO participation.

The government plans to carry out a set of measures in 2005 to improve the support to population in the social sphere; the social budget expenditure will increase by 59 million lats, ensuring pension indexation in 2005. Moreover, in order to improve the demographic situation and promote higher birth rates, 10 million lats have been channelled to a significant rise in childbirth and childcare benefits. Additional funding has been granted also to several other important areas, for example, increasing the wages and salaries of law enforcement institution employees, state probation service, for school song and dance festival, development and construction of the national border infrastructure, investment to improve the infrastructure of places of confinement.

In order to attain the government's objective of reducing the budget deficit, the ministries and other central government institutions have to spend the central government budget funding to a maximum effect and with a maximum efficiency. In the further medium-term budget formulation process it is necessary to evaluate the budget proposals submitted by the ministries for 2005–2009 and legislative acts, in light of the available financing from the central government budget. Implementation of an institutional operation strategy (IOS) is ongoing in public administration.

Institutional operation strategy, in accordance with the priorities established by the government, defines the medium-term development objectives and directions and specific ministry programmes and sub-programmes matching the above as well as their financing. In implementation of the operational strategy, budgetary programmes and policy programmes are gradually integrated, as one of the medium-term tasks of the IOS is to achieve consistency between the budgetary programmes and policy programmes.

Relating to implementation of the institutional operation system, a system of results and performance indicators is required as a part of this system. “Key concepts of the results and performance indicator system” have been developed (approved with the Cabinet of Ministers March 13, 2003 decree No. 162). These key concepts prescribe methodologies how to link the system of results and performance indicators with strategic planning as a necessary component of the strategic planning. The purpose of implementing the system of results and performance indicators is to provide the financial policy management with adequate information on the expected policy outcomes, by measuring alternative policies and types of their implementation in order to take the final decision. Consequently, attainment of the performance indicators will become a criterion for judging the success of implementation of one or another policy, linking the responsibility for meeting the performance targets directly with further financing of the specific policy or measure.

Implementing the IOS, the central government budget programmes are restructured in accordance with the functions and national policies to be implemented by the ministries. In the process of developing the operational strategy, a system of results and performance indicators is also developed for the institutions.

6. Sustainability of public finances

The starting point for evaluation of the sustainability of the Latvian public finances is considerably improved by the existing situation, characterised by a low level of the government debt as well as adequate fiscal discipline resulting in Latvia having had one of the lowest budgetary deficit among the new EU member states during the last years. Latvia's commitment to fulfil the requirements of the Stability and Growth Pact as well as the willingness to join the euro area is another additional guarantee for the sustainability of the positive trends relating to the existing fiscal position.

From the long-term perspective, sustainability of public finances will be mostly influenced by the population ageing trends resulting in a decrease in working-age population and increased social expenditure burden.

This issue was discussed in detail in Latvia's spring 2004 Convergence Programme and, taking into account that only a short period of time has elapsed since then, only slight changes have been introduced to the long-term national financial development indicators of the updated Convergence Programme. All the estimates provided in this section are based on a no-policy-change assumption, taking into account the last actual data and the below-described demographic forecasts. It has to be noted that, with any of those conditions changing, the end result will change as well.

In accordance with the Latvian demographic forecasts, the population of Latvia will have fallen approximately 22% from 2.3 million to 1.8 million by 2050, including the working-age population (aged 15–64) will have diminished by more than 30% totalling 1.0 million, whereas the population above working-age will have grown by more than 30% reaching 0.5 million.

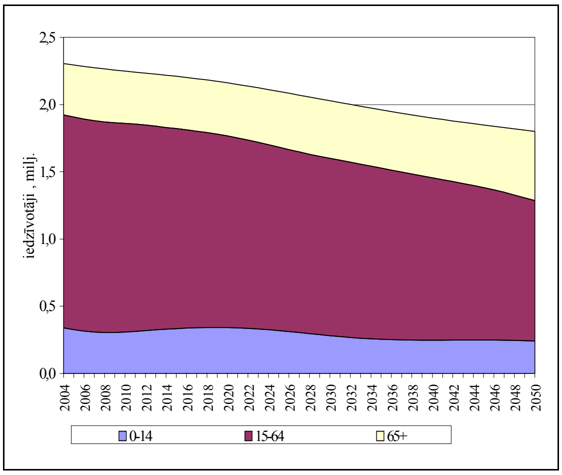

Figure 9. Changes in population from 2004–2050 by age groups.

Ministry of Welfare data

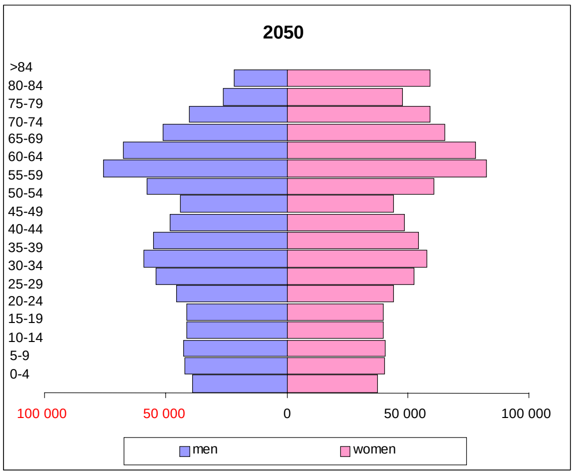

Figure 10. Population by age groups in 2050.

A change in the demographic profile of the population, with the working-age population shrinking, will determine also a decrease in employment after 2015. This decrease, however, will be slightly smaller as it is expected that activity will grow and unemployment will diminish. At the same time, a rise in the number of employed over the working-age stipulated under the legislation could be expected.

As the number of employed will decrease in a more distant future, GDP growth will be primarily driven by growing labour productivity. It can be expected that at the beginning of the forecast period it will be sufficient to ensure gradual convergence with the EU average, but, with the difference becoming smaller, it will slow down.

Unfavourable demographic trends and the need to ensure sustainability of the pension system underlay the implementation of the pension reform in Latvia, which currently is practically finished. Such a timely pension reform mitigated the risks relating to the future financing of the pensions significantly.

Long-term estimates of the pension budget, alongside with the above assumptions include also the transition to pension indexation based on consumer price index and 50% of the real growth in social security contribution wage stipulated in legislation. In accordance with the existing legislation, it will apply to all pensions regardless of their size, starting from 2011. A gradual increase of the state social security contribution rate towards the 2nd tier pension scheme to 10% is planned in 2010. At the same time, the contribution rate towards the 1st tier pension will decrease to 10%.

Although an increase in old-age pension expenditure in the amount of 2.5% of GDP can be expected by 2050, at the same time the pensions payable from the central government budget will shrink by 0.6% of GDP, as the number of state funded pension scheme participants will increase among the pensioners, who will receive part of their pension from life insurance companies in accordance with the law "On state funded pensions". In the medium-term, the decrease in pension expenditure ratio against GDP will be primarily driven by the current raise of the retirement age and the demographic situation among pre-retirement population.

The impact of population ageing on Latvian government expenditure in the long-term is obvious. Although the 1st tier pension scheme in itself is financially stable in the long-term as it has balanced long-term revenue with expenditure through average life expectancy and pension capital index components contained in the pension calculation formula, there may be a deficit in the state pension budget around 2040. It will be primarily driven by a decrease in revenue for financing the deficit rather than an increase in expenditure, as half of the contributions towards pensions will be channelled to the state funded pension tier. It has to be noted that in a more distant period an improvement of the situation can be expected and a decrease in the burden on the pension system relating to both a gradual improvement of birth rates and a decline in death rates among working-age population. Stabilisation of the situation in a more distant future is driven also by the pension system becoming mature (i.e. past the transition period). Forecasts show that all pensions will become contribution-based generation solidarity pensions only around 2080.

At the same time, accumulated assets of the state funded pension scheme will pick up significantly during the next 50 years and will serve as a driving force for economic development.

Table 13. Sustainability of pension system.

% of GDP	**2005**	**2010**	**2020**	**2030**	**2050**
Old age pension expenditure	5.8	4.5	4.8	5.3	8.3
1st tier pensions	5.8	4.5	4.6	4.9	5.2
2nd tier pensions	0.0	0.0	0.1	0.4	3.1
State social security contributions	5.8	5.9	5.9	6.0	6.1
1st tier pensions	5.4	3.8	3.3	3.1	3.0
2nd tier pensions	0.3	2.1	2.6	2.9	3.1
Accumulated assets of state funded pension scheme	1.0	7.3	30.5	58.9	94.9
Assumptions					
Labour productivity growth	5.6	5.4	3.4	2.9	2.0
GDP growth at constant prices	6.7	5.9	2.5	2.2	0.1

Unemployment rate	9.5	7.0	5.6	5.0	5.0
Increase in wages and salaries, at constant prices	5.1	5.0	3.5	2.0	2.0
State social security contribution rate in 1st tier pension scheme	18.0	10.0	10.0	10.0	10.0
State social security contribution rate in 2nd tier pension scheme	2.0	10.0	10.0	10.0	10.0
Average yield in 2nd tier pension scheme	4.0	4.0	4.0	4.0	4.0

Long-term changes in other expenditure relating to ageing population are modelled, based solely on the current situation and forecast demographic changes. Expenditure against GDP in each of the age cohorts is taken as a basis, which changes with the number of population within those cohorts changing.

The estimates are based on 2002 data. They do not factor in any potential policy changes or economic development impact, but show purely demographic impact. In 2005, it is planned to launch a significant medium-term healthcare system reform that may influence the sectoral development in the long-term as well. The impact of this reform on the estimates of the long-term sustainability of the national finances will be reflected in the next Convergence Programmes, by changing the base year for estimates.

Breakdown of healthcare expenditure by age groups clearly shows that the bigger costs fall on older people, the number of which will increase significantly within the next 50 years. Long-term care expenditures are currently quite low in Latvia, determined by both the limited central and local government resources to be spent for this purpose, and traditions and scale of values of the community. If the current expenditure profile for healthcare and long-term care were applied to the future demographic situation, the budgetary expenditure in this area would grow by 13% or 0.5% of GDP.

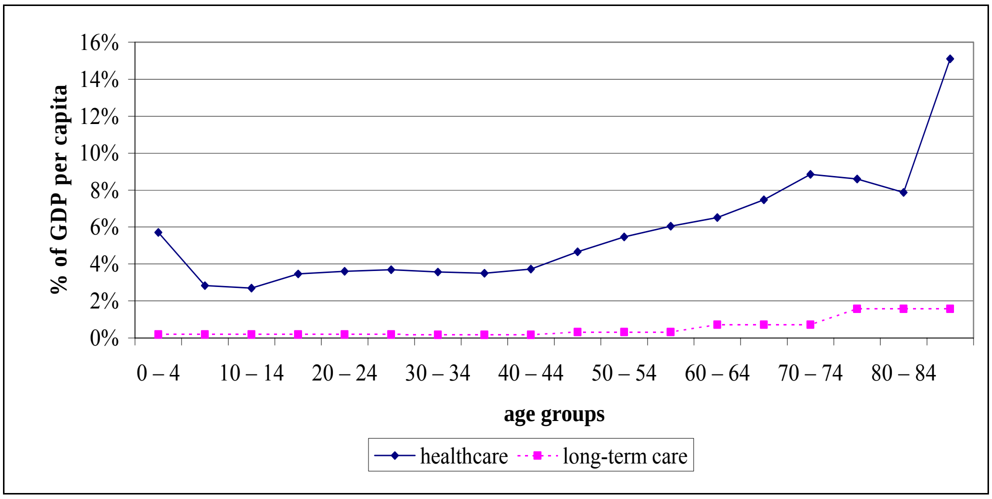

Figure 11. Healthcare and long-term care expenditure by age group, % of GDP per capita in 2002.

The breakdown of education expenditure by age group is broadly opposite to that of the healthcare expenditure. Moreover, the forecast changes in younger age cohorts are different as well. Decrease in population below age of 20 –25 years will be especially rapid within the nearest future, up to 2010. Consequently, due to purely demographic factors, the government expenditure on education could diminish by almost 1% of GDP within the next 5 years. In a more distant future, with the birth rates growing, a slight rise in the expenditure is expected; however, overall the education expenditure could decline by 0.6% of GDP within the next 50 years, under the impact of demographic factors.

Decrease in population and increase in the number and share of elderly people will influence also other fields of economy and public finance, but this influence will be more difficult to model.

Table 15. Impact of demographic factors on healthcare and education expenditure.

% of GDP	**2005**	**2010**	**2020**	**2030**	**2050**
Healthcare (excluding long-term care)	4.0	4.1	4.1	4.2	4.5
Education expenditure	6.4	5.5	5.4	5.6	5.8

Ministry of Finance estimates

Due to demographic factors, healthcare and long-term care expenditure have to increase, whereas education expenditure has to decrease. Moreover, the joint impact of those items as a percentage of GDP is approximately the same and they offset one another, without leaving any impact on the central government budget. These estimates, however, should be approached with great caution. Regarding the healthcare expenditure, it has to be noted that currently they are about 1.5% of GDP[1] lower than the average EU-15 level, and long-term expenditure on elderly people in Latvia are also considerably lower than the EU average, especially if compared with the Scandinavian countries. Therefore, it can be forecast that the reforms required in those sectors relating to improvement of the quality of provided services potentially will also involve an increase in expenditure.

In the area of education, savings caused by changes in the demographic profile, in turn, can be used to improve the quality of education and science rather than to reduce the total expenditure, which is an important factor for raising the future labour productivity. Moreover, it is a medium-term policy issue rather than a long-term one, as the children born in low birth years have reached school age already and in the following years the number of students will only decrease.

Overall conclusion is that population ageing will impact on the Latvian society, economy and public finances, but the impact will be relatively moderate, largely due to the effected pension reform. The low level of Latvia's government debt, with the expenditure pressure growing, also provides certain flexibility to the government, preserving the stability of public finances.

Table 15 Impact of demographic factors on general government budget.

% of GDP	**2005**	**2010**	**2020**	**2030**	**2050**
Total expenditures	39,3	37,0	37,2	38,1	40,3
Total receipts	37,7	36,0	35,5	35,3	35,2
Interest payments	0,8	0,6	0,8	1,1	2,5

Ministry of Finance estimation

Summing up calculations on impact of ageing on general government budget mentioned in this chapter, we see that up to the year 2050 the total public expenditure will increase by 1% of GDP, but total receipts will diminish by 2.4% of GDP. However, implemented pension reform and sharp drop in a number of school age children in the medium-term might even improve budgetary position by about 0.5% of GDP.

Although the initial estimates of sustainability of the public finances, even based on no-policy-change assumption, do not point to significant risks, they show that changes in the public finance policy will be required in the future, in order to adjust the budget to a substantially different demographic situation.

[1] European Policy Committee (2003) "The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme."

7. Horizontal issues affecting public finances

Latvia's currently robust economic growth is largely based on the positive results of the structural reforms implemented in the previous years. Reform processes will continue to be highly significant for the national economic development in the next years as well, and their successful implementation will underlay successful convergence process, with Latvia's integration into the European Union. The structural policy and employment policy measures described herein are integrated also into the macroeconomic development scenario of the programme.

7.1. Latvia's medium-term structural policy objectives and planned measures

7.1.1. Promotion of business and knowledge-based economy

In order to secure a successful convergence process and increase the well-being of the population, Latvia needs to sustain the high economic growth rates, significantly affected by productivity growth. Significant pre-requisites for achieving those results are establishment of an adequate business environment, strengthening of competition and competitiveness, science and innovations. This justifies also the priority attitude undertaken by the state towards the promotion of business and innovations – a total financing in the amount of 159 million lats has been provided for this priority in 2004 – 2006 in the Single Programming Document.

Improvement of business environment

The main goal of business development policy is to ensure favourable business environment, stimulate the initiative of businesses and mitigate general risks, eliminate business obstacles, promote the stability and effectiveness of the financial system and capital market in order to raise the market competitiveness of Latvian businesses.

Activity plan for improvement of the business environment is the most significant, regularly updated policy planning document, incorporating action lines for business environment improvement policy, tasks, measures to be implemented, responsible institutions, performance measures and implementation deadlines. Budgetary financing for 2004 has been allocated in the amount of 260.8 thousand lats.

The plan includes amendments and additions to legal acts, review and simplification of the administrative procedures, improvement of coordination among various institutions, preparation and publication of information as well as training for the staff of public institutions. The plan is a "live" document, as it is being regularly updated with new measures to be implemented, whereas the completed ones are taken out.

Overall, out of 132 tasks that have been included in the Activity plan 127 had been completed by March 1, 2004, which is a very high achievement.

The latest Activity plan has been adopted by the Cabinet of Ministers on September 21, 2004, and the areas addressed are tax policy and administration, legal regulation of the business environment, Latvia's readiness for participation in the EU transit regime and improvement of the legal environment for investment.

Alongside with the attempts to eliminate the administrative obstacles for investment in Latvia, a very important initiative is implemented – Foreign Investors Council in Latvia (FICL), comprising the managers of foreign companies operating in Latvia. Once a year the Council organises meetings with the top government officials. FICL recommendations are incorporated into the Activity plan and represent a specific contribution of investors into improvement of the Latvian business environment. The last summit of the Latvian government and Foreign Investors Council in Latvia took place on October 22, 2004. The next meeting is scheduled for summer 2005.

Promotion of SME development

Latvia's Small and medium size enterprise (SME) development programme 2004–2006 is being prepared. SME development programme implementation measures will be prepared closely linked to the plans for drawing financing from the EU Structural funds, and it is planned to use co-financing from the EU Structural funds for the majority of the envisaged business support measures. Due to this consideration, the next SME development policy implementation programming periods also have been linked to the next Development Plan, so that to include in Development Plans co-financing from the EU Structural funds to fund relevant measures in order to successfully implement the SME development programmes. The following budgetary financing has been envisaged for programme implementation: 8.3 million lats in 2004, 16.5 million lats in 2005 and 17.8 million lats in 2006. The expected return from the programme is an annual increase in budgetary revenue of 5 million lats on average.

Promotion of innovations

On April 4, 2003, the Cabinet of Ministers approved the National Innovations Programme (NIP) 2003–2006, the main task of which is to launch purposeful action to ensure innovation-friendly economic, social and cultural environment, promoting the formation of a new, knowledge-based economy in Latvia. The NIP objective is to encourage an improvement of the National innovations capacity.

Other ministries and institutions are also involved in attainment of the above objectives and implementation of the National Innovations Programme measures (Ministry of Education and Science (MoES), Higher Education Council, Latvian Council of Science, Latvian Development Agency, Latvian Technological Centre, Patent Board as well as other institutions are involved in implementation of specific activities). Every year the involved institutions develop and the National Innovations Programme Council approves an Action Plan for Implementation of the National Innovations Programme.

In 2004, the most significant activities of the plan relate to implementation of public support measures, aimed at promotion of competitiveness and innovations by attracting financing from the European Union Structural Funds. Starting from August 2004, the businesses have an opportunity to submit projects to the Latvian Investment and Development Agency, in order to receive support from the central government budget and the European Regional Development Fund for various business development measures. A special public support programme "Support to development of new products and technologies" is specifically aimed at promotion of innovations and its purpose is to support the development of new or significantly improved products or technologies and their introduction into production. Within the framework of this Programme, support is extended to developing the concept or preliminary sample of new products. Within the next three years, it is expected to invest 25 million euro as public financing to promote research and development through the Programme, and no less than 11 million euro will be attracted from the private sector.

7.1.2. Promotion of exports

On October 12, 2004, the Cabinet of Ministers approved Latvia's exports promotion programme (Programme). The Programme is a medium-term policy planning document for 2005 – 2009, setting the exports promotion targets, main tasks and results to be achieved.

The purpose of the Programme is to actively promote the international competitiveness of the Latvian businesses, facilitate conquering of new markets as well as strengthening of the positions on the existing ones.

In order to attain the set objectives, the following directions for action have been established in the Programme: establish the institutional infrastructure for exports promotion in Latvia and abroad, promote the international competitiveness of the Latvian businesses and professional capacity, provide support to exports marketing measures and develop and ensure financial instruments for exports promotion.

7.1.3. Promotion of tourism development

Latvia's Basic Concepts for Tourism Development 2004 – 2008 state the objective of Latvia's tourism development policy – to increase the share of tourism in Latvia's gross domestic product to 5%–7% at the end of the period. In order to attain this objective, the basic concepts highlight three main directions for action:

- positioning of Latvia as a different, safe and recognisable tourist destination,
- development of the incoming and local tourism,
- development of cooperation.

Within the nearest future, it is expected to introduce the National tourism satellite accounts, in order to provide the tourism sector companies with information on tourism's contribution to the economy and to facilitate comparisons between the statistical indicators of Latvian tourism and those from other countries.

The required budgetary financing to improve the tourism infrastructure, promote the creation of diverse products and services is about 10 million lats within the time period from 2005–2007.

The following amounts are expected to be used on creation of natural and cultural heritage tourism products and infrastructure development from the European Union Structural Funds: 1.3 million lats in 2004, 2.6 million lats in 2005, 2.6 million lats in 2006, while the public contribution of Latvia will be 0.4 million lats in 2004, 0.8 million lats in 2005 and 0.8 million lats in 2006.

The required budgetary financing for international cooperation (including participation in World Tourism Organization) and other representational needs concerning the national interests and those of the tourism industry is 1.1 million lats within the time period from 2004–2007.

7.1.4. Energy sector development

The objective of the energy policy is to ensure supplies to the economy and population at economically justified and minimum prices (tariffs), in accordance with the required amount and quality, through efficient use of energy resources and observing the international commitments and standards in the area of environmental protection.

One of the priorities of the sectoral policy is promotion of market conditions and competition in electricity and gas sectors.

For modernisation of heat supply systems in line with the environmental requirements and raising energy efficiency both on heat supply systems production and distribution side as well as the end user's side, and improvement of the heat supply systems, by reducing the content of sulphur in fuel, the EU Structural Funds and the central government budget funds in the amount of 13 million lats will be attracted from 2004 to 2007.

7.1.5. Development of electronic communication sector

Key policy concepts of the electronic communication sector 2004–2008 set the following objectives:

- unified and transparent regulation of electronic communications, by establishing separate system for technical regulatory issues and specific regulatory issues of the market;
- stable market environment for electronic communication services (successiveness, sustainable development, predictability, public discussion);
- effective competition in electronic communication sector;
- Regulator's independence and strong administrative capacity;
- knowledge-based Information society services accessible to any inhabitant of Latvia;
- promotion of demand for introduction of new electronic communication technologies and provision of new electronic communication services.

In order to attain the above objectives, the following key measures will be implemented:

- tender a licence for work in GSM and UMTS standard;
- stimulate cooperation among electronic communication operators;
- develop universal service financing mechanism;
- in order to promote competition and accessibility of electronic communication as well as to ensure efficient use of electronic communications network infrastructure at the disposal of publicly owned enterprises, ensure access to electronic communication networks by using the existing alternative fixed electronic communication networks;
- implement broadband development in Latvia;
- develop a procedure for allocating, spending and managing national radio band spectrum, numeration space and addressing resources;
- introduce a fee for using limited national resources.

7.1.6. Promotion of public and private partnership

Development of Public and Private Partnership (PPP) Policy has currently started in Latvia; Law on concessions has been developed and adopted, Concession promotion concept (attraction of private capital to discharge the government functions) has been approved.

The Ministry of Economy is in charge of the development of the Public and Private Partnership (PPP) Policy and it has defined the following operational objectives in this area:

- evaluation and improvement of the legal framework;
- coordination of central and local government and private sector activities in the area of implementing concessions;
- evaluation and improvement of the methodology framework;
- implementation of community information measures;

- cooperation with Latvian, EU and other international and foreign institutions on concession policy issues.

An active role in implementation of the PPP is played also by Latvian Investment and Development Agency.

In 2004, a policy planning document “Key Concepts of Latvia’s State and Private Partnership” was developed and is currently in the agreement process. The draft document, in line with *the European Growth Initiative objectives*, provides for using the PPP to create *growth-promoting* infrastructure, by setting the PPP policy application objectives, basic principles and expected results as well as the required actions and financing to attain the set objectives.

Taking into account the European Parliament and Council March 31, 2004 directive 2004/17/EC, coordinating the contracting procedures for subjects engaged in water supply, energy, transport and postal services and directive 2004/18/EC, coordinating contracting in construction, supplies and services sectors and the EC Directorate General for Domestic Market instructions pertaining to improvements of separate provisions, draft amendments to the Law on Concessions have been prepared.

Work is ongoing on development of methodological support instruments for PPP project implementers and provision of methodological support to the potential PPP project implementers.

7.2. Labour market

The long-term objectives of Latvia’s employment policy can only be viewed in the context of common EU objectives, as Latvia has undertaken to address the employment problems within the framework of united Europe, in line with the European Employment Guidelines.

The national employment policy measures are coordinated with the assistance of the annual Latvia’s National Action Plan for Promotion of Employment (previously – National Employment Plan), which is developed in compliance with the concept “On Promoting Employment in Latvia” approved by the government in 1999.

The employment promotion measures envisaged in the plan are closely linked to the Joint Assessment of the Republic of Latvia and the European Commission on “Latvia’s Employment Policy Priorities” and the Single Programming Document 2004–2006, and the new Employment Guidelines 2003–2005 approved by the EU Council of Ministers, as well as the priorities recommended by the employment working group of the European Commission chaired by Mr. Wim Kok.

The National Action Plan’s employment promotion measures have been developed in accordance with the following guidelines – priority operational directions:

1) Active and preventive employment measures for unemployed and economically inactive population.
2) Promotion of businesses and creation of new jobs.
3) Promotion of adaptation capabilities and mobility in labour market.
4) Promotion of human resource and life-long education development.
5) Increasing job offers and promotion of extension of active working age.
6) Ensuring gender equality on labour market.
7) Promotion of integration of socially marginalised risk group population into labour market and elimination of any type of discrimination.

8) Improvement of motivation mechanisms (wages and salaries, taxes, benefit system) by making work more attractive.
9) Transformation of undeclared employment into officially registered employment.
10) Regional cohesion.

The Plan highlights the necessity for effective employment guidelines implementation management, including at the regional and local level, as well as active involvement of the social partners and other stakeholders in this process.

Financing issues of the National Employment Plan 2004–2005 measures relate to the European Social Fund (ESF), which is the main financial instrument for human resources development and improving the functioning of the labour market.

The support available to Latvia from the European Union Structural Funds will generally promote the development of labour competitiveness and quality as well as social inclusion and economic growth, employment opportunities and higher employment. The attainment of these objectives is vital to ensure both the sustainability of the economic development and the resulting sustainability of public finances.

In 2004–2006, the European Social Fund (ESF), which is the financial instrument for implementation of the European Employment Policy, together with Latvia's national co-financing will invest 174 millions euro or 21.22% of total EU Structural Funds financing available to Latvia into the development of human resource skills, expertise and work capacity, by implementing the Single Programming Document[2] priority "Human resources development and promotion of employment".

The support from the European Regional Development Fund (ERDF) is aimed at the elimination of the regional disparities across the EU member states, by promoting the development of disadvantaged regions and structural cohesion. It is expected to provide support to the institutions involved in implementation of the employment policy and social care and social rehabilitation service providers. Together with Latvia's financing, the ERDF will invest 490 million euro in 2004–2006.

[2] Single Programming Document for the European Union Target 1 programme 2004 – 2006 in Latvia approved by June 17, 2004 resolution of the European Commission C(2004) 2121.

Annex

Basic assumptions on external environment

	2004	2005	2006
Interest rate			
Long-term interest rate (LV) (annual average)	4.6	5.2	5.0
United States: short-term (three-month money market)	1.6	2.9	3.6
United States: long-term (10-year government bonds)	4.3	4.7	5.3
Exchange rate			
USD/EUR exchange rate (annual average)[1]	1.23	1.24	1.24
Nominal effective exchange rate (euro area), % change	+2.8	+0.6	+0.3
Nominal effective exchange rate (EU), % change	+5.9	+0.8	+0.1
LVL/EUR exchange rate (annual average)[1]	0.67	0.69	0.69
GDP at constant prices, (%change)			
World excluding EU	5.7	4.8	4.6
EU-15	2.5	2.3	2.4
Global trade (%change)			
EU exports markets, outside EU	11.3	8.9	8.0
Global imports, outside EU	11.6	8.8	8.3
Global imports commodities (commodities, USD)	10.4	3.7	0.5
Commodity prices			
Oil price (Brent, USD per barrel)	39.3	45.1	40.1
Non-oil commodity prices (USD)	12.9	-2.9	-0.5

[1] *Technical assumption*

European Commission data