

Ministry of Finance of the Republic of Latvia

**Convergence Programme of
the Republic of Latvia
2004-2007**

May 2004

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1 Overall Policy Framework and Objectives

With the elaboration of the first Convergence Programme, Latvia fully includes in the EU fiscal and economic policy surveillance procedure starting from the first month of joining the European Union.

Taking into account the short period of time that has elapsed since the Latvia's Pre-Accession Economic Programme 2003 was prepared, the information provided in this programme largely coincides with that reflected in the PEP.

Convergence Programme reflects the objective of Latvia's government to ensure compliance of the fiscal policy with the Maastricht criteria and to become a full-fledged member state of the European Economic and Monetary Union.

Economic and budgetary strategy of the government sets 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 development where the main medium-term priorities are:

- ensuring macroeconomic stability through implementing responsible and sound fiscal policy;
- improvement of business environment by promotion of competition and higher economic activity;
- support to formation of information society;
- strengthening of the human resource capital through improvement of the educational system and promotion of science development;
- addressing the structural problems of employment by promoting growth of activity and employment.

Convergence Programme reflects an internally harmonised economic development scenario providing for an average economic growth of approximately 6.5% which is roughly consistent with the economic potential. Such economic potential is largely based on the implemented and ongoing structural reforms. An additional development stimulus is also Latvia's full integration into the European Union as well as the expected support from the EU structural funds.

The fiscal policy implemented by the government provides that regardless of the increase in spending relating to Latvia's participation in the EU and the NATO, the level of the budgetary deficit will be kept as low as possible, without exceeding the fiscal targets defined already in the previous years (PEP).

2 Economic Outlook¹

2.1 Current Economic Development

Reforms implemented by the government and integration into the European Union have facilitated the development of the national economy. 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.

In the previous years the development of the Latvian economy based on growth in productivity, therefore there was room for higher pickup in real wages and salaries of employed persons in the economy in 2002 and 2003, without threatening overall competitiveness of the economy. The Latvian economy develops in a balanced way and more rapid growth rates of private consumption and investment were presented in 2003. Private consumption grew mainly on account of an increase in real wages and salaries, consumer credit and housing purchase or refurbishment loans. Expansion of lending was encouraged by stability of the financial system, increasing lending opportunities at relatively low interest rates and optimism concerning Latvia's economic development. In 2003, regardless of the fall in direct foreign investment, growing domestic private investment fuelled increase in gross capital formation. Higher public consumption was determined by the need to implement social programmes in Latvia and on account of the costs relating to the accession to the EU and joining the NATO.

In 2003, the economy developed in a balanced way and there was some growth in all the major sectors. Similarly as in the previous years, the largest contributors to the GDP growth were trade, manufacturing and construction. Trade (including retail trade) and construction expanded due to the growing private consumption and development of lending. Active construction of commercial and infrastructure objects still continues, and, within the last year, construction of residential buildings has also activated as the prices on housing have gone up.

Manufacturing expanded by 9.1 percent in 2003. The growth was promoted by the development of woodworking, metal working, food industry and chemical industry. Industrial development in 2003 was also fostered by appreciation of the euro, raising the competitiveness of the sectoral exports in the EU market. Moreover, 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 constitute 56% of Latvia's GDP and rose 8% in 2003. This sector envelops such important services as trade, transport and communications and commercial services. Transport and communications picked up 7.9% in 2003, benefiting from an increase of freight turnover in Latvian ports by 5.0% and in transportation by rail by 20.6%.

Employment increased by 1.8% in 2003. At the end of 2003, the registered unemployment rate was 8.6%. The unemployment rate still differs significantly across

¹ Central Statistical Bureau of the Republic of Latvia has announced that significant changes in the volume of GDP at current prices can be expected in order to achieve better compliance of its estimates with the requirements of ESA 95, by adjusting the data on fixed asset depreciation in the sectors of general government and non-profit organisations providing services to households as well as taking into account imputed rentals for housing occupied by the owners of this housing themselves. The changes will affect the time period starting from 1995. At the moment of preparing this Convergence Programme, the adjusted GDP data were not yet available. The impact of changes on the appraisal of the national economy and the fiscal situation will be examined in to next Convergence Programme to be developed in autumn 2004.

Latvia's districts and towns. In 2003, the average registered unemployment rate in Riga was 4.3%, whereas in separate districts of Latgale it exceeded 20%. The share of long-term unemployed in total unemployed was also decreasing very slowly and stood at 26.1% at the end of 2003. Decline in the share of job seekers (unemployment according to the ILO definition) also signals improvement in the labour market. During 2003, it gradually shrank and recorded 10.3% at the end of the year (11.6% at the end of 2002).

In 2003, real wages and salaries of the employed increased by 8.3% and that is the most substantial growth experienced during the last years.

Latvia's foreign trade turnover experienced buoyant growth in 2003. Imports of goods and services grew by 19.6%, while exports picked up 13.5%. Foreign trade turnover in 2003 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. Principal Latvian goods imported are machinery and mechanical appliances, electrical equipment, raw materials and transport vehicles. The structure of Latvia's exports is dominated by wood and articles of wood, textiles, base metals and articles of base metals. Main trade partners of Latvia in 2003 remained the EU, Baltic and CIS countries.

Due to sharp deterioration of the trade balance in 2003, the current account deficit of the balance of payments reached 9.2% of GDP. Increase of the current account deficit was partly offset by growing current transfers. Current account deficit was covered by direct foreign investment and other investment, and the foreign reserves of the Bank of Latvia grew.

In 2003, consumer prices increased by 2.9% on average, determined by a rise in the administratively regulated prices (increased rent, higher tariffs for heating, higher changes for waste removal), prices on medical services and products as well as imported goods as a result of the euro appreciation. Prices on foodstuffs were influenced by measures to implement the EU requirements in the area of food production and unfavourable weather conditions.

2.2 Macroeconomic scenario

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

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	6.7	6.7	6.5	6.5
2. GDP level at current prices (mln. euro)	B1g	9106	9737	10800	11893	13086
3. GDP deflator		5.2	4.3	3.8	3.4	3.3
4. CPI (average annual) change		2.9	4.5	3.7	3.0	3.0
5. Employment growth*		1.8	1.0	1.0	0.5	0.5
6. Labour productivity growth**		5.5	5.6	5.6	6.0	6.0
GDP by expenditure: changes at constant prices, %						
8. Private consumption expenditure	P3	8.9	8.4	7.8	7.5	7.0
9. Government consumption expenditure	P3	3.0	2.0	2.0	2.0	2.0
10. Gross fixed capital formation	P51	10.6	11.7	10.6	10.5	9.1
11. Changes in inventories and net acquisition of valuables (% of GDP)	P52+P53	5.7	4.5	3.4	2.4	1.8
12. Exports of goods and services	P6	6.8	7.5	8.2	8.1	8.2
13. Imports of goods and services	P7	13.0	8.0	7.7	7.8	7.7

Contribution to GDP growth						
14. Final domestic demand		9.2	9.6	8.8	8.7	8.0
15. Changes in inventories and net acquisition of valuables	P52+P53	2.4	-1.6	-1.2	-1.2	-0.7
16. External sector balance of goods and services	B11	-4,2	-1,3	-0,8	-1,0	-0,9

* 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.

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. In comparison with 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. It is forecast, however, that in the medium-term the greater share of the population's income will be turned into savings, hence slowing down the growth of consumption. Within the nearest years, increase in consumption will be offset by the expected price rises, tighter fiscal and monetary policy.

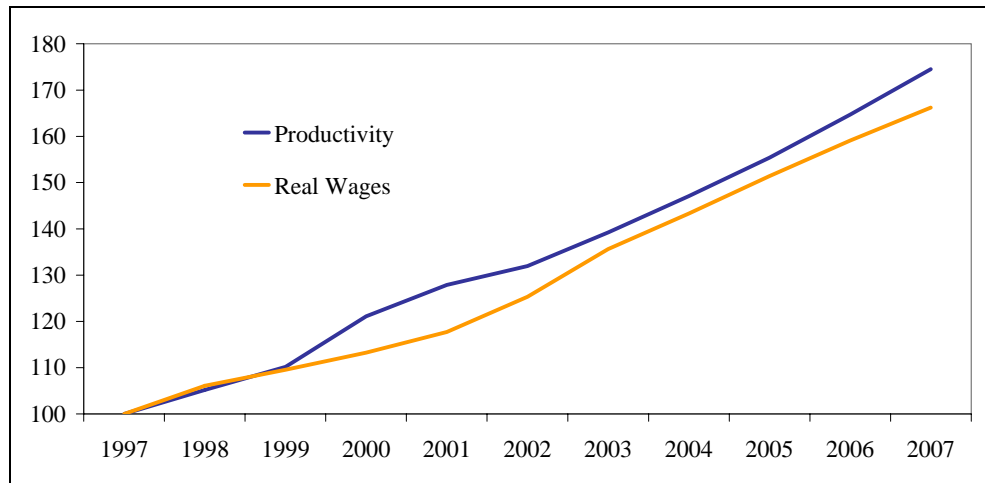


Figure 1. Growth of productivity and real wages, 1997=100.

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, investment favourable 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 constant growth of the foreign trade turnover. It is expected that the growth of **exports** in the medium-term (annual average of 8.1% at constant prices) will exceed that of the imports (7.7%). During the previous periods, several sectors have received significant investment (e.g., manufacturing, transports and communications); therefore, there is hope that productivity and, consequently, also competitiveness will grow significantly. High share of capital goods in the structure of Latvian imports is also a sign of 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 in 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.

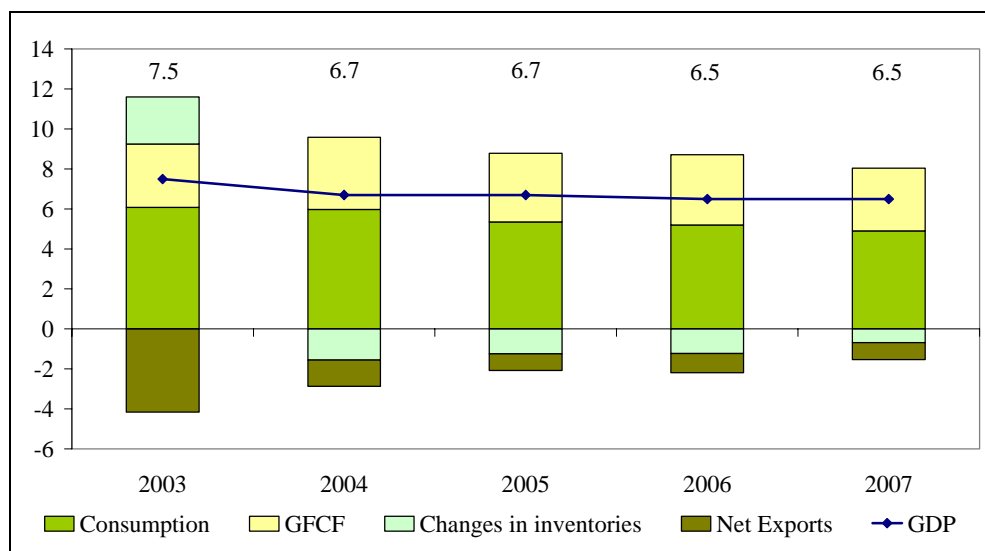


Figure 2. Contribution to GDP growth, %.

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 great 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 rates 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 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 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 in the domestic EU market and the support drawn from the EU funds for modernisation and 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, 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 is 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 private services in the structure of GDP can be also predicted. Development of private services will be driven by the development of various services sectors.

Transport and communications, especially oil transit from Russia, depend on politically regulated factors. However, further development of infrastructure and diversification of services in the future will determine an increase in freight transportation. Sectoral development will be fostered by both growing foreign trade of Latvia as well as the development of the exports in 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 communications 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*.

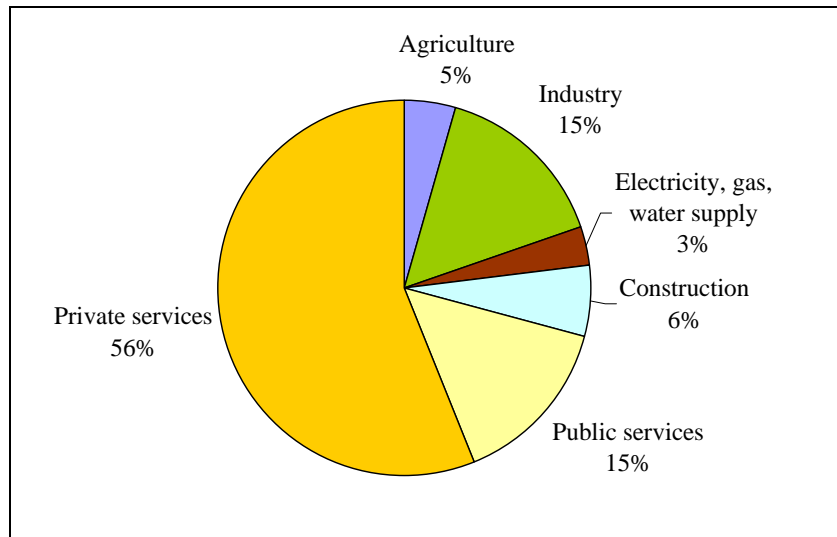


Figure 3. Structure of GDP by sector in 2003, %.

Employment

As a result of low birth rates, comparatively high death rates and negative net migration, population in Latvia will gradually decrease. In 2007, as compared with 2003, it will have declined by 1.4%.

Analysing the demographic trends, relatively stable number of economically active population can be predicted up to 2010. Moreover, by that time large cohorts of young, well-educated people born in 1980-ties will join the labour market, improving employment composition with young and well-educated people. From 2010 to 2020, however, a significant decrease in economically active population can be anticipated. This decrease will be also related to substantial changes in the age profile of the labour force, with the share of young people aged 15–24 years diminishing significantly and that of 45–64 years expanding.

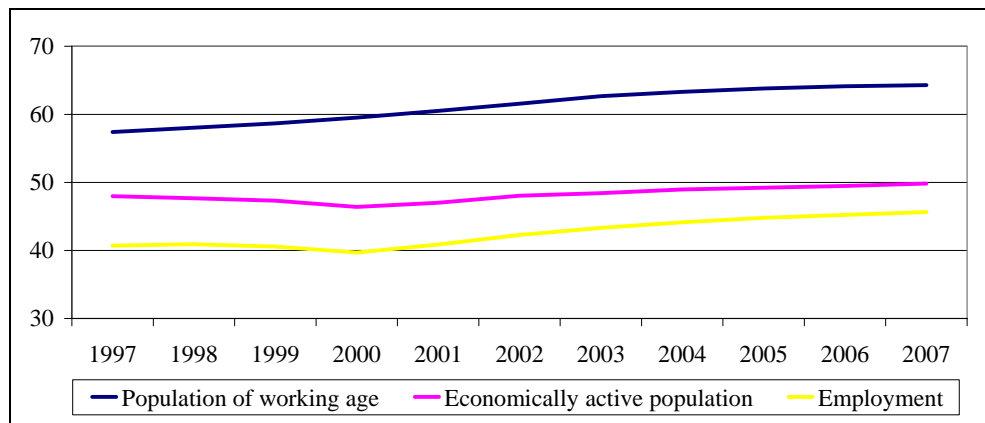


Figure 4. Share of working age, economically active population and employment in total population, %.

Economic activity of population (participation in the labour market) in Latvia is slightly below the EU average, although the economic activity of women has exceeded the EU average already, still being below that of men. Participation of population in the labour

market is influenced by factors like the national system of taxes, benefits and wages and salaries, general level of national economic development, business environment, accessibility and quality of education and training system, accessibility and quality of objective information on labour market, accessibility and quality of active and preventive employment measures, safety at work and quality of work as well as availability of flexible forms of employment contracts.

The existing employment rate in Latvia falls behind the EU average, although the employment rate of women has exceeded the EU average already and has reached the target of 57% set for 2005 in Stockholm. In the medium-term, the growth of employment will be promoted by measures supported by the national economic programme and EU structural funds.

Macroeconomic development scenario envisages a gradual decline in job seekers (unemployment according to the ILO definition) to 8.4% in 2007, facilitated by increasing economic activity as well as various economic policy measures (regional development, promotion of investment, regional mobility of the labour force, development of small and medium size enterprises, finding balance between demand and supply).

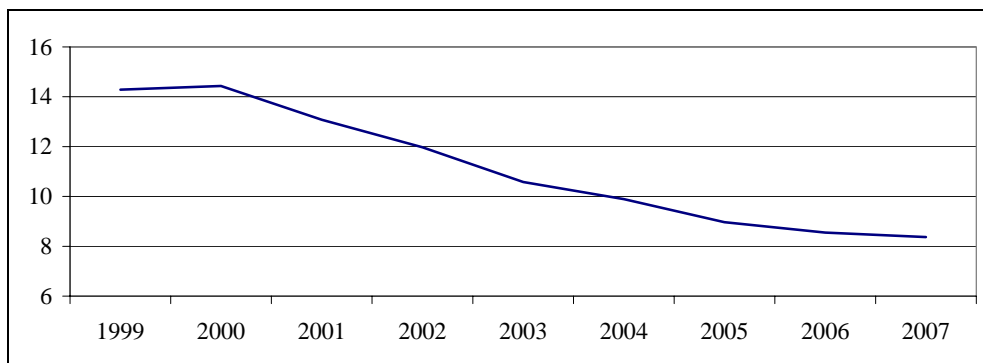


Figure 5. Job seekers, % of economically active population.

2.2.2 Inflation

Average rise of consumer prices in 2003 stood at 2.9%. At the end of 2003, the level of consumer prices was 3.6% higher than at the end of the previous year. The steepest growth in 2003 was experienced in prices on non-food (by 5%), prices for food products increased by 2.6% and services by 3.6%.

Taking into account the peculiarities of the economy and relatively high openness of the economy, Latvia's price developments are largely driven by external factors, the most important being changes in prices on imports. In 2003, as a result of the euro appreciation, the prices on imports rose by 7.7%. Therefore, considering the comparatively high integration of trade with the EU countries, changing the peg of the lats to the euro in 2005 is justified and it will mitigate the impact of exchange rate fluctuations on the prices of imports, hence supporting preservation of the price stability attained within the last years.

In the last year, administratively regulated prices on several important services have changed as well. In 2003, prices on gas (by 9.2%), water supply (12%), sewerage, heating (7.7%) and waste removal went up. Electricity tariffs picked up 15.4% in January 2004 (in comparison with December), and the tariffs for the supply of natural gas will increase in July, at the same time causing an increase in the heat production tariffs.

Growth of inflation in 2004 is expected to be higher, determined by a combination of several one-off factors. Primarily, those will be growing administratively regulated prices,

high import prices and institutional changes relating to the EU accession. One of the reasons for a short-lived increase in consumer prices are also inflation expectations that are based on psychological impact and speculations about the expected price increase with Latvia's accession to the EU drawing close. Such an increase in prices is influenced by both the price level established by producers (mainly for non-marketable services) as well as growing consumer demand. With the view of restricting the increase of private consumption and inflation, the Bank of Latvia raised the refinancing rate by 0.5 percentage points in March 2004 and postponed the reduction of the reserve requirement and harmonisation with the EU level until the end of 2004.

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 provide for stability of the LVL/EUR exchange rate starting with 2005, stable inflation in the EU countries (close to 2%), a slight decline in the global oil prices and a gradual decline in unemployment in Latvia. The forecast also factor in the expected changes in administratively regulated prices and the potential impact of institutional changes relating to the EU accession.

Table 2. Changes in consumer prices

	2003	2004	2005	2006	2007
	actual	forecast			
CPI changes (year-on-year)	2.9	4.5	3.7	3.0	3.0

2.2.3 Monetary and Exchange Rate Policy

Upon accession to the European Union, Latvia acquired a status of a "country with derogation". It means that Latvia has to prove its ability to meet the criteria laid down in the Treaty establishing the European Community required for the Economic and Monetary Union membership.

The status of the new member states provides that until the adoption of the euro they have to implement 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 margins of +/- 15%, which would both ensure the required level of flexibility and promote the stability of the macroeconomic policy and nominal convergence, hence creating pre-requisites for the adoption of the euro.

On 9 December 2003, expressing support to the above position, the Latvian government approved the strategic directions concerning Latvia's preparation for full-fledged participation in the Economic and Monetary Union. In accordance with the Latvia's position formulated in the document and the target dates for completing preparatory activities in order to adopt the euro, the Bank of Latvia plans to change the lats peg from the SDR currency basket to the euro on 1 January 2005. 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 of the role of the euro in foreign trade settlements from 22% in 1994 to 54% in 2003. It can be expected that, with the EU enlargement and further economic integration, the role of the euro in Latvia's economy will continue to grow in the next years as well, and, consequently, changing the currency peg will be adequate to the economic developments in Latvia. Coming to an agreement with the participants of the Eurosystem, the Bank of Latvia plans to enter 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 Economic and Monetary Union.

Considering the small size of the economy and high degree of openness, the Bank of Latvia believes that the fluctuation margins of +/- 15% offered by the ERM II are too wide for Latvia and a narrower band would be more appropriate in order to prepare for successful future adoption of the euro. Firstly, it would facilitate both preservation of the price stability as well as the convergence of interest rates and economic policy discipline, hence supporting the nominal and real convergence. Secondly, a narrower exchange rate fluctuation corridor would eliminate the potential uncertainty that, taking into account the small size of the Latvian economy, could be caused by exchange rate volatility stemming from separate speculative transactions. Moreover, Latvia's economy has proved to possess the level of flexibility required to successfully overcome the consequences of economic shocks within the framework of the existing exchange rate regime, without resorting to adjustments of the national exchange rate; therefore, establishing narrower fluctuation margins will not impede with further economic development and convergence. All the above considered, the Bank of Latvia plans to agree on a unilateral commitment to ensure a +/- 1% exchange rate fluctuation corridor around the central parity rate within the framework of ERM II.

In order to prevent shocks in the financial sector, before joining the Economic and Monetary Union the Bank of Latvia plans to adjust the monetary policy to the monetary policy implemented by the European Central Bank. The Bank of Latvia has introduced and is using all the same indirect, market-based monetary policy instruments that are used by the European Central Bank, the only thing that still has to be done being a review of their importance, elements of procedures and harmonisation of the reserve requirement (3% in Latvia) with the requirements of the European Central Bank.

Duration of participation in ERMII will depend on the ability of Latvian economy to meet the convergence criteria and the evaluation of the involved institutions of Latvia's readiness to join the Economic and Monetary Union. Latvia's progress in reaching the nominal convergence and growing economic integration into the euro area suggest that Latvia is able to meet the required pre-conditions for joining the Economic and Monetary Union already in 2007, which is in line with the target period for fulfilling the convergence criteria set by the government. At the same time, the expected benefits to the Latvian economy related to joining a stable monetary union urge the Bank of Latvia to launch the required measures for introduction of the euro on 1 January 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	-9.6	-7.6	-9.2	-9.0	-8.8	-8.4	-8.5
Direct investment	2.0	4.5	3.2	3.4	3.5	3.8	3.8
Changes in reserve assets*	-4.0	0.0	-0.7	-2.1	-1.3	-1.3	-1.3
<i>Changes in other assets:</i>							
Net portfolio and other investment (including statistical discrepancy)	11.6	3.1	6.7	7.7	6.6	5.9	6.0

* a minus sign points to an increase in reserve assets

Latvia's balance of payments, the same as that of the majority of the Central and East European countries, has been characterised by a trade and, consequently, also current account deficit for a longer period of time.

Latvia's development requires capital, and, as the domestic savings are not sufficient to ensure rapid and sustainable economic development, it is necessary to promote inflows of foreign capital. In the circumstances of a fixed exchange rate, concurrent surplus in the

current account and the financial account is impossible; therefore, with the inflows of foreign capital, current account deficit can be expected.

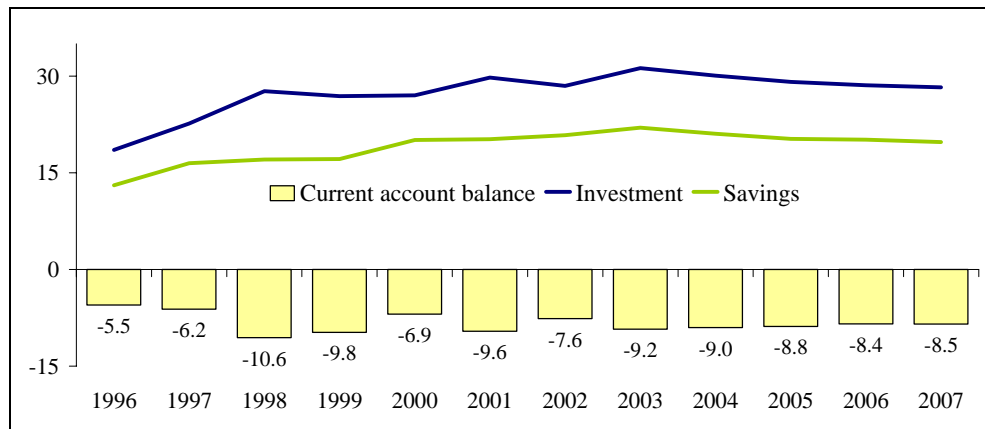


Figure 6. Investment and saving balance, % of GDP.

In 2003, the current account deficit increased in comparison with 2002 and stood at 9.2% of GDP. The main reason for growing current account deficit is increasing trade deficit determined by the need for investment and imports of other goods produced outside Latvia, regardless of the imports becoming more expensive. Similarly as in the previous years, the trade deficit was offset by the services surplus which declined in 2003 year-on-year as the imports of services rose significantly. In 2002 and 2003, the increase of the current account deficit was offset by the growing surplus of current transfers. The deficit of the income account, in turn, has grown and will remain in the medium-term, with the accumulated foreign investment and repatriated earnings of foreign investors picking up.

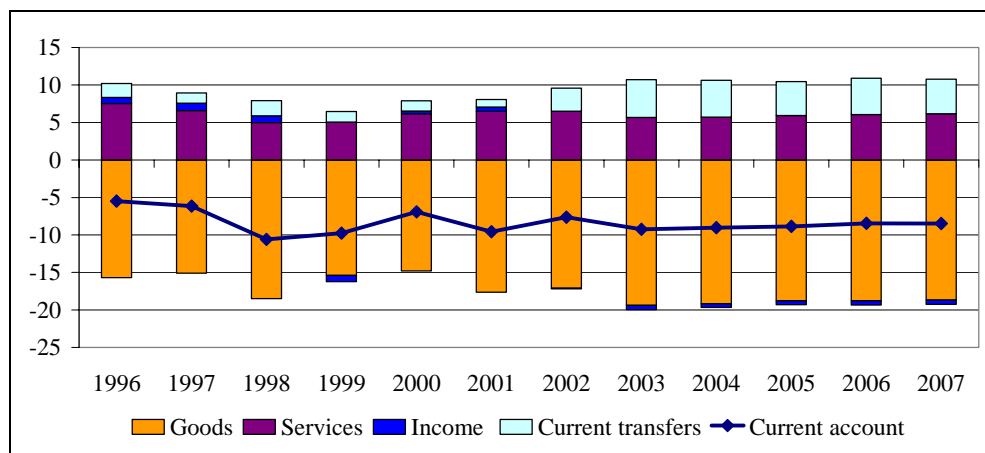


Figure 7. Current account of balance of payments, % of GDP.

In the medium-term, a gradual decline in the current account deficit is forecast, with the exports growing faster than the imports. However, demand for imports will remain relatively high, determined by further modernisation and growing openness of the economy. Stable exports growth can be predicted due to the competitiveness of the Latvia's exported goods in the principal exports markets and the expected increase in return on investment.

In order to achieve an ongoing increase in the volume of exports, it is necessary to increase the share of finished goods and higher value added goods in the overall structure of exports. Within the framework of the national structural policy, the businesses are urged and encouraged to create new products with high value added and engage in exports.

The development of the exports of transit and transport services is dependant on political decisions that are hard to forecast. It especially concerns cooperation with Russia

which is one of the principal partners. Nevertheless, notwithstanding the difficulties, transit has managed to adjust to the situation by diversifying its activities through using various types of transportation and freight. Appreciable pickup in exports is also expected in future due to increasing revenues from tourism and communication services.

Income deficit will continue; both net interest as well as other net factor income will shrink. With the Latvian net foreign debt growing, it is logical to expect a lower interest income balance as before. Steep rise in direct investment income of non-residents, regardless of the deterioration of the current account balance, is a rather good indicator of the financial success of the direct investment made by non-residents.

Current account deficit is financed from the capital account surplus, and the overall balance of payments is with a surplus. Capital inflows enable an increase of the foreign assets.

Mainly private capital (direct investment and financial capital attracted by banks) will be used to finance the current account deficit. Banks and large companies are drawing loans from foreign banks already. As an additional source of financing in the future, issues of corporate securities could be mentioned. Other private sector residents will attract foreign capital through banks and other financial organisations. Consequently, banks, depending on the money demand on the domestic market, will place the attracted long-term and short-term deposits locally or invest abroad.

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 the demand of the trade partners, especially to the economic development in the principal export markets — the European Union and CIS countries. Decrease in 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 unfavourably impacted also by steep changes in the prices of main Latvian imports or exports in the global market. Falling prices of wood which is the main Latvian exports will decrease the value of exports, and the growing oil and energy prices will 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. Latvia has to encourage inflows of long-term capital (direct foreign investment) as short-term capital flows are very volatile and hard to forecast, and their fall may create problems with the balance of payments. With the foreign capital flows diminishing, the foreign reserves of the Bank of Latvia will shrink and that will 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, general government budget balance and 2004 budget

The medium-term goal of the government fiscal policy is to gradually reduce a deficit of the general government budget in order to ensure the long-term balanced budget formation.

The fiscal policy implemented by the Latvian government is established to facilitate balanced growth of the economy. Latvia's accession to the European Union and planned participation in the European Monetary Union requires consistent implementation of the Maastricht criteria. In order to achieve that, it is necessary to implement balanced fiscal policy ensuring friendly tax policy for Latvia's population and entrepreneurship, promoting economic development and ensuring effective and efficient spending of the public finances.

The assumption that it will not be possible to sharply reduce the budget deficit and ensure the balanced budget formation within the next years is determined by a number of factors:

- Within the next years, in addition to financing the existing budgetary programmes, Latvia will have to ensure the national co-financing for the European Union funds, agricultural policy, rural development and European Community programmes and initiatives (INTERREG, EQUAL etc.).
- Additional financing will be required also for ensuring implementation of international treaties and the EU legislation into Latvia's legislation in order to comply with the provisions of the EU Accession Treaty.
- Starting from 2004, Latvia's contributions to the European Community budget have been incorporated into the central government budget expenditures.
- Within the period of up to 2008 resources in the general government budget has to be provided on state defence, security and for integration into NATO in the amount of 2% of GDP.
- The increase of the budget expenditure on human capital investments and for development of public infrastructure.

In order to assess the effect of expenditure mentioned above on the increase of the general government budget deficit, the theoretical calculation was made by assuming and determining new policies influence on the increase of deficit. 2003 is assumed as a base year. The calculation was made by assuming that in 2004 the resources of the program "State defence, security and integration into NATO" and co-financing for the pre-structural EU funds are in the same level as it was in 2003 and no payments are provided for the European Union budget and co-financing and pre-financing of the projects of the EU funds. The theoretical calculations indicate that the influence of the new policies' expenditure is significant and it increases the deficit by 0.7 percentage points in 2004, without changing existing policies.

Table 4. Changes in the general government budget deficit in compliance with new policies (% of GDP)

	2003	2004
Deficit, % of GDP	-1.8	- 2.1
Deficit excluding influence of new policies, % of GDP		- 1.4

It is necessary to mark that within the late years the role of the state sector diminishes in connection with redistribution of revenues, because the improvements of entrepreneurship by reducing the rates of several taxes, which decrease the budget revenues in the short-term, took much attention. However such a policy promotes together development of entrepreneurship, investment attraction and creation of new work places, which will promote the increase of budget revenues in the medium-term and long term. An important goal of Latvia's tax policy is to ensure complete harmonization of the Latvian tax system with requirements of the EU directives, and at the same time to ensure protection of the state national interests. Information in details about the changes and impact of the tax policy can be found in the Chapter 5 "Quality of public finances".

Social transfers in kind and social transfers other than in kind form 30 percent of the Latvia's budget expenditure. Mainly those are expenditures for pensions and relieves, which are social sensitive expenditures and reduction is problematical especially because of the low living standards for many Latvia's residents.

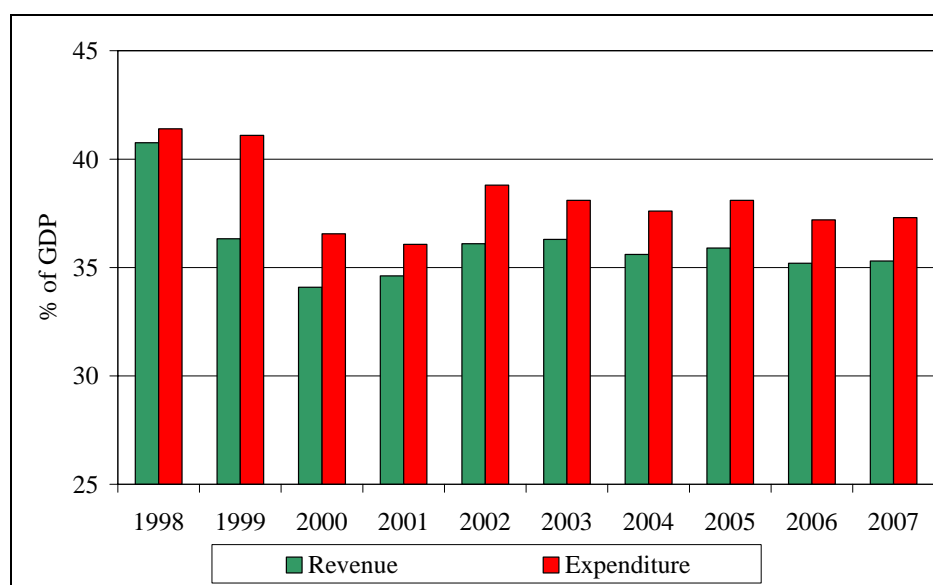


Figure 8. General government budget revenue and expenditure, % of GDP

In 2003, the general government deficit was 1.8% of GDP, although a higher amount of deficit was forecast. In 2004, the general government deficit is forecast at 2.1%. Taking into account that currently work on the formulation of the 2005 budget continues, it is possible that the budgetary deficit for the next year will be revised.

Table 5. General government budget (millions of lats)

	2003	2004	2005	2006	2007
	actual	plan		forecast	
Revenue	2131.5	2322.7	2663.3	2846.9	3093.1
Expenditure	2237.0	2457.7	2822.5	3006.3	3268.4
Balance	-105.6	-134.9	-159.2	-159.4	-175.3

Overall general government budget deficit in 2004 and in the medium-term will be determined by the central government budget deficit. 2004 central government budget has been formed based on the principle of savings and maximum efficiency of spending the public finances as well as increasing expenditure on priorities.

Taking into account that in 2004 Latvia becomes a full-fledged member of the European Union and has joined the North Atlantic Treaty Organisation (NATO), Latvia's government have selected for one of the main priorities to use opportunities, which offer the participation in the European Union and NATO, promoting Latvian economic development and ensuring security to population.

Becoming a member state of the NATO, Latvia has made a provision in the amount of 2% of GDP in the national budget for the programme "State defence, security and participation in NATO". In 2004, it is planned to spend 121.9 million lats on state defence, security and integration into NATO. Provisions in the amount of 2% of GDP will have to be made in the national budget for national protection, security and NATO integration also in the years to follow (up to 2008).

In order to ensure implementation of Latvia's commitments to make contributions into the European Community's budgetary revenue through participation in the own resource system of the European Community, in 2004 Latvia will have to make payments to the European Community budget.

In order to ensure sustained and well-balanced social economic growth in Latvia, the activities appropriate to the priorities established by the government can be financed by the European Union funds. The top priorities are to increase competitiveness and facilitate high employment, to facilitate the development of human resources and infrastructure.

In addition to funding contained within the budgets of several ministries, 8.5 million lats have been dedicated for raising the administrative capacity of ministries involved in EU funds management, 30.9 million lats have been provided for implementation of projects and activities co-financed from the European Union funds in order to ensure implementation of projects from the Structural funds, guarantee section of the EAGGF and Community initiatives, and 3.2 million lats for implementation of projects co-financed from the Cohesion fund. Additional financing have been provided for continuing the reform of the teacher wages and increasing the wages of medical personnel, policemen, prosecutors, judges and court employees as well.

2004 local government budget deficit has been established in accordance with the overall increase of local government borrowing prescribed in the law on the state budget. It is expected that the local government budget deficit will remain at the 2004 level also in the medium-term. In accordance with Article 22 of the law "On Local Government Budgets", the overall allowable increase in local government borrowing is established by the annual law on the state budget, and currently it is not expected that the borrowing limit will be changed significantly.

In 2003, there was a surplus in the amount of 0.7% of GDP in the social security budget. Currently it is forecast that the surplus in this budget will prevail also in the next years unless there are essential changes in social security system. However, it is anticipated that the amount of the surplus will decline to 0.3% of GDP in 2007 as an increase in expenditure is expected.

The pension indexation has a significant effect on the amount of expenditure in the social security budget. According to the law "On State Pension", all state pensions below five-fold state social security benefit have to be reviewed annually, but if year's average inflation exceeds 3%, then in every half year, based on the actual consumer price index and

the real increase index of social contribution wage. In 2004 and 2005, all state pensions below three-fold state social security benefit will be indexed twice a year, based on the actual consumer price index and 50% of the real increase index of social contribution wage, whereas all state pensions exceeding three-fold state social security benefit but below five-fold state social security benefit will be indexed 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 index of social contribution wage.

Conventional risk that may affect the size of the social security budget expenditure is the solution incorporated in the summary of the concept "On Required Action to Eliminate Gaps in Implementation of the State Pension Policy" supported in accordance with the Cabinet of Ministers January 14, 2004 decree No.23 "On Concept "On Required Action to Eliminate Gaps in Implementation of the State Pension Policy"", providing that from January 1, 2005 additional payment has to be added to the pensions from the social security budget funding for each year of insurance record accumulated before January 1, 1996, so that the pension together with the additional payment would not exceed 80 lats in 2005, and hereinafter this limit has to be reviewed every year (with the view of gradually lifting it). The additionally required financing will be identified depending on the surplus accumulated in the social security budget, i.e. in accordance with the Concept it will be 28–39 million lats.

Table 6. General government budgetary developments

% of GDP	ESA code	2002	2003	2004	2005	2006	2007
Net lending (B9) by sub-sectors*	S 13						
1. General government	S 1311	-2.7	-1.8	-2.1	-2.2	-2.0	-2.0
2. Central government	S 1312	-1.6	-2.1	-2.6	-2.6	-2.2	-2.2
3. State government	S 1313						
4. Local government	S 1314	-0.9	-0.4	-0.2	-0.2	-0.2	-0.2
5. Social security funds	S 1315	-0.2	0.7	0.7	0.6	0.4	0.3
General government (S13)							
6. Total receipts	ESA	36.1	36.3	35.6	35.9	35.2	35.3
7. Total expenditures	ESA	38.8	38.1	37.6	38.1	37.2	37.3
8. Budget balance	B 9	-2.7	-1.8	-2.1	-2.2	-2.0	-2.0
9. Net Interest payments	D 41	0.9	0.9	0.9	0.9	0.8	0.8
10. Primary balance		-1.8	-0.9	-1.2	-1.3	-1.2	-1.2
Components of revenues							
11. Taxes	D2 + D5	21.2	21.4	19.8	20.0	19.7	19.5
12. Social contributions	D 61	10.3	10.0	9.7	9.5	9.5	9.4
13. Other		4.6	4.9	6.0	6.4	5.9	6.4
14. Total receipts	ESA	36.1	36.3	35.6	35.9	35.2	35.3
Components of expenditures							
15. Collective consumption	P 32	9.7	9.9	10.1	10.4	10.4	10.8
16. Social transfers in kind	D 63	0.7	0.8	0.7	0.6	0.6	0.6
17. Social transfers other than in kind	D 62	11.4	10.4	9.7	9.7	9.2	8.8
18. Interest payments	D 41	0.9	0.9	0.9	0.9	0.8	0.8
19. Subsidies	D 3	0.8	0.9	0.9	0.9	0.9	0.9
20. Gross fixed capital formation	P 51	1.5	1.7	1.7	1.8	1.8	1.9
21. Other		14.5	14.2	14.3	14.5	14.1	14.1
22. Total expenditures	ESA	38.8	38.1	37.6	38.1	37.2	37.3

* Operative data, which may change during improving methodology.

3.2 Structural balance

Actual budgetary deficit reflects the impact of permanent (structural) and transient (cyclic) factors. Structural factors relate to the permanent government policies in circumstances when the economy is developing in accordance with its potential. Cyclically adjusted budgetary balance shows the impact of business cycle fluctuations on the government revenue and expenditure.

Cyclically adjusted budgetary balances were calculated in accordance with the methodologies developed by the European Commission, using the macroeconomic and fiscal development scenario discussed in the Convergence Programme.

In order to evaluate the cyclically adjusted budgetary balance, a difference between the potential and actual GDP as a percentage of the potential GDP is estimated and the elasticity of the budgetary revenue against the actual GDP. Production function was used in estimating the potential GDP. In order to establish the elasticity of the public finance, the elasticity of the budgetary revenue was calculated using the data on 5 main taxes (corporate income tax, personal income tax, social security contributions, value added tax and excise duty). The cyclic part of the budget 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.

Calculated revenue elasticities reflect the main correlation between the amount of tax revenue and economic growth, however do not consider changes in the taxation policy as well as elasticity deviations in different stages of the business cycle. Average elasticity of the revenue part of the cyclically adjusted budgetary balance to the GDP amounts to 0.7.

The analysis of structural balances and other economic indices have been improving by the development of availability and quality of statistical information, as well as implementing ESA 95 accounting standards. Though, on the other hand, changes in the statistics cause a problem of insufficiently long data row.

Within the short period of time after restoration of independence, profound structural reforms have been implemented in the Latvian economy on the way from planned to market economy, several internal and external economic shocks have been overcome. Therefore, it is difficult to make a judgement about the cyclic development of the economy, and the evaluation of the economic potential is approximate.

Taking into account the trend that the business cycle fluctuations become smaller, no significant differences between the potential and actual GDP level have been observed nor forecast. Therefore, the actual budget deficit will almost coincide with the cyclically adjusted budgetary balance.

Table 7. Cyclical developments

% of GDP	ESA code	2003	2004	2005	2006	2007
1. GDP growth at constant prices	B1g	7.5	6.7	6.7	6.5	6.5
2. Actual balance	B9	-1.8	-2.1	-2.2	-2.0	-2.0
3. Interest payments	D41	0.9	0.9	0.9	0.8	0.8
4. Potential GDP growth		7.4	6.8	6.5	6.4	6.3
5. Output gap		-0.2	-0.2	0.0	0.1	0.2
6. Cyclical budgetary component		-0.1	-0.1	0.0	0.0	0.0
7. Cyclically adjusted balance (2-6)		-1.7	-2.0	-2.2	-2.0	-2.0
8. Cyclically adjusted primary balance (7-3)		-0.9	-1.1	-1.3	-1.2	-1.3

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 all financial system. At the same time, the objective of the government's debt management policy is to support stable development of the domestic financial market and promote availability of long-term financial resources to the central government.

Objectives, basic principles and tasks of the government debt portfolio and borrowing management within the framework of the government debt management in the long-term are established by 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 Ministry of Finance and 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 not exceed 2% of GDP 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 domestic government securities market ensuring favourable terms and conditions for attracting resources at relatively low costs. Therefore, it is expected that issues of government securities will remain one of the main sources of financing also in the future, ensuring a constant increase in the amount of government securities in circulation significantly exceeding 100 million lats per annum. In addition to short-term 6 and 12-month Treasury bills, medium and long-term instruments well known in the market of the government securities would be used for financing from 2005 to 2007 (new issues of Treasury bonds with the initial maturity of 3, 5 and 10 years) as well as the possibilities of a tag-on to the 10-year bonds maturing in 2014 is being considered. If necessary, short-term loans and credit facilities offered by domestic financial institutions will be used to ensure short-term financial liquidity.

As the capacity of the domestic financial market is insufficient, in order to attract resources to cover the planned financing needs in full, attraction of the required financing in the external financial market also can be anticipated by using borrowing from international

financial institutions, private or public aimed 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 in 2006 and 2007 are being investigated. The volume and maturity (5, 7 or 10 years) 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 projects 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, which is 60% of GDP, in the medium-term.

Table below displays the data on factors affecting the government debt development and changes in the debt from 2003 to 2007.

Table 8. General government debt developments

% of GDP	ESA code	2003	2004	2005	2006	2007
Gross debt level		15.3	16.2	16.8	17.3	17.7
Change in gross debt		-0.2	0.9	0.6	0.5	0.4
Contributions to change in gross debt						
Primary balance		0.9	1.2	1.3	1.2	1.2
Interest payments	D41	0.9	0.9	0.9	0.8	0.8
Nominal GDP growth	B1g	-2.0	-1.8	-1.8	-1.7	-1.7
Other factors influencing debt ratio		0.0	0.6	0.2	0.2	0.2
Of which: privatisation receipts		-0.1	-0.1	-0.1	-0.1	-0.1
p.m. implicit interest rate on debt		7.4	7.0	6.0	5.4	5.0

Section 4.1. contains information on the changes in general government debt if exchange rates and interest rates change.

4 Sensitivity analysis and comparison with the previous programme

4.1 Sensitivity analysis

Sensitivity analysis is aimed to evaluate the changes in tax revenue while economy growth is changing. Sensitivity analysis is based on the tax revenue forecast set in the 2004 central government budget. In order to evaluate the impact of changes in economic activity on consolidated general budget² tax revenue in 2004, in addition to the base scenario that envisages real GDP growth in the amount of +6.7% at constant prices in 2004, optimistic and pessimistic scenarios were developed where the 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 sectoral structure of the national economy and the GDP deflator (+4.3%) remain unchanged. The volume of public consumption in all scenarios has been preserved unchanged as well.

Table 9. Real GDP growth scenarios used in sensitivity analysis.

Scenario	Real GDP growth 2004.g./2003.g.
optimistic scenario	+7.7%
base scenario	+6.7%
pessimistic scenario	+5.7%

Tax revenues have been forecast similarly as in the central government budget formulation process, based on the existing relationship between changes in macroeconomic indicators and tax revenues.

The results of sensitivity analysis show that, in the event of changes in economic activity, the biggest changes in tax revenue relate to the personal income tax, social security contributions and value added tax.

Table 10. Impact of changes in real GDP growth rates on main tax revenue in 2004 (millions of lats)

Tax revenues	changes in pessimistic scenario	base scenario	changes in optimistic scenario
Personal income tax	-2.3	392.8	2.9
Social security contributions	-3.8	615.3	4.2
Value added tax	-7.2	480.7	5.5
Excise duty	-0.6	225.0	0.6

Changes in the personal income tax and social security contributions revenue mainly relate to both changes in employment as well as changes in the average wages and salaries growth for those employed in the national economy. In accordance with the optimistic scenario, higher investment will facilitate creation of new jobs and increase in wages and salaries. The pessimistic scenario, in turn, forecasts a drop in the wages and salaries growth and also lower employment, due to lower exports growth.

² taxes in accordance with the national definition and cash accounting principle

Changes in value added tax revenue are determined mainly by changes in the growth rates of the imports of goods. The optimistic scenario predicts growing imports, caused by increasing private consumption and investment. The pessimistic scenario, in turn, forecasts lower export growth and expects a drop in private consumption growth as well, with the imports growth being impacted by both lower demand for intermediate consumption goods (used in manufacturing goods for exports) and consumer goods. Accordingly, changes in the value added tax revenue in the pessimistic scenario are much bigger than in the optimistic scenario.

Taking into account that the majority of excise goods are considered inflexible, it is assumed that changes in the consumption of these goods will be insignificant. Higher impact can be forecast on the consumption of oil products (with growing economic activity the consumption of diesel fuel and petrol could increase and vice versa). However, overall it is not forecast that the total excise duty revenue could significantly change as a result of higher or lower economic development rates.

According to the sensitivity analysis, the changes in forecasted tax revenues are asymmetric to the changes in GDP growth rate: worsening in economic situation will have greater influence on the budget deficit. Therefore during preparation of annual government budget forecasts of tax revenues, they are usually considered to be conservative.

Taking into account the possible negative impact, a special procedure has been established in the Latvian legislation. According to Article 25(2) of the law "On Budgetary and Financial Management", the Minister of Finance informs about the delay or decrease in allocation of the necessary expenditure in case, if it is expected that the budget deficit will exceed the level approved in the law on annual state budget. Within the period of seven days since reception of the report from the Minister, the Cabinet of Ministers makes a decision on a delay or decrease in the allocations, and not later than within three working days submits proposals on necessary amendments to the law on annual state budget to the Parliament.

Sensitivity analysis of the public debt portfolio has been carried out calculating the impact of changes in currency exchange rate and interest rates on the amount of the debt and its service expenditure. The calculations have been made for the year 2004.

According to the correlations observed in the previous years, the calculations has been made based on the following assumption – if EUR exchange rate vs. lats increases by 10 basis points then USD exchange rate vs. lats decreases by 4 basis points, GBP exchange rate vs. lats increases by 4 basis points, but JPY exchange rate vs. lats decreases by 9 basis points (per 100 units). With accordance to the structure of the government debt portfolio, while EUR exchange rate vs. lats increases by 10 basis points the state external debt increases by 864.4 thousand lats, at the same time the debt services increases by 249.8 thousand lats. But taking into account that the Treasury uses derivative financial instruments for the debt management the value of the state debt increases by 707 thousand lats.

The sensitivity analysis of interest rates designates that while the average weighted interest rate of the government debt portfolio increases by 1 basis point, the debt services increases by 42.9 thousand lats.

4.2 Comparison with 2003 Pre-Accession Economic Programme

Table 11. Comparison with 2003 Pre- Accession Economic Programme forecasts

	ESA code	2003	2004	2005	2006	2007
GDP growth (%)	B1g					
PEP 2003		6.5	6.1	6.0	6.0	
CP of spring 2004		7.5	6.7	6.7	6.5	6.5
Changes		1.0	0.6	0.7	0.5	
Actual budget balance (% of GDP)	B9					
PEP 2003		-2.9	-2.4	-2.2	-2.0	
CP of spring 2004		-1.8	-2.1	-2.2	-2.0	-2.0
Changes		1.1	0.3	0.0	0.0	
Total general government debt (% of GDP)						
PEP 2003		19.1	17.0	17.4	17.4	
CP of spring 2004		15.3	16.2	16.8	17.3	17.7
Changes		-3.8	-0.8	-0.8	-0.5	

In 2003, economic growth was higher than was forecast in the Pre-Accession Economic Programme. Better than planned budgetary performance underlay a lower budgetary deficit and, consequently, smaller government debt. Nevertheless, the difference with the government debt forecasts was quite big as a eurobond issue that was initially planned in 2003 was postponed to 2004.

Last years development points to a high potential of the Latvian economy, and Latvia's accession to the EU and the possibility to increase investment through using the structural funds will further improve Latvia's productive capacity which will be translated into higher growth.

Initially a higher 2003 budgetary deficit of the general government was forecast. When formulating 2003 central government budget, a lower GDP growth at constant prices was forecast. During all of 2003, very robust economic development was observed, imports grew at a considerably brisker pace than was initially forecast, and that ensured a substantial increase in the value added tax revenue. Large attention was paid to improving the tax collection, facilitating a steep increase in excise duty revenue (especially excise on oil products).

Alongside with the economic development, significant improvement of the fiscal situation in 2003 was determined by the following factors:

- The financial situation of the social security budget improved significantly. While during the previous years there was a deficit in this budget, a surplus of 38.6 million lats formed in 2004. That was driven by a sharp rise in social security contributions determined by an increase in the average wages and salaries in the national economy by 11.4% in comparison with 2002. It has to be noted that the rate of the social security contributions was reduced from 35.09% to 33.09% in 2003.
- Although the total local government budget deficit remains high, overall financial discipline of the local governments is improving. As a result of that, the local government budget deficit declined from 49.3 million lats in 2002 to 23.5 million lats in 2003.

5 Quality of public finances

5.1 Budgetary revenue of the general government

Tax policy of Latvia's government is aimed at reducing the tax burden on businesses, which would facilitate economic development and ensure competitiveness of the economy. In order to attain this objective, the following measures have been implemented:

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

As a result of a reduction in the tax rates, tax revenue over GDP declined from 37.3% in 1995 to 31.4% in 2003. At the same time the tax base was expanded excluding exceptions of tax allowances and improving the tax revenue administration.

In 2004, tax revenue are determined by economic development forecasts providing for high GDP growth rates; wages and salaries, domestic demand and other most important economic indicators will continue to grow. At the same time, the corporate income tax is reduced from 19% to 15% in 2004, and, as a result of that, a decline in the corporate income tax revenue is forecast. Reduction of the tax rate will support businesses and that will ensure an increase in the tax revenue in the medium-term. Therefore the tax reform is completed.

It is also forecast that customs duty revenue will decrease year-on-year in 2004, as it is expected that after the EU accession only 20–25% of the goods will be subject to the customs duty that were taxed before Latvia's accession to the EU.

Starting from 1 May 2004, a reduced value added tax rate in the amount of 5% is introduced. Starting from 1 May 2004, excise tax rates on beer are changed, providing that the average rate will diminish in comparison with the current average rate.

In 2004 and in the medium-term, harmonisation of the excise duty rates with the minimum rates set by the EU will continue. In order to ensure that:

- in 2004, amendments are made to the law "On Excise Tax", providing that excise tax on all oil products will correspond to the rates set in the EU starting from 1 May 2004;
- in 2004 and within the time period up to 2010, excise tax rates on tobacco products will be increased year-by-year.

Table 12. Tax revenue of the general government. (millions of lats)

	Code (ESA 95)	2003	2004	2005	2006	2007
		actual	plan	forecast		
Total tax revenue:		1844.8	1928.9	2134.6	2328.7	2533.3
1. Production and imports taxes	D.2	725.0	750.9	836.5	902.7	975.0
2. Income taxes	D.5	531.5	545.1	607.3	670.5	731.9
3. Social security contributions	D.61	588.3	632.9	690.9	755.1	826.3

In the medium-term, it is forecast that the tax revenue will continue to grow relatively quickly, 9% per annum on average. A slight slow-down in growth is determined by the fact that lower growth rates of wages and salaries are forecast in the medium-term (primarily

impacting on revenue from personal income tax and social security contributions). Taking into account the forecast slowdown in imports, lower increase in domestic demand and stable exports growth rates, the growth of the value added tax revenue could decline.

In accordance with Article 13 of the Council of Europe directive 2003/96/EC, member states that have not yet adopted the euro establish the value of the euro in the national currency once every year and then apply it to the value of the excise tax level. Taking into account the planned change of the peg of the national currency to the euro on January 1, 2005, there is a possibility that it will be necessary to review the rates for the excise tax on oil products. Currently the medium-term forecasts of the revenue from excise tax on oil products assume that the 2004 rates will be preserved.

An improvement of tax administration is due to progressive work of the State Revenue Service. From 2003 to 2004 the State Revenue Service has been made several activities to improve tax administration:

- changes in legislation are accomplished, which determinate a framework of tax inspection and collection of tax payments,
- the organization and management of the State Revenue Service is improved, thereby the data bases are available for public, information systems are established and the handbooks of taxes are created,
- Electronic System for Declaration of the State Revenue Service is completed, as well as a work on accomplishing the management and analysis system of collected tax revenue has been started,
- the tax control is improved by making regular auditing processes and inspections, administrative cooperation and mutual cooperation is developed.

5.2 Budgetary expenditure of the general government

Latvian government has adopted medium-term key concepts for macroeconomic development and fiscal policy 2004–2008, 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 established by the government - to increase competitiveness and facilitate high employment, to facilitate the development of human resources and infrastructure for medium-term are the same.

In order to achieve gradual improvement of the fiscal situation, the government continuously works on improvement of budgetary procedures to increase the effectiveness of budgetary spending and optimise planning.

With the view of increasing the effectiveness of budgetary spending, transparency and flexibility, amendments to the law “On budget and financial management” have been introduced. The amendments govern the management of the European Union financing, provide procedures for the financial management of own resources of the European Community as well as specify the authority of the Minister of Finance to increase the appropriation established in the state budget law in relation to Latvia’s membership in the European Union (upon agreeing with the Budget and finance (tax) committee of the Parliament).

In order to improve the linkage between the policy and budget planning processes, a system of institutional operation strategy (IDS) is being introduced 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 and 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 IDS 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 13 March 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 IDS, 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

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

6.1 Demographic forecasts

In accordance with the Ministry of Welfare forecasts, population in 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.

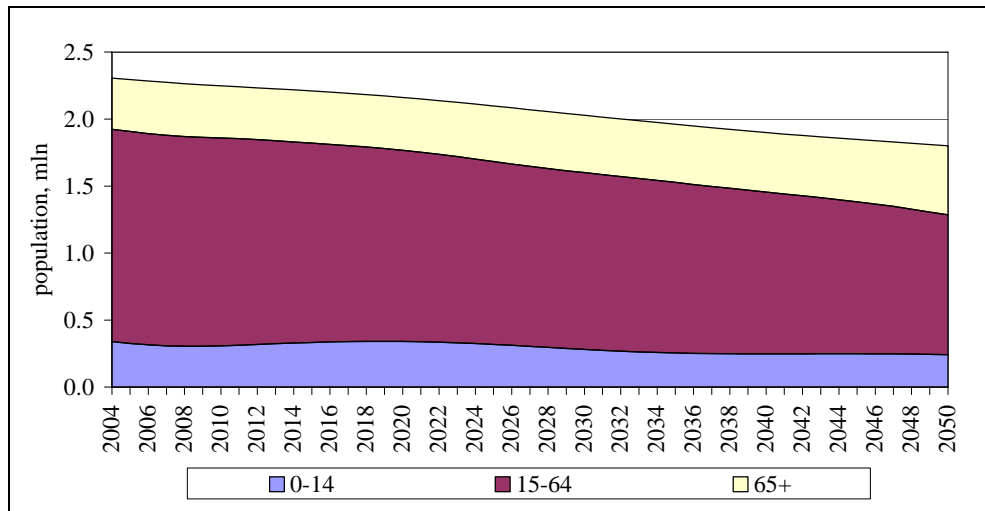


Figure 7. Changes in population from 2004–2050 by age groups.

Ministry of Welfare forecasts

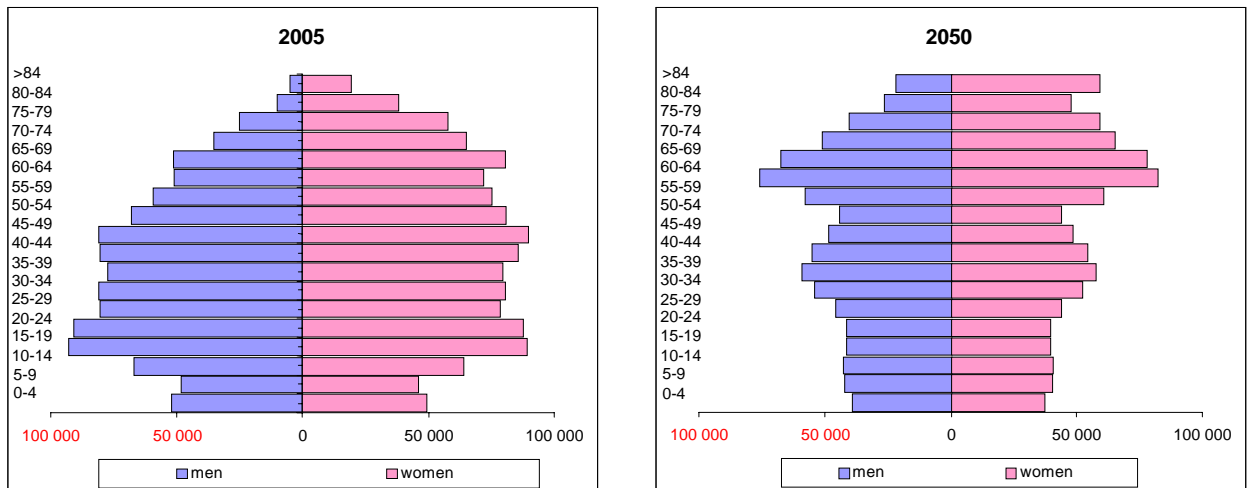


Figure 8. Population by age groups in 2005 and 2050.

Ministry of Welfare forecasts

Table 12. Assumptions used in demographic forecasts.

	2002	2025	2050
Birth rate	1.232	1.527	1.586
Life expectancy for men, upon birth	65.4	70.4	73.8
Life expectancy for women, upon birth	76.8	79.3	81.1
Migration balance, in thousands	-1.8	0.0	0.0

CSB and Ministry of Welfare data

6.2 Impact of population ageing on the budget

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.

However, it has to be understood that the increase in the number of elderly people will not only determine higher old-age pension expenditures but also push up healthcare and long-term care expenditures that are always higher within the oldest cohorts of the population. At the same time it can be forecast that some types of expenditure could go down. For example, with the share of children and young people diminishing, the number of required educational establishments and teachers could decrease. Lower supply in labour market and government policy aimed at employment will ensure a higher activity of the working-age population and lower unemployment, resulting in reduced related public expenditure. It has to be also understood that, with the population decreasing, the main driving force of the economic growth will be increasing labour productivity.

It is obvious that evaluation of the impact of ageing on the central government budget is a complex and difficult task, and by the time of preparing this Convergence programme nothing of that scale has been completed in Latvia.

A task has been given to the special working group of the Economic Policy Committee of the European Union, including also Latvia's representatives, to prepare forecasts and a report on long-term impact of ageing population on public finance in all the EU member states by mid-2005. At the time of preparing this Convergence Programme, the working group is still working on development of joint methodology; therefore, the estimates published herein should be evaluated carefully and they are also not fully comparable with the forecasts of other member states.

Overall, all the estimates are based on a no-policy-change assumption, taking into account the last actual data and the above-described demographic forecasts. It has to be noted that, with any of those conditions changing, the end result will change as well.

6.2.1 Sustainability of pension system

Development scenario assumptions

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 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.

Pension budget will be significantly affected also by 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) and a gradual increase of the state social security contribution rate towards the 2nd tier pension scheme to 10% in 2010. At the same time, contribution rate towards the 1st tier pension will decrease to 10%.

Forecasts up to 2050

Although an increase in old-age pension expenditure in the amount of 2.8% of GDP can be expected by 2050, at the same time the pensions payable from the central government budget will shrink by 0.4% 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.

Nevertheless, it can be expected that, due to demographic, economic factors and growing contributions to the state funded pension scheme, a deficit will form in the 1st tier pension scheme. Consequently, the deficit in the 1st tier pension scheme could reach 2.3% of GDP by 2050.

In Latvia, long-term forecasts of the pension scheme are prepared by the Ministry of Welfare.

Table 13. Sustainability of pension system.

% of GDP	2005	2010	2020	2030	2050
Expenditures on old-age pensions	6.2	4.8	5.3	5.9	9.0
1 st tier pensions	6.2	4.8	5.2	5.6	5.8
2 nd tier pensions	0.0	0.0	0.1	0.3	3.2
State social security contributions	9.5	8.0	7.4	7.1	7.1
1 st tier pensions	6.1	4.5	3.9	3.6	3.5
2 nd tier pensions	3.4	3.5	3.5	3.5	3.6
Accumulated assets of state funded pension scheme	0.9	6.2	29.2	60.7	101.9
Assumptions					
Labour productivity growth	5.6	4.5	3.6	2.5	2.0
GDP growth at constant prices	6.7	4.7	2.2	2.3	0.1
Unemployment rate	9.2	8.0	5.0	5.0	5.0
Increase in wages and salaries, at constant prices	5.6	4.5	3.0	2.0	2.0
State social security contribution rate in 1 st tier pension scheme	18.0	10.0	10.0	10.0	10.0
State social security contribution rate in 2 nd tier pension scheme	2.0	10.0	10.0	10.0	10.0
Average yield in 2 nd tier pension scheme	4.0	4.0	4.0	4.0	4.0

6.2.2 Healthcare and long-term care, education and other expenditures

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

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.

Breakdown of healthcare expenditure by age groups clearly shows that the bigger changes directly affect 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 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.

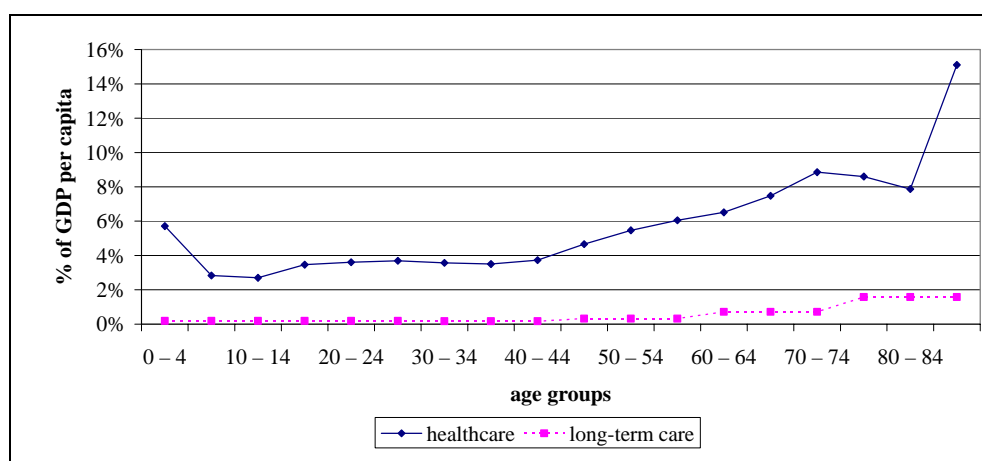


Figure 9. Healthcare and long-term care expenditure by age group, % of GDP per capita in 2002.

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 aged 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 it will be more difficult to model. In the previous reports, Economic Policy Committee estimated changes in unemployment benefits, depending on the changes in unemployment and number of employed established in the scenario. It can be forecast that in Latvia the impact will be positive while rather moderate.

Table 14. 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

6.2.3 Conclusions

Impact of population ageing on Latvian government expenditure in the long-term is obvious. Although 1st tier pension scheme in itself is 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 improvement of the situation can be expected and a decrease in the burden on the pension system relating to both gradual improvement of birth rates as 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.

Due to demographic factors, healthcare and long-term care expenditure have to increase, whereas education expenditure has to decrease. Moreover, total impact of those items as a percentage of GDP is approximately the same and the types of expenditure offset one another, without leaving any impact on the government budget. These estimates, however, should be approached with caution. Regarding the healthcare expenditure, it has to be noted that currently they are about 1.5% of GDP³ lower than the average EU-15 level, and long-term expenditure on elderly people in Latvia are also considerably lower than the EU average and as especially in the Scandinavian countries. Therefore, it can be forecast that reforms are required in those sectors relating to improvement of the quality of provided services, and potentially relating also to an increase in expenditure.

In the area of education, savings caused by changes in demographic profile, in turn, can be used to improve the quality of education and science rather than to reduce total expenditure, which is an important factor for raising the future labour. 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. Low level of Latvia's government debt, with the expenditure pressure growing, also provides certain flexibility to the government, preserving the stability of public finance.

Although the initial estimates of sustainability of public finance, 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.

³ 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 in 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

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 prepared regularly, which is a cross-ministerial 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.

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 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 co-financing from the EU Structural funds to fund relevant measures in order to successfully implement development programmes in Development Plans. During execution of the program supporting financing is envisaged to amount to 153.8 million lats, of which 107.4 million lats are EU financing. The expected return from the programme is an annual increase in budgetary revenue of 5 million lats on average.

Promotion of innovations

On 1 April 2003 the Cabinet of Ministers approved 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 new, knowledge-based economy in Latvia. 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 Investment and Development Agency, Latvian Technological Centre, Patent Board as well as other institutions are involved in implementation of specific activities).

The planned central government budget financing for implementation of the National Innovations Programme in 2004 is: 0.1 million lats (MoE) plus 0.9 million lats (MoES). The required financing in 2005 is 8.1 million lats (MoE) plus 2.1 million lats (MoES) and 8.1 million lats (MoE) plus 2.1 million lats (MoES) in 2006. Starting from 2005, EU Structural funds will be also used for implementation of measures of the National Innovations Programme.

7.1.2 Promotion of exports

Due to Latvia's accession to the EU and new priorities in the area of foreign trade, the Ministry of Economy with the support of the United Nations Development Programme (UNDP Latvia) has started work on updating the Latvian National Foreign Trade Programme. The programme will include industry, agriculture and services sectors, evaluating the institutional framework for exports promotion, identifying the target markets for Latvian exports and key types of activity as well as the measures planned to promote the production of exports-oriented goods. Latvia's export promotion programme envelops the time period from 2005 to 2009.

The following financing is planned in the central government budget for implementation of Latvia's export promotion programme: 4.7 million lats in 2005, 4.3 million lats in 2006 and 3.9 million lats in 2007.

Financing from the EU structural funds has been planned for the programme in the amount of 5.2 million lats in 2005, 5.5 million lats in 2006 and 5.8 million lats in 2007.

With 2005, it is also planned to introduce Exports lending system with 2005 budgetary financing in the amount of 3 million lats, 2.5 million lats in 2006 and 2 million lats in 2007.

7.1.3 Promotion of tourism development

Three main objectives have been set in tourism development promotion policy:

- Latvia – a different and recognisable tourist destination;
- competitive tourism industry;
- development of cooperation.

Within the nearest future, it is expected to introduce the National tourism satellite accounts in order to provide the tourism companies with information on tourism's contribution to the economy and to facilitate comparisons between the statistical data of Latvian tourism and those from other countries. The required 2005 project financing is 0.5 million lats.

The required budgetary financing to improve the tourism infrastructure, promote the creation of diverse goods and services is 3.2 million lats within the time period from 2004–2007. Drawing from the EU structural funds is expected.

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 supply of energy resources 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 electric energy and gas sectors.

7.1.5 Development of electronic communications

Key policy concepts of electronic communications 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 communications services (successiveness, sustainable development, predictability, public discussion);
- effective competition in electronic communications;
- 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 communications technologies and provision of new electronic communications 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;
- develop universal service financing mechanism;
- in order to promote competition and accessibility of electronic communications as well as to ensure efficient use of electronic communications network infrastructure at the disposal of publicly owned enterprises, ensure access to electronic communications networks by using the existing alternative fixed electronic communications networks;
- implement broadband development in Latvia;
- develop a procedure for allocating, spending and managing national radio band spectrum, numeration space and addressing 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 government functions) has been approved.

Implementing the instructions of the “Concession promotion concept”, a Concession division started working in the Ministry of Economy in September 2003, with the main task to promote the development of public and private partnership policy in Latvia, and its main objectives are:

- 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.

In parallel, implementation of the “Concession promotion concept” began also in Latvian Investment and Development Agency (LIDA), where work began in February 2004 on promotion of the PPP mechanism, with the main tasks to discharge PPP project support functions. The most significant tasks implemented by LIDA are:

- support to pilot project/project implementation (application of best practice);
- communication with resource holders (central/ local government);
- support throughout PPP project management cycle – methodological support in project and contract preparation (development of document templates etc.);
- identification of concession resources;
- community information measures.

7.2 Labour market

The key principles of the European Union employment policy have been introduced in Latvian employment policy already from 1995, when Latvia signed the Treaty of Europe in Luxemburg. In accordance with the concept “On promoting employment in Latvia” approved by the Cabinet in 1999, starting from 2000, annual national employment plans are being prepared in Latvia based on the European employment strategy, employment policy guidelines for the EU member states as well as the specific socio-economic developments. Such important employment-related medium-term strategy documents like the Joint Assessment of the Republic of Latvia and the European Commission on Latvia’s Employment Policy Priorities and Joint Inclusion Memorandum have been developed and signed in 2003.

Marking a new stage in implementation of the European employment strategy, the Council of Europe adopted new Employment Policy Guidelines 2003–2006 on 22 July 2003, ensuring closer coordination between economic and social policies. General objectives defined were full employment, quality and productivity of labour, social inclusion and reduction of social exclusion.

In the last years, Latvia’s labour market displayed positive development trends, as the activity of population and employment is growing and unemployment is decreasing. At the same time, Latvia realises that there are gaps requiring active political participation of the government. Some of them are:

- economic restructuring process, significant role of social partners in them;
- creation of new jobs, services development need, especially in economically disadvantaged regions;
- employment measures to diminish the high level of undeclared employment (impact of minimum wages and salaries, taxes and benefits system on solving this problem);
- development of active and preventive policy, paying special attention to such measures as assistance in job-seeking, promotion of businesses, geographical mobility and access to training;
- modernisation of State Employment Agency and services provided by it;

- integration of young and poorly-educated and skilled people into the labour market: reducing high „drop-out“ level in educational establishments, ensuring access to training, especially for poorly-educated and skilled people;
- not knowing the official language is a risk factor to participate in labour market;
- existing inadequacy of education and skills in context of labour market demands is a problem which is linked to the life-long education principle and system enforcement.

These and other problems identified in the above-mentioned documents and recommendations for effective solutions are being taken into account when developing National employment plan 2004–2005, where employment promotion and unemployment reduction measures are grouped in accordance with the 10 new European employment special guidelines – priority operational directions, i.e. active and preventive employment measures for unemployed and economically inactive population, promotion of businesses and creation of new jobs, promotion of adaptation capabilities and mobility in labour market, promotion of human resource and life-long education development, increasing job offers and promotion of extension of active working age, ensuring gender equality in labour market, promotion of integration of socially marginalised risk group population into labour market and elimination of any type of discrimination; improvement of motivation mechanisms (wages and salaries, taxes, benefit system) by making work more attractive, transformation of undeclared employment into officially registered employment, regional cohesion. Representatives from the Ministries of Economy, Welfare, Education and science, Regional development and local government affairs as well as from Latvian Union of Local Governments, Latvian Association of Free Trade Unions and Latvian Employers Confederation are involved in the development of the Plan.

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. In the development of the Single Programming Document (SPD) priority 3 “Human resources development and promotion of employment“ the employment policy priorities identified in the Joint assessment of the Latvian government and the European Commission were taken into account as well as the European Employment Strategy and guidelines that ensure overall agreement between employment promotion measures.

Annex

Basic assumptions of external environment (European Commission spring 2004 forecasts)

	2003	2004	2005
Exchange rate			
USD/EUR exchange rate (annual average) ¹	1.13	1.25	1.24
Nominal effective exchange rate (euro area), % change	11.8	4.2	-0.2
Nominal effective exchange rate (EU), % change	12.8	6.9	-1.1
LVL/EUR exchange rate (annual average) ¹	0.65	0.67	0.67
GDP at constant prices, (%change)			
World excluding EU	4.4	5.1	4.7
EU-15	0.8	2.0	2.4
Global trade (%change)			
EU exports markets, outside EU	6.7	9.2	8.3
Global imports, outside EU	7.3	9.7	8.5
Global imports commodities (commodities, USD)	8.8	6.4	0.7
Commodity prices			
Oil price (Brent, USD per barrel)	28.5	31.1	28.9
Non-oil commodity prices (USD)	6.6	15.6	-2.6

¹ Technical assumption