Since regaining independence in 1991 Latvia has made substantial progress towards macroeconomic stabilization and a market economy. The fiscal and financial crisis of 1995 has been surmounted, inflation is down as is unemployment, and growth was 6 percent in 1997.

We therefore welcome and support this Country Assistance Strategy (CAS) for Latvia, which comes as a propitious time, and appreciate staff efforts in providing us a complete and detailed report on the situation of the economy.

Latvia’s agenda includes completing its transition to a modern market economy, reinforcing macroeconomic stability and seeking to complete the European Union (EU) integration process during the next decade. The country has reached broad political consensus for this and for the steps necessary to strengthen production, including improving public administration and implementing further structural reforms. This is an important indication of ownership and commitment.

Furthermore, Latvia’s progress towards a clear constitutional separation of functions, evolving from a system in which economic, political and judicial decision-making was unified in a single state authority, is necessary for continued development.

In this area, as the government reshapes the role of the public sector, it would appear that additional attention to protecting public policy over private interests is warranted. The reported emergence of large commercial groups with strong political linkages is an area for vigilance and for the difficult responsibility of taking the legitimate concerns of all elements of society into account, while not allowing favoritism and rent-seeking to emerge. This is an area of concern, especially in a smaller economy such as that of Latvia.

The CAS also emphasizes that “policies” should encourage the speedy reintegration of the shadow economy, which existed even before the transition, but which has grown excessively as a consequence of heavy payroll taxes and is the breeding ground for crime and corruption.
The tendency to expansionism has allowed an uncoordinated growth of new bodies and agencies, without eliminating those that are no longer necessary. Allocation of resources in line with government strategy is weak and needs improvement. During the last several years, the government has implemented important reforms to achieve macroeconomic stabilization, restore GDP growth, lower CPI inflation and achieve a budget surplus by imposing strict control of overall expenditures. However, the Ministry of Finance has not yet developed sufficient capacity for policy and budget analysis to support reallocation of funds among Ministries or programs, or to provide for new government responsibilities. Additionally, there is not a transparent system of remuneration, although special allowances are permitted.

The privatization of small and medium-scale enterprises has been almost completed and this is welcome. However, the privatization of large enterprises, housing and land has experienced delays. Also, public sector agencies, state-owned enterprises and local governments (with some limits) are permitted to borrow for investment, which is financed through net lending.

All of the foregoing — the increasing number of new agencies and weak overall planning, the access of state-owned companies to net lending and the problems of corruption and business/political cronyism — raises a number of warning signs that will need to be addressed as the government implements the program agreed to with the Bank.

We think it important to emphasize, however, that the Bank has agreed to engagement in five critical areas identified by the government, contributing to ownership. We are also pleased to note that Bank support is especially valued by the government in terms of advice and technical involvement, confirming the important role of serving as a "knowledge bank.”

On the other hand, Latvia still faces a number of serious challenges, including a highly unbalanced regional economy and social structure, an income differential between rural and urban areas, shortage of off-farm investment, transport and economic development in smaller rural communities. Although municipalities are responsible for implementing regional and rural development programs, in actuality they can do little to help.

Furthermore, social assistance has been undermined by the devolution of social assistance responsibilities to municipalities, most of which lack the resources or the institutional capacity to administer benefits effectively. Municipalities will be in the front line to implement the EU accession agenda in infrastructure development and environmental management, but this concept seems to have a contradiction as we are told “most local governments lack the expertise and resources to fulfill the functions being given them, manage their finances and to develop strategies and implement projects to improve local conditions.” However, we wonder if staff has considered bringing assistance to the municipalities through new lending or new financial instruments such as the Adaptable Lending Program.

Although we have identified a number of areas for concern, the proposed CAS would help to address completion of structural reforms needed for EU accession in key areas such as fiscal reform, public sector management, and private sector participation.
Therefore, we agree with the overall strategy proposed and the three lending scenarios envisioned, linked to different evolutions of the economy, and are confident that Latvia will continue to progress.