

EBRD strategy for Latvia 1996-97: a summary

Operational priorities

Latvia has made major progress on the macroeconomic level, but structural reform has proceeded more slowly. The following priority needs for the country have emerged:

- strengthening the banking sector;
- overcoming the lack of medium-term to long-term capital (loans and equity);
- strengthening the privatisation process;
- attracting sufficient levels of foreign direct investment;
- transfer of know-how at the enterprise level;
- upgrading key infrastructure.

Other concerns are integration in the international economy, as well as the environment.

In response to these concerns, the future operational work of the European Bank for Reconstruction and Development (EBRD) will focus on the following main priority areas, where there is clear "additionality" for EBRD financial support:

- **Financial intermediaries:** Due to their small size, most private sector enterprises in Latvia can be reached only through local financial intermediaries. The EBRD's interventions in the banking sector will be further increased and diversified, covering debt and equity investments, selected new institutions and other products, with a view to both strengthening the banking sector and supporting the development of small and medium-sized enterprises (SMEs).
- **Support for privatisation:** The high priority given to privatisation in Latvia should open opportunities for the EBRD to participate in the resulting transactions.
- **Infrastructure:** The EBRD aims to improve critical infrastructure, particularly in the energy and environmental sectors, to assist with the commercialisation and/or privatisation of infrastructure-related utilities and enterprises, and to support/facilitate private sector participation. Priority will be given to limited-recourse project financing in these sectors. However, the Bank will not exclude state-

guaranteed operations, as the transition to limited-recourse financing is likely to require some time.

Other areas of activity will include:

- **transfer of know-how:** The EBRD has developed unique and cost-effective tools, such as the TurnAround Management (TAM) programme and the Business Advisory Services (BAS) project.
- **environment:** In addition to operations which are specifically targeted at providing environmental benefits, all EBRD operations in Latvia are subject to the Bank's Environmental Procedures and incorporate, where appropriate, Environmental Action Plans into the legal documentation in order to address issues raised during due diligence. In addition, the Bank has an environmental technical co-operation programme, which is implemented in all its countries of operations, encompassing environmental guidelines for investors and institutional support and training for financial intermediaries with which the EBRD is working.
- **advancing transition and integration in the international economy:** The EBRD, in consultation with the European Union, will continue to support Latvia's process of integration into the international community, of which accession to the EU is a major component. The Bank will explore means by which it could financially support the regional integration of energy sector grids (e.g. electricity, gas) and it intends to participate in the financing of regional transport corridors (e.g. the Via Baltica). It will continue to give priority to activities related to environmental improvements. Commercialisation of utility services in ways compatible with Western regulations will be emphasised. Assistance is being planned for the telecommunications sector in regulatory development and may also be provided for legal transition.
- **Direct support for private sector enterprises:** Apart from support for the financial sector and the privatisation of key utilities, other state-owned infrastructure-related enterprises (e.g. ports) and some other larger

industrial and service enterprises, only a limited number of transactions will be of a sufficient size to justify direct EBRD financing. These will be pursued actively. Further development of existing or new intermediaries will take place, and co-financing arrangements with these institutions will be undertaken if suitable project pipelines can be identified.

Mobilising other sources of financing

In addition to syndications in the financial sector, the EBRD will continue to seek to mobilise external sources of financing, including export credit agencies (ECAs), the Export Import Bank of Japan, the European Investment Bank and bilateral assistance agencies. It is also expected that the second phase of the Baltic Investment Programme will make further funds available for co-financing of EBRD projects in support of SME development. Co-financing with local financial intermediaries will be encouraged. Further support for equity schemes should, over the medium term, help to mobilise local savings for investment.

Financial and banking sector

By working with reputable and significant banks, the EBRD's objective is to achieve maximum transition impact by:

- fostering confidence in the banking system, both domestically and internationally;
- providing debt and equity financing, where it is not yet available to Latvian banks via the international market;
- enabling banks to support the emerging private enterprise sector through medium-term loans.

As the strength of the Latvian banking sector increases, the EBRD will consider extending the maturity of its debt instruments and encouraging the introduction of new products, such as housing loans, as well as syndicating some of its existing and future debt exposures. A local bond issue may also be given consideration.

Enterprise sector

The EBRD strategy will continue to rely heavily on financial intermediaries (e.g. local banks and equity funds) to reach SMEs, which account for a substantial number of enterprises in Latvia. In addition, the Bank will seek to participate directly in a number of larger transactions, including through financial support on a limited-recourse basis for infrastructure-related enterprises, although this will depend on progress with the restructuring and privatisation process. The Bank will continue to

provide technical assistance to local enterprises through TAM and the BAS Fund.

Activities of the Baltic Investment Fund are expected to increase, and new (regional) equity funds may be considered.

Legal transition

An assessment will be made of areas directly affecting Bank operations where law reform might contribute to the transition process.

Energy sector

The EBRD's operational strategy will continue to focus on the rationalisation of energy use and security of supply through: (i) introduction of greater efficiency in energy use and generation; (ii) development and increase in utilisation of indigenous hydropower resources; and (iii) assistance in the optimal use of Latvia's underground gas storage potential. Particular attention will be given to regional cooperation in the electricity and gas sub-sectors.

Whenever possible, new operations in the sector will be developed on a limited- or non-recourse financing basis involving a private sector sponsor, but this will be dependent on the financial health of the clients in question and on the speed with which regulatory frameworks and/or privatisation are implemented in the sector. The EBRD will also seek to develop an energy services company (ESCO).

Transport sector

The EBRD will continue to explore ways of assisting Latvia with key transport investments, taking into account the likely development of the country into an important trade platform in the region. Priority will be given to East-West links, including ports, as well as to improving connections between the ports and other means of transport. Other areas of activity would include urgent maintenance of transport assets as well as commercialisation of the sector, including privatisation and private sector ventures. Priority will also be given to institutional restructuring measures to equip the administration of the respective sectors to operate in a competitive, market-based environment.

Preliminary discussions have taken place on developing a railway project that would address the restructuring issues identified in the Baltic Railway Survey and other studies. It is envisaged that other projects to be financed in the sector will be private sector initiatives or on a concession basis involving the private sector.

Telecommunications

Apart from Eurovision, the EBRD currently has no other projects in the telecommunications sector, but it is considering potential future operations within the mobile and value-added services sub-sectors. In preparation for future developments in the sector, including liberalisation and potential competition, EBRD assistance is under preparation through an extensive programme for telecommunications regulatory development.

Municipal and environmental infrastructure

The EBRD will promote a decentralised approach, assisting the development of efficient utilities under sound financial and operational management at the municipal level. Restructuring of municipal utilities and service enterprises, through improved revenue collection, cost recovery and other measures leading to corporatisation of the utilities, will be promoted. The Bank will target private sector involvement in the provision of local public services.

The EBRD will explore with the municipality of Riga and other municipalities the opportunity to support projects involving other municipal services on a limited-recourse or private sector basis. Some of these undertakings could potentially be financed through multi-project municipal services facilities.

Environment

Considerable importance is attached to establishing a sound financial sector to support SME development. Supported by Phare financing, the EBRD has conducted environmental due diligence training for the staff of local commercial banks in Latvia so that the EBRD's requirements could be incorporated into the banks' existing procedures.

The EBRD will continue to provide training to Latvian banks and to investment funds established in the country. Through the Bank's energy loan, important environmental measures have been implemented through a number of energy efficiency projects both in the industrial sector and municipal district heating infrastructure. The Daugava hydro scheme upgrade project contains an important component on dam safety and an Environmental Management Action Plan (EMAP) along the Daugava River.

Comprehensive environmental investigations, including impact assessments and audits, will

continue to be required for all operations which could have a potentially significant environmental impact. Such projects are likely to relate to improvements to existing energy generation and storage facilities, railway restructuring, ports development and any major industrial developments or restructuring.

Project sponsors will generally be required to incorporate Environmental Action Plans into the legal documentation to address issues raised during the due diligence process. These Plans will incorporate steps to bring operations into compliance with regulatory requirements and in accordance with international standards. Particular attention will be given to measures which will facilitate the gradual harmonisation of Latvian environmental standards with requirements under international conventions and protocols signed by Latvia and those required to meet the accession criteria of the European Union.

Cooperation with other multilateral institutions

The EBRD cooperates closely with a number of multilateral institutions concerned with the Baltic states. The Bank actively participated in the High Level Working Party on the Via Baltica project (which included the Nordic Investment Bank, the International Bank for Reconstruction and Development, the European Investment Bank and the European Commission).

The European Investment Bank (EIB) is involved in two projects, both of them in close cooperation with the EBRD: the upgrading of Daugava hydropower plants and the Riga water project. Baltic Investment Programme resources provided by the Nordic countries to the EBRD under phase one of the Programme have been fully committed. A second phase of the Programme has been approved and covers the period 1996-99.

Close coordination with the Nordic Investment Bank (NIB) continues under the Baltic Investment Programme. The NIB participated with the EBRD in financing a forest industry sector study in the region and has funded a study of emissions from agriculture in the Baltic states.

This document is based on the EBRD's Strategy for Latvia, approved by the Board of Directors at its meeting on 29 July 1996.