STRATEGY FOR LATVIA

As approved by the Board of Directors at its meeting on 10 February 2016
# TABLE OF CONTENTS

EXECUTIVE SUMMARY ................................................................................................................................. 3

1 OVERVIEW OF THE BANK’S ACTIVITIES ........................................................................................... 5
  1.1 THE BANK’S CURRENT PORTFOLIO ............................................................................................... 5
  1.2 IMPLEMENTATION OF THE PREVIOUS STRATEGIC DIRECTIONS ............................................. 5
  1.3 KEY LESSONS ............................................................................................................................... 7

2 OPERATIONAL ENVIRONMENT ............................................................................................................ 7
  2.1 POLITICAL CONTEXT .................................................................................................................... 7
  2.2 MACROECONOMIC CONTEXT ...................................................................................................... 8
  2.3 STRUCTURAL REFORM CONTEXT ............................................................................................... 9
  2.4 ACCESS TO FINANCE .................................................................................................................. 10
  2.5 BUSINESS ENVIRONMENT AND LEGAL CONTEXT .................................................................... 12
  2.6 SOCIAL CONTEXT ......................................................................................................................... 13
  2.7 ENERGY EFFICIENCY AND CLIMATE CHANGE CONTEXT ......................................................... 14

3 STRATEGIC ORIENTATIONS ............................................................................................................... 15
  3.1 STRATEGIC DIRECTIONS .............................................................................................................. 15
  3.2 KEY CHALLENGES AND BANK ACTIVITIES .............................................................................. 16
  3.3 POTENTIAL RISKS TO COUNTRY STRATEGY IMPLEMENTATION ............................................ 22
  3.4 ENVIRONMENTAL AND SOCIAL IMPLICATIONS OF BANK PROPOSED ACTIVITIES .............. 22
  3.5 EBRD CO-OPERATIONS WITH THE EUROPEAN UNION AND MULTILATERAL DEVELOPMENT BANKS (MDBs) .................................................................................................................. 23

ANNEX 1 – POLITICAL ASSESSMENT ......................................................................................................... 24

ANNEX 2 – SELECTED ECONOMIC INDICATORS .................................................................................. 27

ANNEX 3 – ASSESSMENT OF TRANSITION CHALLENGES ................................................................... 28

ANNEX 4 – LEGAL TRANSITION .............................................................................................................. 32
EXECUTIVE SUMMARY

The Republic of Latvia is committed to and applying the principles of multiparty democracy, pluralism and market economics in accordance with Article 1 of the Agreement Establishing the Bank.

Latvia is a small and open economy with deep links to the European Union, and still significant connections to some countries in the CIS region. Although the 2007-2010 financial crisis had a major adverse effect on Latvia, exposing its external vulnerabilities, the country has managed one of the most successful macroeconomic adjustment programmes in recent history, registering a quick and consistent economic recovery with admirable resolve in fiscal policy and rapid labour market adjustment. The EBRD lent major support for the restructuring of the banking sector through its interventions in Parex Banka, a major systemic bank. Latvia’s accession to the euro area in 2014 and its regained access to sovereign funding markets are testaments that the task of macroeconomic adjustment has been successfully tackled. After a deep contraction, average growth of more than 4 per cent annually since 2011 has been significantly above the EU average.

Domestic demand continues to be the main driver of growth, underpinned by increasing real wages and a recovery in the labour market. Although the overall investment rate remains relatively low for a converging economy, at about 23 per cent of GDP in 2014, public investment in particular is likely to recover as the new phase of EU structural and investment funds are disbursed.

As a member of the Eurozone, Latvia will continue to confront deflationary pressures in the currency area, although it will also benefit from various monetary easing measures. Adoption of the euro entailed participation in the banking union, which should contribute to overall confidence in local supervision. After years of post-crisis fiscal consolidation, the Government plans to continue relaxing spending controls, as a result of encouraging revenue trends, while remaining in line with the EU’s Stability and Growth Pact.

At the same time, investment and productivity growth have been held back by certain structural deficiencies in the economy, where some transition gaps remain even though Latvia has been an EU member since 2004. While these gaps, as assessed under the Bank’s methodology, are modest overall, pockets of significant transition gaps exist. Export orientation is also modest, with exports only accounting for 58.3 per cent of GDP in 2014, and primarily in low and medium technology manufacturing. The share of high-tech products stood at only 9.2 per cent of total exports in 2014, significantly below the EU average. Greater efforts are needed to stimulate innovation and raise local value added. Integration through inward direct investment is also limited, and participation in global value chains that disseminate key international technologies sparse.

The relative isolation from EU energy markets has also been a long standing cost and risk to private sector investment. The country was connected to a regional electricity trading platform, and although transmission capacity is relatively limited, interconnections are being added steadily. There has also been some progress in overcoming vertical integration in the domestic gas market that has limited competition, which should gradually encourage alternative supplies and competition.
In designing its support and related instruments, the Bank will tailor them to the advanced stage of transition of Latvia. As Latvia’s transition has become more advanced, the Bank has accordingly narrowed the scope of its activities as a consequence of the fewer market segments in which Bank activities can satisfy its operating principles (transition impact, sound banking and additionality).

Latvia reaffirms its commitment to the principle of graduation. Although there has been significant progress in its transition to a sustainable market economy, some gaps remain and new challenges have arisen related to uncertainties in the broader geopolitical and investment environment. Latvia will continue to keep the question of graduation under review and will indicate its graduation intention at the appropriate time.

To help Latvia address these key challenges, the Bank will pursue the following strategic orientations in the new Strategy period:

- **Strengthening energy security and improving energy efficiency.** As Latvia relies heavily on imported natural gas from one supplier, the Bank will support diversification of energy sources through regional energy market integration as well as investments in domestic, in particular renewable energy resources to boost local energy generation. The Bank will also seek to facilitate investments in energy efficiency.

- **Boosting private sector competitiveness through innovation.** Latvia scores relatively low in cross-country surveys of competitiveness. New investment in high value added production and innovation is badly needed to enhance capacity, provide important demonstration effects to other businesses and achieve sustainable economic growth. The Bank will thus seek to enhance access to finance (equity in particular) for innovative and potentially competitive companies through direct investment and via investment in private equity funds.
1 OVERVIEW OF THE BANK’S ACTIVITIES

1.1 The Bank’s current portfolio

Private sector portfolio ratio: 100 per cent, as of 31 December 2015

<table>
<thead>
<tr>
<th>Sector Group</th>
<th>Sector Team</th>
<th>Portfolio no of operations</th>
<th>Portfolio (€m)</th>
<th>% Portfolio</th>
<th>Op Assets (€m)</th>
<th>% Op Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Energy</td>
<td>Natural Resources</td>
<td>0</td>
<td>0</td>
<td>0%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>Power and Energy</td>
<td>3</td>
<td>95</td>
<td>36%</td>
<td>72</td>
<td>34%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3</td>
<td>95</td>
<td>36%</td>
<td>72</td>
<td>34%</td>
</tr>
<tr>
<td>Financial Institutions</td>
<td>Depository Credit (banks)</td>
<td>3</td>
<td>114</td>
<td>44%</td>
<td>114</td>
<td>54%</td>
</tr>
<tr>
<td></td>
<td>Insurance, Pension, Mutual Funds</td>
<td>0</td>
<td>0</td>
<td>0%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>Leasing Finance</td>
<td>0</td>
<td>0</td>
<td>0%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>Non-depository Credit (non-bank)</td>
<td>0</td>
<td>0</td>
<td>0%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3</td>
<td>114</td>
<td>44%</td>
<td>114</td>
<td>54%</td>
</tr>
<tr>
<td>Industry, Commerce &amp; Agribusiness</td>
<td>Agribusiness</td>
<td>0</td>
<td>0</td>
<td>0%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>Equity Funds</td>
<td>16</td>
<td>34</td>
<td>13%</td>
<td>15</td>
<td>7%</td>
</tr>
<tr>
<td></td>
<td>ICT</td>
<td>2</td>
<td>6</td>
<td>2%</td>
<td>6</td>
<td>3%</td>
</tr>
<tr>
<td></td>
<td>Manufacturing &amp; Services</td>
<td>1</td>
<td>10</td>
<td>4%</td>
<td>1</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>Property and Tourism</td>
<td>0</td>
<td>0</td>
<td>0%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>19</td>
<td>50</td>
<td>19%</td>
<td>23</td>
<td>11%</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>Municipal &amp; Env Inf</td>
<td>1</td>
<td>2</td>
<td>1%</td>
<td>2</td>
<td>1%</td>
</tr>
<tr>
<td></td>
<td>Transport</td>
<td>0</td>
<td>0</td>
<td>0%</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1</td>
<td>2</td>
<td>1%</td>
<td>2</td>
<td>1%</td>
</tr>
<tr>
<td>Summary</td>
<td></td>
<td>26</td>
<td>261</td>
<td>100%</td>
<td>210</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: EBRD Business Performance Navigator

1.2 Implementation of the previous strategic directions

Over the previous country strategy period, the Bank’s main priorities in Latvia have been to: (1) provide higher-risk financial products for corporations to fund growth with a focus on cross-border expansion; (2) provide support to selected financial institutions and strengthen corporate governance; (3) commit capital to regional equity funds targeting SMEs; (4) promote investments to improve energy efficiency and develop renewable energy; and (5) enhance private sector involvement in the provision of public services in co-operation with EU funds.

In making investments against these strategic priorities, the Bank has been targeted in its approach, bearing in mind the need for high transition impact and additionality. Hence, over this period, the Bank signed 10 new transactions, totalling just over €44 million. Eight projects have been regional in focus, with 7 being investments in private equity funds and one in the energy sector. Two of the operations were related to the sale of the Latvian Government’s shares in Citadele Banka. Notably, the Bank has:

- Continued to strengthen the financial sector through its ongoing engagement in Citadele Banka and support for the Government’s efforts to return the bank to the private sector under challenging circumstances, at a time when interest for bank assets
in Central in Eastern Europe has been low. At the end of April 2015 the Government sold its 75 per cent share to a consortium of investors led by a US-based private equity firm. The Bank will remain engaged in Citadele with a 25 per cent shareholding and subordinated debt. Over the last four years, Citadele, which received commendations in 2012 and 2013 for its corporate governance, increased its lending portfolio by approximately 14 per cent – at the same time that the equivalent loan portfolio for the Latvian banking sector as a whole shrank by 15 per cent.

- Launched the Integrated Approach for the Further Development of the Venture Capital and Private Equity (VC/PE) Ecosystem in the Baltic States (the “Baltics IA”) which aims to facilitate the emergence of a strong, more sustainable VC/PE sector in all three countries, with equity and quasi-equity/mezzanine financing available at all growth stages of companies. The Baltics IA addresses the key transition challenges of the Baltics VC/PE ecosystem through a two-pronged methodology that pairs investments into identified VC/PE funds across the financing lifecycle with targeted policy dialogue addressing barriers to further development.

- As part of the Baltics IA, invested in three Baltics dedicated private equity funds, managed by local teams and focused on SMEs. One was a mezzanine fund, with the Bank’s support further developing the market for this still little used instrument in Latvia. Another, Baltcap II, follows a buy-and-build strategy incorporating cross-border activity, which will help integrate investments across all three Baltic States. And in June 2015 the Bank signed a €17 million investment in Livonia Partners Fund I. The Fund will have a generalist sector strategy and will provide growth and acquisition capital to companies in the Baltics. All three funds are actively screening business opportunities.

- In addition the Bank has maintained a close dialogue with relevant stakeholders, including three Baltic-wide capacity building events for existing and aspiring Baltic fund managers covering, among other topics, regulatory and legislative aspects affecting the VC/PE sector (e.g., local collective investment vehicles laws or procurement procedures) and other means of improving networks among the Baltic states and beyond in order to realise synergies among market participants.

- Financed an energy efficiency investment of an Estonian wood pellet producer in a CHP-plant (Combined Heat and Power Plant) next to its existing pellet production facilities in Latvia, helping boost the export competitiveness of this important, local and renewable source of energy.

- Worked closely with the authorities, the company, European Investment Bank (EIB) and Nordic Investment Bank (NIB) concerning a corruption case related to the procurement activities of EBRD’s client, Latvenergo AS. The irregularities extended to the procurement of the Bank-financed Riga CHP-2 combined cycle gas turbine plant, and had prevented the Bank from disbursing its loan for nearly 3 years. To the great satisfaction of the company and the authorities the issues were resolved, allowing the Bank to proceed with disbursement for this important investment.

- Continued policy dialogue with the authorities to develop Energy Performance Contracts (EPCs) in order to improve availability of financing for energy service companies making energy efficiency investments in various sectors of the economy. Some technical assistance has also been provided. The implementation of EPCs will help leverage the use of EU funds as well as increase private sector involvement in energy efficiency related services and investments.
1.3 Key lessons

The EBRD’s role in stabilising the banking sector via its investment in and policy support to Parex/Citadele Banka is widely considered an integral and critical part of the international community’s support for Latvia’s post-crisis macroeconomic adjustment. The Bank took high risks by investing in a badly managed and poorly governed systemic bank, and persevered with equity finance and policy advice, in close coordination with other IFIs and the European Commission. This greatly aided Latvia’s remarkable turnaround and eventual acceptance to the eurozone in 2014.

During this period the Bank was constructively flexible in its response, supporting critical energy investments and helping stabilise local financial markets. However, small deal size and residual risk limited the number of bankable investments. Although there seems to be greater promise for increased activity now that Latvia has emerged from the crisis, credit growth and foreign investment nonetheless remain low. The Bank’s ability to provide long-term financing, as well as equity, may be an important facilitator to investment at a time when the mostly foreign-owned banks are deleveraging.

Going forward, with the financial sector offering few alternatives to traditional bank lending, the Bank, working with stakeholders ranging from investors to other IFIs and regulators, will have an important role to play to in increasing availability of equity in the economy. A key element of this integrated approach will be the Bank’s investments in regional PE/VC funds, including those noted above.

Energy security is also gaining in importance, particularly as geo-political uncertainty persists. The Bank has an opportunity to play a role in regional integration and support local, in particular renewable, energy generation, as well as facilitate financing structures that increase private sector involvement in providing much needed energy efficiency investments in public, commercial, industrial and residential buildings.

2 OPERATIONAL ENVIRONMENT

2.1 Political context

Since adoption of the previous Country Strategy, Latvia has been governed by centre-right coalition governments. Continuity in policies helped the country rebound from the 2007-10 economic crisis. After the last parliamentary elections, which took place in October 2014, the governing coalition was formed by three centre-right parties – the Unity Alliance, the Union of Greens and Farmers and the National Alliance. Following the resignation of Prime Minister Laimdota Straujuma at the end of 2015, the same three parties have been in a process of forming a new government. Harmony Centre, which came first in the last election and which is the main party representing the Latvian Russian-speaking minority, continues to be in opposition.

Socio-economic disparity and ethnic divisions remain an issue, particularly in view of the changed regional geopolitical context. National defence and security, as well as reduction of income inequality, have become the policy priorities broadly shared by the key political parties, particularly in view of the changed regional geopolitical context.
2.2 Macroeconomic context

Latvia is a small and open economy with deep links to the European Union and still significant connections to certain countries in the CIS region. Since the recession in the early 1990s at the onset of transition, the country has undergone three further recessions. The latest, between 2007 and 2010, corrected the excesses of the boom-year demand growth and financial sector expansion. The contraction by almost a quarter was one of the steepest of any emerging market in recent history.

Since 2011, Latvia has registered a rapid and consistent recovery, though GDP still remains slightly below its peak in the fourth quarter of 2007. Average growth of about 3.7 per cent annually between 2011 and 2015 has been significantly above the EU average of about 0.5 per cent over the same time period.

Domestic demand continues to be the main driver of growth, underpinned by increasing real wages, and a recovery in the labour market and remittances. The current fall in fuel prices has resulted in a significant boost to household real disposable income. The overall investment rate remains relatively low for a converging economy at about 23 per cent of GDP in 2014. There was a further contraction in gross fixed capital formation in 2013, followed by only meagre growth in 2014 as banking sector credit to the corporate sector continued to decline. As the new phase of EU structural and investment funds are disbursed, public investment in particular is likely to recover. Since the second half of 2015, investment expenditures have seen a sharp recovery, at 6.5 per cent in the third quarter of 2015 alone.

Exports accounted for 58 per cent of GDP in 2014 – which is low compared to other economies in the Baltic region. One third of this is accounted by services, such as transport, with low and medium technology manufacturing accounting for the rest. Given the traditionally strong links to economies in the CIS, the exposure to the contraction in the Russian economy weighs on Latvia’s trade performance. Exporting companies had some success in re-orienting sales to other markets. In value terms, exports to Russia decreased by almost 30 per cent and about 7 per cent to other CIS countries. However, exports to the EU countries as well as to new markets, such as Africa and Asia, saw positive growth over the same time period.

Given the ample capacity reserves over recent years, inflation has remained well in check. There is some pressure from real wage growth (which increased by nearly 15 per cent over the last three years), and on the supply side from electricity market liberalisation.

Having joined the Eurozone in 2014, Latvia will continue to confront deflationary pressures in the currency area, though also benefit from various monetary easing measures. Adoption of the euro entailed participation in the banking union which should contribute to overall confidence in local supervision. The three largest financial institutions have been directly supervised by the European Central Bank (ECB) since end-2014.

The labour market has improved. Total unemployment declined to 10.2 per cent at end-2015, with youth unemployment falling to 18.2 per cent over the same period. Nevertheless, both figures still remain the highest among the three Baltic countries. Going forward, continued emigration and an aging population are likely to weigh on employment.
The government continues to ease austerity measures. After years of post-crisis fiscal consolidation, it plans to continue relaxing spending restraint, as a result of encouraging revenue trends, while remaining in line with the EU’s Stability and Growth Pact. Following a significant improvement in 2012, the budget deficit reached 1.5 per cent of GDP in 2014. Under the ongoing competitiveness programme, plans are under way to reduce labour taxation by gradually increasing the non-taxable minimum.

2.3 Structural reform context

With the pressing tasks of macroeconomic stabilization concluded, Latvia has begun to take on a new phase of structural reforms. Substantial challenges remain in areas such as innovation, labour taxation, energy security, energy efficiency and renewable energy, as well as the judiciary and public administration.

Greater efforts are needed to stimulate innovation and raise local value added. As in other transition countries in the Central Europe region, Latvia has achieved productivity gains from the reallocation of factors of production across sectors. A substantial reduction in domestic wages and prices (“internal devaluation”) afforded temporary competitiveness gains during the crisis recovery but are now exhausted. Going forward, productivity growth will need to be reinvigorated through firm level innovation. This will need to be implemented through the adaptation of existing technologies that are new to the country, alongside local innovation that expands the technological frontier. Comparative data from the EU on a range of indicators, including the employment of a skilled labour force and share of technology-intensive exports, confirms that Latvia remains among the poorest performing in the EU in this regard.

Latvia’s exports consist mainly of low-technology goods, such as wood products, food and metals. The share of high-tech products stood at only 9.2 per cent of total exports in 2014, well below the EU average. R&D expenditures are extremely low, at only 0.6 per cent of GDP in 2013, much below the government’s EU target or levels seen in other countries in the region. The lack of cooperation between research institutions and businesses is the key obstacle to the commercial utilisation of research results. A comprehensive indicator of innovation spending and outcomes ranks Latvia at the second lowest place in the EU.

The tax burden on labour income has decreased somewhat. The government cut social contributions in 2014 for both employees and employers, while the personal income tax rate of 24 per cent was reduced to 23 per cent in 2015.

The relative isolation from EU energy markets has been a long standing cost and risk to private sector investment. The country was connected to a regional electricity trading platform, though transmission capacity is as yet limited and will be lifted only gradually. There has also been some progress in overcoming vertical integration in the domestic gas market that has limited competition, and this should gradually encourage alternative supplies and competition.

Poor governance in state-owned companies has been a long-standing problem in Latvia. Although a law on enterprise reform has been adopted, timing and pace of implementation remain uncertain. A coordination institution, which aims to improve the transparency and professionalism of the selection process for management and boards of directors was appointed and began its work in June 2015. The remainder of the regulations are being
reconciled with line ministries. Domestic competition has therefore been less intense than is desirable, underlined by relatively high price-cost margins.

### 2.4 Access to finance

**Private sources of capital**

Latvia’s successful post-crisis recovery is reflected in its sovereign credit ratings. Improving public finances, solid domestic-demand driven GDP growth and euro adoption have resulted in multiple rating upgrades towards the current A- grade awarded by all three rating agencies. The outlook is rated as stable notwithstanding the geopolitical risks related to the Ukraine/Russia crisis and a still weak Eurozone environment.

Shortly after its euro accession in 2014, Latvia issued two Eurobonds, at 7 and 10 year maturities, for a total of €2 billion. These two placements enabled Latvia to repay a loan to the EC in January 2015 while still covering general financing needs. In September 2015, Latvia issued a further €500 million in 10-year bonds at a historically low interest rate.

The pace of deleveraging by foreign bank creditors to Latvia’s economy has moderated. Yet total withdrawals as of the third quarter of 2014 amounted to 6.7 percent of GDP, the highest such rate in the region, according to BIS data. Since 2011 these banks have reduced their exposure by about 25 per cent of Latvian GDP, which exceeds the combined value of its two Baltic peers over the same time period. Domestic bank credit to the corporate sector therefore continued to contract. Following a drop of 5.85 per cent in annual terms in 2013, the outstanding amount of total loans to non-financial corporations shrunk further by 10.4 per cent in 2014. In terms of consumer financing, alternatives to traditional bank financing like Mintos, a Latvian peer-to-peer lending platform for private individuals, are developing. It remains to be seen if the development of alternative financing platforms is as successful in the Baltics as it is in other jurisdictions like the UK.

A sustainable venture capital and private equity sector is as yet not in place. While the banking sector is well developed this will limit the capacity of firms to invest in own technology and new plant and equipment.

The commercial bond market is very poorly developed. Corporate issuance is against the background of a relatively strong sovereign rating (A- / A3) and substantial sovereign bond issuance. The greatest difficulty that Latvian companies have in accessing capital markets is the size of individual companies and the size of the Latvian market. Notwithstanding the fact that the stock exchange in Riga (NASDAQ OMX Riga) is part of the Nasdaq Baltic Market, and is 93% owned by NASDAQ OMX (meaning that listed Latvian companies have exposure to the global universe of investors and efficient transaction costs), the Latvian market is limited to those investors both undertaking the necessary due diligence on the country and the individual companies as well as accepting the limited liquidity that is associated with smaller issuers. Corporate credit is dominated by bank loans, and most bonds issued in the corporate sector are by financial institutions, such as ABLV Bank and a range of local small/medium and microcredit lenders. The latest bond issuance by a non-financial company took place in July 2015 (Latvenergo). The local private pension fund industry offers some supportive demand for such issues (as of the end of 2014, there was €286 million in private pension funds, representing nearly 1.1% of GDP).
Non-resident deposits (NRDs) represent about 50 per cent of all deposits in the banking sector in Latvia, with Russia related entities accounting for a large share. Due to the ongoing geopolitical uncertainty, the banking system requires more intensive supervision. However, until now no significant disruptions have been observed and the banks active in the NRDs are subject to more stringent supervision, particularly now that Latvia is a member of the eurozone’s Single Supervisory Mechanism.

Finally, foreign direct investment (FDI) flows into Latvia have slowed to a trickle. The total inflows in 2014 amounted to only 1.9 per cent of GDP, a far cry from the pre-crisis peak of almost 8 per cent (when such flows were admittedly distorted by financial and real estate investments). While the region as a whole has suffered from the retrenchment by direct investors, Latvia seems to have been affected particularly hard. This is one of the lowest such ratios in the region.

Multilateral and bilateral development bank finance
During the 2007-2013 planning period Latvia was eligible for up to €4.5 billion in EU structural funds. Latvia’s absorption rate has been reasonably good, and stood at 89.9 per cent as of the end of March 2015. During the subsequent planning period (2014-2020), €5.6 billion will be available through the European Structural and Investment Funds (ESIF), of which approximately 26 per cent is envisaged for sustainable transport, 14 per cent for environment and resource efficiency, 12 per cent for education, 11 per cent for carbon emissions reduction, 11 per cent for research and innovation, and the remainder allocated to social inclusion and reduction of poverty, support of SME competitiveness, employment and mobility and access to IT.

As all other member states, Latvia is expected to absorb about 6 per cent of these funds through Financial Instruments, implying a leveraging of EU funds from private investors, and supporting the above programmes through repayable instruments, including equity, loans and guarantees. The development institution ‘Altum JSC’ was created in April 2015 under government ownership and will be responsible for both direct funding programmes and those extended through financial intermediaries.

Latvia is also expected to benefit from the European Fund for Strategic Investments (‘EFSI’, also known as the “Juncker Plan”). While project selection will be initiated by the EIB, Latvia submitted 58 projects to the Special Task Force on Investment in the EU for potential funding. Projects submitted are in the areas of transport, energy, knowledge and digital economy, social infrastructure and resources and the environment, and envisage a total financing of €10.3 billion.

In addition, several other institutions have been active in the country, largely in the energy infrastructure and transport sectors:

- From early 2011 to the end of March 2015 the European Investment Bank (EIB) signed twelve loans totalling €478.5 million in Latvia. Six operations worth €200m were to co-finance EU cohesion funds during the period 2014 to 2020; five were to Latvian banks, mainly in support of SMEs; and one was for Latvenergo. The latter €100 million loan to Latvenergo signed in December 2014 will finance modernization of the electricity distribution network and introduction of smart metering infrastructure.
Since 2011 the **European Investment Fund** (EIF) has committed €40 million to the Baltic Innovation Fund with a partial allocation to Latvia. Since establishment, the BIF has extended funding to one private equity fund and one mezzanine fund, both pan-Baltic in focus.

The **Nordic Investment Bank** (NIB) has signed two loans in Latvia since 2011 totalling €34.5 million. Both loans were for Latvian Railways.

In October 2015 the **Council of Europe Development Bank** (CEB) has approved a loan of €50 million for the co-financing of the Energy Efficiency Improvement Programme in multi-apartment buildings during 2015-2018.

### 2.5 Business environment and legal context

**Business context**

Latvia’s business environment is relatively positive, although there is room for improvement. The World Bank’s 2016 *Doing Business* report ranks Latvia 22nd globally (out of 189 countries). It outperforms Poland and Slovakia, while it remains behind Estonia. The World Bank report acknowledges progress made in indicators such as starting a business, registering property and enforcing contracts.

The World Economic Forum’s *Global Competitiveness Report* 2015-16 highlights a number of additional obstacles. Inefficient government bureaucracy, tax regulations, access to finance and corruption were assessed as the most problematic business obstacles.

In the 2012-13 EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS), the top three business environment obstacles identified by Latvian enterprises were workforce skills, access to finance and political instability. As in other reports, access to finance tops the list for SMEs and young enterprises, especially as the share of bank loans used to finance fixed assets has decreased in all countries in Central Europe and the Baltics. Electricity is the third most pressing obstacle for large enterprises. Young enterprises also flagged prominently that practices of competitors in the informal sector impeded development.

**Legal Context**

Latvia continues to rank among the EBRD countries of operations with a relatively advanced set of commercial laws. The country's pledge law is reported to function well in practice. The most recent EBRD assessment looking at the corporate governance legislation and practices of companies undertaken in 2014 highlighted a relatively sound framework, despite some shortcomings remaining in the “internal control” section, especially with reference to the functioning and independence of the audit committee. Latvia’s insolvency regime provides for framework allowing both liquidation and reorganisation; however, it would benefit from targeted reform aimed at improving the institutional framework aligning the standards for the insolvency office holder profession with international best practice. In addition, Latvia should focus on making further improvements to the court system in order to accelerate the administration of justice.

The 2009 Public Private Partnerships Law as amended is a detailed, modern and a fairly comprehensive piece of legislation governing concessions and non-concession forms of PPPs. The 2011 EBRD Public Procurement Assessment scored the public procurement law to be in high compliance with international standards and incorporating modern, uniform and comprehensive regulatory provisions.
In the energy sector, legislative measures towards strengthening independence should be continued and intensified, in particular, in strengthening the regional energy connections and the country’s integration into EU networks, liberalisation of the gas market, and introduction of clear and consistent measures to promote renewable energy sources and energy efficiency, including in transport. Annex 4 offers more detailed analysis on the legal context for investments in Latvia.

2.6 Social context

Latvia ranks 46th out of 188 countries on the UN Human Development Index 2014, and 28th out of 36 countries from the Central Europe and Baltics region displayed. Life expectancy at birth has been improving every year and, at 74.2 years, is drawing near to the EU average life expectancy of 80.6 years. Educational attainment is relatively high, with average years of schooling at 15.2 years and literacy rates above 99 per cent across gender and age groups.

According to Eurostat, 32.7 per cent of the population was at risk of poverty and social exclusion in 2014, the highest proportion among countries in the region and significantly above the EU-28 average of 24.4 per cent. Latvia’s income level remains among the lowest in the EU and inequality is still an issue: compared to the EU-28 average of 31 in 2014, Latvia had the second highest Gini coefficient of 35.5.

As with neighbouring countries, Latvia struggles with negative population growth, on account of a low (though recently increasing) birth rate and emigration among its younger, well-educated labour force.

The percentage of the population with tertiary education attainment in Latvia in 2014 was 26.9 per cent, above the EU-28 average. The same trend is seen amongst women, where 33.9 per cent had attained tertiary education (versus the EU-28 average of 27.5 percent). However, there is room to improve the adequacy of the skills supply to better match the needs of the labour market and increase labour productivity. According to the World Bank’s Enterprise Surveys, almost a third of employers considered an inadequately educated workforce to be a major constraint for their operations in 2013.

Although there is only a small gap between women and men in fulltime employment rates, the distribution of men and women varies significantly by sector and there is a 17.6 per cent average gender pay gap across all sectors. The representation of women in decision-making has improved in recent years. In Latvia, the share of women in executive and legislative institutions is 45 per cent – which compares favourably to Lithuania, Slovakia, Slovenia, Poland and Hungary. Only Finland scores higher than Latvia in terms of women on boards in companies listed on stock exchanges, among EU countries. In 2012, 33 per cent of Latvian firms were women owned businesses.

Although a relatively small country, Latvia experiences significant disparities in investment levels and economic development between the Riga region, where more than half of Latvia’s GDP is produced, and the rest of the country, in particular the eastern part. In addition, according to the WHO, 28 per cent of Latvia’s rural population do not receive sanitation.

---

1 Population with tertiary educational attainment level by sex and age (edat_lfse_07), http://ec.europa.eu/eurostat/web/education-and-training/data/database.
coverage of adequate quality, a significantly higher proportion than most countries in the region. Latvia’s rural areas also have less access to safe water, particularly quality drinking water and sustainable wastewater services, and therefore are more at risk to water borne diseases and reduced economic activity.

2.7 Energy efficiency and climate change context

Over the last few years, Latvia has made significant progress in promoting sustainable energy compared to other EBRD countries. However, Latvia’s carbon intensity is still relatively high compared to the EU-28 average (0.41 CO2/GDP versus 0.24 for the EU). One of the main energy challenges is that Latvia remains heavily dependent on gas imports, mainly coming from Russia.

The share of renewable energy has traditionally been high in Latvia’s energy supply owing largely to the country’s sizable hydropower resources. Some 48.8 per cent of electricity generated in 2013 was from renewable sources. Latvia has committed under the EU 20/20/20 targets to produce 40 per cent of its final energy consumption from renewable sources by 2020. To attain this Latvia needs to generate about 59.8 per cent of electricity and 53.4 per cent heat from renewable sources in 2020.

Further attention to increasing energy efficiency and the supply of renewable energy up to 40 per cent, in line with the EU Energy and Climate Package 2020 targets, is needed. Increasing sources of and access to financing for investment, particularly for smaller renewable energy and energy efficiency projects and those with longer pay back periods, will be key in meeting these targets. In addition, there is a need to encourage innovation and use of climate technologies in the market, e.g., in conjunction with the EU (Horizon 2020). Supporting the expansion of renewable and sustainable energy and promoting energy efficiency across all sectors including in transport thus remains vital, considering that Latvia seeks to comply with its significant EU targets and to diversify its energy supplies. Focus will be needed as well on exploring the development of energy service companies (ESCOs) with a focus on street lighting and public buildings as great potential can be realised for these sectors. Another interesting sector is residential energy efficiency and a residential ESCO market is currently being developed with a focus on standardised Multi-Family Buildings. Interested companies include utilities (district heating companies), housing maintenance companies and engineering companies who show significant interest in developing residential ESCO projects. However, a key problem for ESCO market development is the lack of long term money, as commercial banks only offer agreed interest rates for up to 5 years, after which loans can be re-negotiated and called.

It will therefore be important to continue supporting investments in energy security and energy efficiency in Latvia going forward. The Bank will focus in particular on promoting and financing new renewable energy generation capacity and improving energy efficiency in both the municipal, industrial and residential sectors. In addition, Latvia’s competitiveness will depend on further improvements in the business environment, and policy dialogue to support the Latvian authorities’ efforts will enable sustainable projects to flourish across the sectors, both for private and public.
3 STRATEGIC ORIENTATIONS

3.1 Strategic Directions

The 2007-2010 financial crisis had a major adverse effect on Latvia, but the economic recovery, managed with admirable resolve in fiscal policy and labour market adjustment, has been robust. Latvia’s accession to the euro area in 2014, and its regained access to sovereign funding markets, underline that the immediate task of macroeconomic adjustment has been tackled.

At the same time, investment and productivity growth have been held back by certain structural deficiencies in the economy, where some transition gaps remain even though Latvia has been an EU member since 2004. While these gaps, as assessed under the Bank’s methodology, are modest overall, pockets of significant transition gaps exist. State involvement in the economy remains considerable, governance of state-owned enterprises poor, and product market regulation excessive. Furthermore, export orientation is modest, and primarily in low and medium technology manufacturing, a symptom of one of the weakest innovation performances in the EU. Integration through inward direct investment is limited, and participation in global value chains that disseminate key international technologies is sparse. Latvia will also need to confront a number of longer term challenges, such as the aging and shrinking workforce, and volatility and geopolitical risks.

With this in mind, the authorities have renewed their efforts to accelerate long-term structural reform to bring about sustainable growth. The implementation of the Government’s 2012 comprehensive competitiveness report is encouraging in this regard. With limited input from other international financial institutions, the Bank’s involvement in policy design and structural reform will be a key contribution to creating a more supportive environment for private sector growth. In addition to assisting the authorities with the design and utilisation of EU Financial Instruments, there may be scope for engagement on, for example, the knowledge economy, governance of state-owned enterprises and insolvency law reform.

To help Latvia address these key challenges, the Bank will focus on pursuing the following two strategic orientations in the new Strategy period:

- **Strengthening energy security and improving energy efficiency.** As Latvia relies heavily on imported natural gas from one supplier, the Bank will support diversification of energy sources through regional energy market integration as well as investments in domestic, in particular renewable energy resources to boost local energy generation. The Bank will also seek to facilitate investments in energy efficiency.

- **Boosting private sector competitiveness through innovation.** Latvia scores relatively low in cross-country surveys of competitiveness. New investment in high value added production and innovation is badly needed to enhance capacity, provide important demonstration effects to other businesses and achieve sustainable economic growth. The Bank will thus seek to enhance access to finance (equity in particular) for innovative and potentially competitive companies through direct investment and via investment in private equity funds.

---

In designing its support and related instruments, the Bank will tailor them to the advanced stage of transition of Latvia. As Latvia’s transition has become more advanced, the Bank has accordingly narrowed the scope of its activities as a consequence of the fewer market segments in which Bank activities can satisfy its operating principles (transition impact, sound banking and additionality). This is also intended to enable the Bank to gather further experience and develop its knowledge in its advanced markets that it could share in other parts of the EBRD region.

Likewise, during the strategy period, Latvia’s donor activities will continue to strengthen private sector development in the EBRD region and the authorities will seek opportunities to share their experience and expertise gained during Latvia’s transition with other countries in the EBRD region.

Reaffirming the principle of graduation and consistent with the Medium-Term Directions for the Bank (BDS14-098 (F)), the Bank considers that the main instrument for decision-making on graduation is the respective country strategies, jointly agreed by the Bank and country authorities. Latvia reaffirms its commitment to the principle of graduation. Although there has been significant progress in its transition to a sustainable market economy, some gaps remain and new challenges have arisen related to uncertainties in the broader geopolitical and investment environment. Latvia will continue to keep the question of graduation under review and will indicate its graduation intention at the appropriate time.

3.2 Key challenges and Bank activities

Theme 1: Strengthening energy security and improving energy efficiency

Transition challenges

The Latvian economy has suffered from the relative isolation of its energy markets, and reliance on Russia as the single gas supplier. Some progress in vertical unbundling and creating greater competition in domestic energy markets has only recently been made. Latvia’s energy intensity is about twice the EU average, suggesting an immense scope for further energy savings.

- An LNG terminal is now operational in Lithuania and new pipelines between Poland and Lithuania are being planned. Estonia is seeking to build an LNG terminal in co-operation with Finland. Latvia has sizable underground storage facilities (UGS). All of these combined emphasise the need for strengthening the pan-Baltic pipeline grid.
- Further unbundling and liberalisation of the gas sector is needed to encourage entry of private players and create a competitive domestic market.
- While full liberalization of electricity tariffs for retail consumers commenced in January 2015, remaining cross-border limitations to energy trade need to be overcome.
- Sustainable energy projects should be further developed, especially in the residential and SME sectors (e.g., only two per cent of multi-apartment residential housing stock has been renovated). Energy pricing encourages energy efficiency investments, but projects in both the residential (especially in the capital city of Riga) and SME sectors are still held back by institutional barriers. The parliament has yet to adopt an energy efficiency law to provide the legislative framework transposing the EU Directive on
energy efficiency. Delays have impeded the implementation of a number of key requirements of the Directive.

- Some uncertainty prevails in the renewable energy support framework, with the feed-in tariff phased out in 2011. Support frameworks and market development for energy efficiency still lag the EU average considerably. There are some concerns on the transparency of the institutional framework.

- Although Latvia has a relatively high proportion of electricity generation from renewable sources, this is predominantly from large hydro power owned by the state-owned energy company Latvenergo. Considerable investments have been made in developing a regional network of renewable energy based combined heat and power CHPs, mainly with the support from the EU Cohesion policy funds. Continued regulatory uncertainty over renewable energy support has inhibited investments in other renewable electricity technologies.

Operational response

- The Bank will aim to support Latvia’s integration in the regional energy market as part of strengthening energy links within the greater Baltic region, and will look to finance the further development of the Latvian and Baltic energy infrastructure, including projects focused on the efficient use and transfer of energy, electricity or gas, within Latvia and the Baltics.

- To enhance Latvia’s energy security the Bank will seek to support the renewable generation of electricity. This will be mainly done through financing renewable energy generation based on local energy sources, i.e. biomass, biogas, wind and to some extent solar. Increased participation of the private sector in electricity generation will be sought.

- It is envisioned that energy efficiency investments will be pursued mainly through a new financing framework based on Energy Performance Contracts (EPCs), thereby facilitating access to long-term funds for ESCOs that provide energy efficiency investments in buildings, as well as for municipal services like street lighting.

Policy dialogue and technical assistance

- Policy dialogue will focus on structuring co-financing from EU funds to achieve optimal leverage and increase the involvement of the private sector in providing energy saving services. Further technical assistance to help implement financing based on EPCs is also envisaged.

- Promoting the use of Financial Instruments, in conjunction with EU structural funds, to support the financial structuring of projects in the energy and resource efficiency sectors.
Results Framework for Theme 1: Strengthening energy security and improving energy efficiency

<table>
<thead>
<tr>
<th>CHALLENGES</th>
<th>OBJECTIVES</th>
<th>ACTIVITIES</th>
<th>TRACKING INDICATORS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.1 Latvia’s economy has suffered from the relative isolation of its energy markets</td>
<td>Strengthen regional energy market integration through cross-border energy connections and gas pipelines, including increased usage of UGS facilities</td>
<td>• Boost pan-Baltic transmission and storage capacity by financing interconnectors through, e.g., long term debt and equity for gas grid and electricity distribution companies, linked, where feasible, to UGS facilities</td>
<td>• Evidence of increased regional interconnectivity of electricity and/or gas transmission, distribution or storage capacity as a result of Bank activities Transition Impact Monitoring System/Technical Co-operation Results Framework (TIMS/TCRF) (Baseline – established at projects’ approval)</td>
</tr>
<tr>
<td>1.2 Latvia remains dependent on external energy suppliers; domestic generation requires additional private sector investment</td>
<td>Boost Latvia’s energy security by increasing electricity generation from local, in particular renewable resources and increasing private sector participation</td>
<td>• Direct/indirect financing to generating companies (“gencos”) using local energy sources, including renewables • Support for further liberalisation and unbundling in the gas sector to promote competition and the entry of private players</td>
<td>• Number of investments in gencos utilising local, renewable energy sources, and evidence of improved financial and operational performance (TIMS/TCRF) (Baseline – established at projects’ approval)</td>
</tr>
<tr>
<td>1.3 Latvia’s energy intensity remains one of the highest in the EU</td>
<td>Improve energy efficiency</td>
<td>• Finance energy efficiency investments, including through support for EPC framework to improve access to finance for ESCOs providing energy efficiency investments • Policy dialogue, including technical assistance, to facilitate development of regulatory structure for EPCs and co-financing from EU funds</td>
<td>• Volume of energy savings achieved through Bank investments based on EBRD methodology in toe/year (Baseline – 0) • Number of energy efficiency investments successfully implemented or financed (Baseline – 0) • Evidence of successful strengthening of regulatory framework for EPCs (Baseline – N/A)</td>
</tr>
</tbody>
</table>

Context indicator: Δ in Latvia’s energy intensity (Source: Eurostat (Baseline (2013) – 310.6 kg oil equivalent/€1000))
Theme 2: Boosting private sector competitiveness through innovation

Transition challenges

While Latvia has managed a strong recovery from the low point at the end of the financial crisis, with productivity remaining one-third below the EU average, growth may not be sustainable in the long-run. It remains vulnerable to a number of structural deficiencies and external shocks, such as workforce shrinkage or regional volatility. Export orientation is modest and predominated in low-tech products. FDI penetration is relatively shallow, and innovation performance is underwhelming. The foundations for structural reforms in support of the competitiveness agenda have been laid, however, and the government is implementing the recommendations of its 2012 competitiveness report. Yet, a comprehensive agenda remains:

- Latvia will need to further enhance the export-orientation of the economy and facilitate engagement of foreign direct investors. Greater openness is a prerequisite for the transmission into Latvia and subsequent broader adoption of new technologies and production processes. Given the minimal local innovation, this is the most promising path to a more innovative economy.
- As EU indicators demonstrate, the transfer of technology from research institutions to the private sector remains poor, although the Government is exploring how to utilise EU funds to boost technology transfer and increase co-operation between enterprises and scientists. Greater commercial orientation of research should be encouraged.
- Energy efficiency among Latvian enterprises remains very low. Regulations that could create economic incentives for energy savings are poorly developed. Raising energy efficiency could be a key factor in boosting productivity.
- While Latvia enjoys a well-developed and stable banking system, the funding environment for innovative enterprises needs to be expanded to include new financial instruments, such as private equity and venture capital. At present, these remain underdeveloped and fragmented between relatively small local markets as local stock exchanges in the Baltics continue to lose liquidity.
- Latvia stands to benefit from a substantial allocation of EU structural and investment funds in 2014-2020 (€5.6 billion, or about 3.3 per cent of annual GDP). This funding is expected to increasingly shift away from the traditional grant-based instruments and towards commercially based financial mechanisms that leverage private funds. There is a need to establish the institutional underpinnings of such EU finance that could partner with private investors. PPPs in public infrastructure are one such avenue worth developing.

Operational response

- In order to promote development of local capital markets and improve availability of capital for growing SMEs the Bank will continue its work under the Baltics IA and invest in regional PE and VC funds targeting the Baltics. The Bank will also seek ways to support development of alternative financing mechanisms like crowd-funding and peer-to-peer financing.
- The Bank will seek to deepen its engagement in Latvia’s knowledge economy by financing investments in innovation, research and development and adoption of modern technology in knowledge-intensive industries and by investment and
aggregation (consolidation) in related Information Communication Technology (ICT) infrastructure.

- The Bank will support, through equity and long-term debt, export-oriented companies and innovative producers of higher value added goods, including cross-border investments by Latvian companies into other EBRD countries of operation where the Bank’s local presence and involvement can facilitate investment. Resource efficiency and, in particular energy efficiency investments, by corporates will be targeted.
- To help bolster FDI into Latvia the Bank will support foreign companies’ investments, especially when these include knowledge transfer, adoption of best business practices and/or improvement of corporate governance standards.
- The Bank will work with the authorities in developing proper PPP structures, where feasible, mainly to improve provision of transport infrastructure services in a country where transit-related businesses are an important part of the economy.

Policy dialogue and Technical Assistance

- The Bank will continue working under the Baltics IA together with market participants and authorities through policy dialogue to further improve the legal and regulatory environment enabling the PE/VC to grow in Latvia. This will involve also some technical assistance for capacity building, early stage development support, creating and enhancing networks, and increasing the availability of information on VC/PE funds.
- The Bank will closely cooperate with the authorities through advisory to develop and structure PPP projects, coupled where possible with finance.
## Results Framework for Theme 2: Boosting private sector competitiveness

<table>
<thead>
<tr>
<th>CHALLENGES</th>
<th>OBJECTIVES</th>
<th>ACTIVITIES</th>
<th>TRACKING INDICATORS</th>
</tr>
</thead>
</table>
| 2.1 Funding environment for innovative enterprises remains limited | Strengthen private sector competitiveness through investment in innovative and export-oriented companies | ▪ Debt and equity investments in support of export-oriented and innovative producers of higher value-added goods, including, as applicable, those further developing adoption of modern technologies and/or Latvia’s knowledge economy | ▪ Evidence of successful operation of export-oriented and innovative companies supported directly or indirectly by the Bank (qualitative account) *(Baseline – N/A)*  
▪ Evidence of development of innovation or adoption of modern technology by local companies as a result of the Bank’s investments (qualitative account) *(Baseline – N/A)* |
| 2.2 Risk-oriented private equity and venture capital remain underdeveloped and fragmented | Diversify sources of finance, including private equity and venture capital, as alternatives to the banking sector | ▪ Under the Baltics IA, investments in regional PE and VC funds targeting the Baltics, supported by policy dialogue and technical assistance to improve the legal and regulatory environment | ▪ Evidence of availability of innovative financing (e.g., number of PE and VC funds financed) and number of innovative companies financed by client funds *(Baseline – 0)*  
▪ Evidence of improvement in the regulatory environment as a result of the Bank’s policy dialogue (qualitative account) *(Baseline – N/A)* |
| 2.3 Increased private sector investment and participation are necessary to improve the operational management and financial sustainability of Latvia’s transport infrastructure services | Increase use of private sector-led solutions to enable sustainable funding (potentially in conjunction with EU funds) and efficient management of transport infrastructure services | ▪ Encourage private sector participation and promote use of PPP structures in transport infrastructure via finance and policy dialogue  
▪ Policy dialogue on development and structuring of PPP projects, potentially in conjunction with leveraging EU funds | ▪ Evidence of transport infrastructure services successfully outsourced to private sector (e.g., PPPs) (qualitative account) *(Baseline – N/A)*  
▪ Evidence of improvements in PPP environment as a result of the Bank’s policy dialogue *(Baseline – N/A)* |

**Context indicator:** Δ in Sub-indicator on Innovation systems from Adjusted Knowledge Economy Index *(Baseline (2013) – 5.87)*
3.3 Potential Risks to Country Strategy implementation

The EBRD’s ability to deliver on its strategy in Latvia will be influenced by a number of factors outside the Bank’s control. Where feasible, the Bank will work to address and mitigate these risks through proactive and sustained engagement with clients, the authorities and other stakeholders.

i. Continued sluggish growth in Western Europe

The EU is an important market for Latvian exports. As a result, any negative impact on the EU economy would be reflected in the local economy through a smaller contribution to gross domestic product from exports.

ii. Continued geopolitical tension surrounding Ukraine/Russia

Latvia’s trade relations with Russia have been very close through Russia being an important export market and a source of energy for Latvia. A changed geo-political situation arising from the Ukrainian conflict may trigger a deterioration of market confidence and economic outlook in major trading partners. Perceived increased risks might also deter foreign investors, although the EBRD’s presence and support may mitigate this to some extent.

iii. Low investment in the corporate sector

For the Bank to be able to implement an important part of its strategy, the corporate sector in Latvia needs to invest. The uncertain geo-political situation could lower investments in Latvia and, more likely, cross-border by Latvian companies, thereby reducing the number of opportunities for the Bank.

3.4 Environmental and Social Implications of Bank Proposed Activities

The relatively low density of heavy industry in Latvia and the large areas of natural environment alleviate some of the more significant legacy issues neighbouring countries inherited from previous regimes. Notwithstanding, as in all countries, Latvia faces a number of environmental and social challenges where development and good environmental and social governance exist together. Through support for projects in Latvia and the application of the Bank’s Environmental and Social Policy (2014) these challenges can be met and sustainable development achieved.

Latvia has made substantial progress in advancing the environmental and social agenda since joining the European Union and implementing EU Directives. There are further improvements to be made associated with the historic structure of the energy sector and reliance on imported electricity and fuels for domestic production. In addition, underfunded municipal and public infrastructure, notably in terms of waste management, wastewater and public transport systems continues to be a challenge. The Bank has assisted and continues to assist in the financing of projects aimed at achieving compliance with EU standards.

As the president of the Council of the EU in the first half of 2015, Latvia oversaw a number of developments and chaired discussions relating to pertinent environmental issues to be adopted at the EU level and implemented in Latvia, thereby demonstrating Latvia’s
commitment to further progress and enhance the environmental agenda. Latvia’s 2015 presidency also emphasised inclusive and sustainable labour market participation.

Nevertheless significant challenges remain, notably in terms of restructuring the power sectors to achieve EU environmental standards, particularly with regard to domestic generation of electricity using imported fossil fuels. The recent implementation of the EU Industrial Emissions Directive (IED) is a challenge to many operators, notably as existing facilities must comply with Best Available Techniques (BAT) post-2016. In other sectors, Latvia faces the need to move away from an energy import dependent economy and implement state of the art non-fossil fuel-based generation assets, such as renewable generation. The investments needed will require substantial capital and know how. The Bank will assist in this process to help Latvia implement an energy dependant low carbon strategy, and continue assisting with the restructuring of the industrial sector. This aligns with the Bank’s strategy to strengthen energy security and improve energy efficiency.

Challenges also exist in overcoming gender discrimination in employment related to recruitment practices, the lack of part-time work options on the labour market, a lack of flexible working arrangements, discrimination against women based on age and family status, especially in the private sector, as well as a high incidence of sexual harassment in the workplace. The Bank will assist in this process by ensuring projects identify and overcome existing gender-bias in recruitment and employment practice, and thereby ensure that women are able to benefit equally with men.

3.5 EBRD co-operations with the European Union and Multilateral Development Banks (MDBs)

- The EBRD will continue to work closely and actively co-ordinate its efforts with the EIB, EIF, NIB, and EU to enhance the leverage of its investment financing by, where appropriate, jointly engaging in policy dialogue with the Latvian authorities, for example, in developing PPP projects. The Bank will look for opportunities to co-finance projects with the EIB and/or the NIB, especially to increase private sector participation in infrastructure and energy.
- The Bank will also continue to co-operate with the EIB, EIF and NIB to support the development and use of new Financial Instruments to enhance the leverage of EU funds.
ANNEX 1 – POLITICAL ASSESSMENT

The Republic of Latvia is committed to and applying the principles of multiparty democracy, pluralism and market economics in accordance with Article 1 of the Agreement Establishing the Bank.

Latvia has successfully continued the consolidation of multiparty democracy since restoration of independence in 1991. The constitutional and legislative framework for a pluralistic parliamentary democracy is in place. The separation of powers and checks and balances in the political system, and guarantees for human rights and fundamental freedoms are largely in line with international and European standards, as assessed by the Council of Europe. The media are pluralistic, and civil society is vibrant and diverse. Elections are conducted in a manner deemed by the Organization for Security and Co-operation in Europe (OSCE) and the Council of Europe to be free and in line with international standards. Latvia became a member of the European Union in 2004 and joined the Eurozone in 2014.

In the period since the adoption of the previous Strategy, Latvia has made further progress in all areas of democratic reform. At the same time, some challenges remain in the areas of the rule of law and minorities.

Free Elections and Representative Government

The electoral legal framework, which was last amended in 2014, generally provides a sound basis for the conduct of democratic elections, as assessed by the OSCE’s Office for Democratic Institutions and Human Rights (OSCE/ODIHR). The last general elections took place in October 2014. The elections were competitive and voters were given a diverse choice of political alternatives. The campaign was conducted in an environment characterised by respect for the freedom of expression, association and assembly, despite remaining divisions along ethnic and linguistic lines. The voting process was well managed and the election administration performed its duties in an impartial and transparent manner. At the same time, the OSCE/ODIHR offered several recommendations related to candidate rights, election observation, secrecy of the vote and inclusive political participation.3

Latvia is a parliamentary republic, with the legislative power lying with the 100-seat parliament, which approves the government and elects the president. Effective checks and balances amongst the branches of power are in place. The legislature is independent and has powers to hold the government to account. Key political decisions are made by elected officials, who are free of undemocratic constraints on their powers to govern effectively.

Civil Society, Media and Participation

The Constitution enshrines the right to form associations, political parties and trade unions. Civil society is diverse and independent, and there are multiple channels of civic and political participation. The freedom to form political parties is implemented in practice and is highlighted by the existence of a significant opposition, including a party representing the Latvian Russian-speaking minority, able to campaign freely and oppose government initiatives. Political parties, however, are divided along ethnic lines, and parties representing Russian speakers are usually excluded from government coalitions at national level.

The media environment is pluralistic. It includes public and private broadcasters and offers citizens a wide range of political views. At the same time, media ownership is concentrated and lacks transparency. While censorship is outlawed, defamation remains a criminal offence.4

Rule of Law and Access to Justice
Legislative and institutional safeguards for the supremacy of law and independence of the judiciary are in place. The Constitution guarantees everyone the right to a fair trial and citizens are free from arbitrary arrest or detention. The government and citizens are equally subject to the law. While improvements were achieved in the reform of the judiciary in the period since the adoption of the last Strategy, it still faces low levels of trust by the public. Concerns have been raised, in particular, regarding frequent delays in completion of trials including cases of detention on remand while awaiting judgements.5

Transparency International’s 2015 Corruption Perceptions Index ranks Latvia 40th out of 168 countries assessed (an improvement from rank 43 in 2014)6. Latvia’s legal and institutional framework to prevent and address corruption has been further strengthened in the period since the adoption of the last Strategy. The Council of Europe’s Group of States against Corruption (GRECO) commended Latvia for implementing almost all recommendations regarding incriminations and the transparency of political funding.7 At the same time, in 2015 GRECO noted that not all recommendations were implemented regarding corruption prevention in respect of members of parliament, judges and prosecutors.8

Civil and Political Rights
The fundamental freedoms of speech, information, religion, conscience, movement, association, assembly and private property are fully guaranteed in the Constitution and upheld in practice.

The last United Nations Universal Periodic Review (UPR) assessed Latvia in 2011. Regarding remaining weaknesses, the largest share of recommendations concerned women’s rights (21.43 percent of all recommendations). Latvia has introduced measures since to reduce gender inequality, although women still receive less pay on average. The share of female Members of Parliament decreased from 23 per cent in 2011 to 18 per cent in 2014. At the same time, the Prime Minister and the Speaker of the Parliament are female, and 30 per cent of ministerial level positions are held by women. In 2014, the UN Human Rights Committee regretted the absence in Latvia of specific legislation on domestic violence.9

---

The third report on Latvia by UN Human Rights Committee highlighted also concerns over the situation of “non-citizen” residents and linguistic minorities.\(^\text{10}\) With a sizable Russian speaking minority and 13 percent of the population being “non-citizens”, both issues remain a challenge.

Constitutional guarantees against harassment, intimidation and torture are in place and upheld in practice.

\(^{10}\) UN Human Rights Committee (2014): Concluding observations on the third periodic report of Latvia on the International Covenant on Civil and Political Rights, p.3.
### ANNEX 2 – SELECTED ECONOMIC INDICATORS

<table>
<thead>
<tr>
<th>Output and expenditure</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015 (projection)</th>
<th>2016 (forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GDP</strong></td>
<td>-3.8</td>
<td>6.2</td>
<td>4.0</td>
<td>3.0</td>
<td>2.4</td>
<td>2.7</td>
<td>3.1</td>
</tr>
<tr>
<td>Private consumption</td>
<td>2.8</td>
<td>3.0</td>
<td>3.2</td>
<td>5.1</td>
<td>2.3</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Public consumption</td>
<td>-8.1</td>
<td>3.0</td>
<td>0.3</td>
<td>1.6</td>
<td>4.9</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
<td>-20.0</td>
<td>24.2</td>
<td>14.5</td>
<td>-5.2</td>
<td>1.3</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>13.4</td>
<td>12.0</td>
<td>9.8</td>
<td>1.1</td>
<td>3.1</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>12.4</td>
<td>22.0</td>
<td>5.4</td>
<td>-0.2</td>
<td>0.8</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Industrial gross output, excl. construction</td>
<td>14.4</td>
<td>8.9</td>
<td>6.2</td>
<td>-0.3</td>
<td>-0.9</td>
<td>3.4</td>
<td>na</td>
</tr>
</tbody>
</table>

**Labour Market**

<table>
<thead>
<tr>
<th>(Percentage change)</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross average monthly earnings in economy (annual average)</td>
<td>-3.4</td>
<td>4.3</td>
<td>3.8</td>
<td>4.5</td>
<td>6.8</td>
</tr>
<tr>
<td>Real LCU wage growth</td>
<td>-2.3</td>
<td>0.1</td>
<td>1.5</td>
<td>4.5</td>
<td>6.2</td>
</tr>
</tbody>
</table>

**Unemployment rate (annual average)**

<table>
<thead>
<tr>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>19.5</td>
<td>16.2</td>
<td>15.0</td>
<td>11.9</td>
<td>10.8</td>
</tr>
</tbody>
</table>

**Prices**

<table>
<thead>
<tr>
<th>(Percentage change)</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015 (projection)</th>
<th>2016 (forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer prices (annual average)</td>
<td>-1.2</td>
<td>4.2</td>
<td>2.3</td>
<td>0.0</td>
<td>0.7</td>
<td>0.2</td>
<td>na</td>
</tr>
<tr>
<td>Consumer prices (end-year)</td>
<td>2.5</td>
<td>4.0</td>
<td>1.6</td>
<td>-0.4</td>
<td>0.2</td>
<td>0.4</td>
<td>na</td>
</tr>
</tbody>
</table>

**Fiscal Indicators**

<table>
<thead>
<tr>
<th>(In per cent of GDP)</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015 (projection)</th>
<th>2016 (forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General government balance</td>
<td>-8.5</td>
<td>-3.4</td>
<td>-0.8</td>
<td>-0.9</td>
<td>-1.6</td>
<td>-1.2</td>
<td>na</td>
</tr>
<tr>
<td>General government revenues</td>
<td>36.2</td>
<td>35.6</td>
<td>36.1</td>
<td>35.9</td>
<td>35.6</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>General government expenditure</td>
<td>44.7</td>
<td>39.0</td>
<td>36.9</td>
<td>36.8</td>
<td>37.1</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>General government debt</td>
<td>47.5</td>
<td>42.8</td>
<td>41.4</td>
<td>39.1</td>
<td>40.6</td>
<td>36</td>
<td>na</td>
</tr>
</tbody>
</table>

**Monetary and financial sectors**

<table>
<thead>
<tr>
<th>(Percentage change)</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015 (projection)</th>
<th>2016 (forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eurozone broad money (M2, end-year)</td>
<td>2.1</td>
<td>2.0</td>
<td>4.4</td>
<td>2.4</td>
<td>3.5</td>
<td>5.3</td>
<td>na</td>
</tr>
<tr>
<td>Credit to the private sector (end-year)</td>
<td>-3.5</td>
<td>-6.6</td>
<td>-10.5</td>
<td>-6.3</td>
<td>-8.9</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Non-performing loans ratio (end-year)</td>
<td>19.0</td>
<td>17.2</td>
<td>11.1</td>
<td>8.3</td>
<td>6.9</td>
<td>na</td>
<td>na</td>
</tr>
</tbody>
</table>

**Interest and exchange rates**

<table>
<thead>
<tr>
<th>(In per cent per annum, end-year)</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015 (projection)</th>
<th>2016 (forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ECB deposit facility rate</td>
<td>0.25</td>
<td>0.25</td>
<td>0.00</td>
<td>0.00</td>
<td>-0.20</td>
<td>-0.30</td>
<td>na</td>
</tr>
<tr>
<td>ECB main refinancing operations rate</td>
<td>1.00</td>
<td>1.00</td>
<td>0.75</td>
<td>0.25</td>
<td>0.05</td>
<td>0.05</td>
<td>na</td>
</tr>
<tr>
<td>ECB marginal lending facility</td>
<td>1.75</td>
<td>1.75</td>
<td>1.50</td>
<td>0.75</td>
<td>0.30</td>
<td>0.30</td>
<td>na</td>
</tr>
</tbody>
</table>

**External sector**

<table>
<thead>
<tr>
<th>(In per cent of GDP)</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015 (projection)</th>
<th>2016 (forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current account</td>
<td>2.3</td>
<td>-2.8</td>
<td>-3.3</td>
<td>-2.3</td>
<td>-3.1</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>External balance</td>
<td>-9.5</td>
<td>-12.1</td>
<td>-12.0</td>
<td>-11.3</td>
<td>-10.0</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Export of good</td>
<td>36.8</td>
<td>42.1</td>
<td>44.8</td>
<td>43.2</td>
<td>42.6</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Import of good</td>
<td>46.3</td>
<td>54.1</td>
<td>56.8</td>
<td>54.4</td>
<td>52.6</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Foreign direct investment, inward</td>
<td>1.6</td>
<td>5.2</td>
<td>3.9</td>
<td>2.9</td>
<td>1.5</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Gross external debt stock</td>
<td>165.8</td>
<td>145.8</td>
<td>137.2</td>
<td>131.3</td>
<td>138.7</td>
<td>na</td>
<td>na</td>
</tr>
</tbody>
</table>

**Memorandum items**

<table>
<thead>
<tr>
<th>(Denominations as indicated)</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015 (projection)</th>
<th>2016 (forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (end-year, thousand)</td>
<td>2 074.6</td>
<td>2 044.8</td>
<td>2 023.8</td>
<td>2 001.5</td>
<td>1 986.1</td>
<td>1 971.3</td>
<td>na</td>
</tr>
<tr>
<td>GDP (in billions of Euro)</td>
<td>17.8</td>
<td>20.1</td>
<td>22.0</td>
<td>22.8</td>
<td>23.6</td>
<td>24.2</td>
<td>na</td>
</tr>
<tr>
<td>GDP per capita (in Euro)</td>
<td>8 566.7</td>
<td>9 851.4</td>
<td>10 862.1</td>
<td>11 394.1</td>
<td>11 873.0</td>
<td>12 285.1</td>
<td>na</td>
</tr>
<tr>
<td>Share of industry, incl. construction, in GDP (in per cent)</td>
<td>23.6</td>
<td>23.7</td>
<td>23.9</td>
<td>23.4</td>
<td>23.3</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Share of agriculture in GDP (in per cent)</td>
<td>4.5</td>
<td>4.1</td>
<td>4.3</td>
<td>4.1</td>
<td>4.1</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Inward FDI (in million of Euro)</td>
<td>286.5</td>
<td>1 045.4</td>
<td>863.2</td>
<td>680.2</td>
<td>448.6</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>External debt/exports of goods and services (in per cent)</td>
<td>312.9</td>
<td>252.1</td>
<td>225.4</td>
<td>221.1</td>
<td>240.3</td>
<td>na</td>
<td>na</td>
</tr>
</tbody>
</table>

1 Figures do not include emigrant workers abroad.
ANNEX 3 – ASSESSMENT OF TRANSITION CHALLENGES

<table>
<thead>
<tr>
<th>Market Str:</th>
<th>Market Inst:</th>
<th>Key challenges:</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CORPORATES</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Agribusiness</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Small</td>
<td>Medium</td>
<td>• Improving access to finance, especially for primary agriculture.</td>
</tr>
<tr>
<td><strong>Manufacturing and Services</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Negligible | Small | • Implementing best international practice with regard to regulation and anti-money laundering standards;  
• Further reducing red tape and the size of the grey economy, to make Latvia a more attractive destination for foreign direct investment;  
• Enhancing the adoption of improved standards in environment and energy efficiency management practices. |
| **Real estate** |
| Small | Negligible | • Although the sector is already well developed, market penetration of innovative construction techniques and technologies, including energy efficiency, could be further increased;  
• The process of dealing with construction permits could also be further streamlined. |
| **ICT** |
| Small | Negligible | • Selling the remaining government owned shares in the fixed line incumbent Lattelecom and the mobile operator LMT;  
• Further increasing competition in the wireline segment. |
| **ENERGY** |
| **Natural Resources** |
| Medium | Negligible | • Completing the unbundling and liberalisation process in the gas sector;  
• Encouraging the entry of private players in the Latvian gas market to create a competitive gas market;  
• Enhancing competition in the oil products distribution segment. |
| **Sustainable Energy** |
| Medium | Small | • Enhancing project development especially in housing and SME sectors;  
• Further capacity for implementation of carbon finance projects. |
| **Power** |
| Medium | Negligible | • Increase in private sector participation in generation and retail energy supply;  
• Increasing cross border energy trading and regional integration. |
## INFRASTRUCTURE

### Water and wastewater

<table>
<thead>
<tr>
<th>Scale</th>
<th>Impact</th>
<th>Measures</th>
</tr>
</thead>
</table>
| Small   | Small  | - Improved contractual arrangements outside of the capital city;  
- Additional private sector participation;  
- Introduction of independent tariff setting methodology. |

### Urban Transport

<table>
<thead>
<tr>
<th>Scale</th>
<th>Impact</th>
<th>Measures</th>
</tr>
</thead>
</table>
| Small   | Small  | - Implementation of a more holistic planning and regulation of the urban transport sector in Riga;  
- Increased private sector involvement;  
- Improved contractual arrangements with clear operational targets, particularly in the smaller cities. |

### Roads

<table>
<thead>
<tr>
<th>Scale</th>
<th>Impact</th>
<th>Measures</th>
</tr>
</thead>
</table>
| Medium  | Medium | - Enhancement of competition in road maintenance and introduction of performance based contracts;  
- Development of PPP projects in line with international best practice. |

### Railways

<table>
<thead>
<tr>
<th>Scale</th>
<th>Impact</th>
<th>Measures</th>
</tr>
</thead>
</table>
| Small   | Negligible | - Further enhancement of private sector participation;  
- Further liberalisation and enhanced competition in the market;  
- Development of multi-modal transport networks and operations. |

## FINANCIAL INSTITUTIONS

### Banking

<table>
<thead>
<tr>
<th>Scale</th>
<th>Impact</th>
<th>Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small</td>
<td>Small</td>
<td>- Developing and facilitating growth of new innovative products (e.g., products related to Carbon Finance and Energy Efficiency).</td>
</tr>
</tbody>
</table>

### Insurance and other financial services

<table>
<thead>
<tr>
<th>Scale</th>
<th>Impact</th>
<th>Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small</td>
<td>Small</td>
<td>- Developing and facilitating growth of new innovative insurance products.</td>
</tr>
</tbody>
</table>

### Micro, Small and Medium-sized enterprises

<table>
<thead>
<tr>
<th>Scale</th>
<th>Impact</th>
<th>Measures</th>
</tr>
</thead>
</table>
| Medium  | Small  | - Developing investment instruments and guarantees available to SMEs, especially outside the capital city;  
- Increasing training and advice services to improve SMEs’ financial reporting and business practices;  
- Increasing access to specialised finance through private commercial sources and promoting venture capital investments in SMEs. |

### Private equity

<table>
<thead>
<tr>
<th>Scale</th>
<th>Impact</th>
<th>Measures</th>
</tr>
</thead>
</table>
| Medium  | Medium | - Broadening companies’ access to PE and VC financing through facilitating the launch of new institutional quality (Baltic-focused) PE and VC funds;  
- Facilitating development of the VC-related ecosystem in the country (e.g., through facilitating improved effectiveness of business accelerators). |

### Capital Markets

<table>
<thead>
<tr>
<th>Scale</th>
<th>Impact</th>
<th>Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medium</td>
<td>Small</td>
<td>- Facilitating increase in liquidity in local capital markets, including by developing local institutional and private investor base.</td>
</tr>
</tbody>
</table>
## ECONOMIC INCLUSION GAP RATINGS - LATVIA

### ECONOMIC INCLUSION

<table>
<thead>
<tr>
<th>Inclusion gap dimension</th>
<th>Inclusion gap</th>
<th>Key challenges</th>
</tr>
</thead>
<tbody>
<tr>
<td>Youth</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Opportunities for Youth | Medium        | ▪ Improving progress routes for young people into employment by facilitating new collaborations between local private sector employers and education providers, with the goal to develop work based learning opportunities.  
▪ Supporting on-going development of national youth policy programmes (such as the Youth Guarantee), improving labour market outcomes for young people. |
| Quality of Education    | Medium        | ▪ Improving the quality of the Latvian education system, with a particular focus on vocational education and training, to ensure that the skillset of the young labour force meet the demand of the private sector. Envisioned by supporting initiatives to include private sector companies in the development of National Qualification Frameworks. |
| Gender                  |               |                |
| Labour Practices        | Large         | ▪ Incentivise clients to improve HR policies with regards to equal opportunity practices, including equal pay practices, access to child care and non-discrimination practices.  
▪ Supporting policy dialogue in relation to gender equality, ideally under a larger inequality umbrella. |
| Employment and firm ownership | Medium | ▪ Support continued improvement of women in employment and equal opportunities in career progression.  
▪ Improving the access to female leadership programmes to improve women’s progress routes into management positions. |

---

The EBRD Economic Inclusion gaps rate the institutions, markets and education systems across all of EBRD’s countries of operation in terms of their capacity to extend economic opportunity to individuals regardless of their gender, age or place of birth. These gaps measure *differences* in opportunities – between 15 to 24-year-olds and older workers, and between women and men – rather than opportunity *levels*. Gaps are reported in this Country Strategy where there exists an Inclusion Gap above Small. These gaps are consistent with the EBRD 2014 Inclusion Gap update.
<table>
<thead>
<tr>
<th>Health Services</th>
<th>Medium</th>
</tr>
</thead>
</table>
|                        | ▪ Supporting better access to and quality of health care for women (particularly to improve contraceptive prevalence) as part of initiatives that seek to improve HR policies.  
                        | ▪ Improve access to quality drinking water and sustainable wastewater services causing waterborne diseases, with a specific focus on women where a robust link can be established between water improvements and women’s health (e.g. economic opportunities). |

<table>
<thead>
<tr>
<th>Regions</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Access to Services</td>
<td>Medium</td>
</tr>
<tr>
<td></td>
<td>▪ Improving water and wastewater infrastructure in Latvia’s underserved areas, particularly where poor quality and limited access cause waterborne diseases.</td>
</tr>
</tbody>
</table>

| Education              | Medium                                                             |
|                        | ▪ Promoting territorial cohesion, by improving access to quality training and work based learning opportunities for local populations in predominantly rural regions.  
                        | ▪ Develop opportunities for youth with social risk status through improved career guidance and professional competences of career counsellors, ideally with private sector involvement. |
ANNEX 4 – LEGAL TRANSITION

Introduction

This annex offers critical analysis on selected legal topics relevant to the Bank’s investment strategy in Latvia during the forthcoming period. It is based on the assessments of commercial laws conducted by EBRD Legal Transition Programme. For ease of reference, the analysis is presented along the main strategic orientations defined in this country strategy.

1. Strengthen energy security and improve energy efficiency

Latvia is a net energy importer, and with its energy networks still being largely isolated from the EU, remains highly dependent on Russian fossil fuel. Energy security is therefore a key priority for the country, as acknowledged in the most recent Energy Strategy 2030 adopted in 2013. Ensuring sustainability of energy supply, promotion of energy efficiency (EE) and the use of renewable energy sources (RES) are stipulated as key measures in achieving this goal.

Recent improvements include completion of the Klaipeda LNG terminal in Lithuania (started operating in 2014), which is expected to serve as a regional hub for the Baltic states, as well as construction of two new regional electricity interconnectors (the former started operations in late 2015 and the latter is expected in 2016). However, efforts aimed at ensuring smooth functioning of the regional electricity market and integration of the Latvia’s energy network into that of the EU need further attention. There has been some progress in improving competition in electricity and gas markets, with the electricity retail market becoming fully open in January 2015, despite several delays, and liberalisation of the gas market and unbundling of the transmission system operator expected to be completed by 2017. As part of measures to meet the deadline, in September 2015 the regulator adopted third party access rules for natural gas transmission and storage systems and the government finalised a plan for splitting the natural gas monopoly, Latvijas Gaze. Going through with all the measures to ensure liberalisation of the market and further enhancing relevant supportive regulatory framework should remain the government’s priority.

Renewable energy

Promotion of RES use is one of the government’s priorities towards meeting the 2020 RES target (40 per cent of gross final energy consumption by 2020). As of 2013, the share of RES was 37.1 per cent of total final energy consumption, and concerns have been posed regarding the country’s ability to meet the 2020 target. There are particular concerns regarding meeting the RES target for transport (10 per cent by 2020), with the 2012 figure being just 3.1 per cent.

RES use in Latvia is governed by a set of national legal acts, including the Electricity Market Law and Energy Law, and secondary legislation, such as on electricity production from renewable energy resources or authorisations for electricity generating capacities, transposing Directive 2009/28/EC on the promotion of the use of energy from renewable sources. Current support measures include a feed-in tariff (on hold until 2016). Access to the electricity grid by renewable energy plants is subject to general legislation on energy, governed by the key

---

12 See www.ebrd.com/law
principle of non-discrimination. Heating and cooling from RES to a great extent is promoted with financing from EU structural funds. RES installations and their use are being promoted through a certification scheme for RES system installers and an obligation to use RES heating and cooling in new and renovated buildings.

Latvia ratified the Kyoto Protocol to the United Nations Framework Convention on Climate Change in 2002 and has met the binding targets of 8 per cent reduction by 2012 (compared to 1990) in total greenhouse gas (GHG) emissions. For Kyoto’s second commitment period (2013-2020), a joint target for the EU countries and Iceland is set at 20 per cent of GHG emissions reduction by 2020 (compared to 1990). Latvia implements a range of cross-sectorial climate change mitigation policies and measures that include controlling and reducing polluting emissions, participating in the flexible mechanisms of the Kyoto Protocol or implementing the EU ETS (emission allowance trading scheme). However, despite the progress made to achieve the targets, Latvia remains among the top countries in terms of its GHG emissions per GDP, with the energy sector (including fuel combustion in transport) accounting for the largest share of such emissions.

Liberalisation of the gas market and advancement of RES legislation are two important items on the government’s reform agenda. While certain progress has been made, efforts will need to be intensified. The current deadlines (2017 for liberalisation of the gas market and 2020 RES targets for the RES share) provide some tangible goals to work towards, and progress needs to be closely monitored, especially in transport sector. Stability and predictability of RES support measures, both current and planned, is crucial to investment and achievement of the country’s RES targets and progress towards energy security. Enhancing regional market connections and integration into the EU market is another priority for the government, where efforts need to be coordinated with those of the other regional players (Baltic states).

**Energy efficiency**

Latvia is one of the most energy intensive EU economies, with its energy intensity being significantly higher than the EU average.

Promotion of EE is stipulated as one of the key measures in achieving energy security, as acknowledged in the country’s Energy Strategy 2030. Legislation governing EE promotion is centred around the Law on Energy End-Use Efficiency adopted in 2010 (the “EE Law”) and the Law on Energy Performance of Buildings adopted in 2008 (the “EPB Law”). The EE Law aims, among other things, at development of the energy services market, including by regulating energy service companies (ESCOs). However, the market itself still needs to be developed. The EPB Law focuses on promoting a rational utilisation of the energy resources and improving energy performance of buildings.

There have been delays in adoption of a new Law on Energy Efficiency (a draft has been prepared by the government) that would transpose EU Directive 2012/27/EU, including with respect to introduction of the EE obligation scheme. There is also uncertainty regarding setting up of the proposed National Energy Efficiency Fund which is expected to fund renovation of buildings. While some progress has been achieved already in introducing EE measures in buildings, so far, only 2 per cent of the residential multi-apartment buildings have been renovated, and there is still a significant potential for EE savings in the buildings sector. Given the high energy intensity of the transport sector, efforts need to be intensified in promotion of EE in transport.

The government is reported to work on the new energy efficiency law that will aim at transposing the EU Directive 2012/27/EU, including EE obligations, measuring energy
savings for tracking down the national targets, EE monitoring procedures. Next National Energy Efficiency Action Plan (NEEAP) is due in 2017 and should report on the progress achieved towards meeting the targets set in the most recent NEEAP (2014).

2. Enhancing private sector competitiveness

Electronic Communications/Telecoms

The electronic communications sector is governed mainly by the base Electronic Communications Law, 2004, amended and supplemented through recent years. That law harmonised Latvia’s legislation with that of the European Union (EU) as part of the accession process whereby Latvia became a member state of the EU. More recent amendments have updated the Latvian framework with the 2009 framework. The sector is regulated by a multi-sector public utility commission (SPRK), itself governed by the Public Utility Regulators Law. The Ministry of Transport oversees the implementation of communications policy in Latvia.

Latvia is a member state of the EU, with fully liberalised electronic communications markets in place since 2003. While this liberalisation has attracted competition in the fixed-line market, incumbent majority state owned Lattelecom, continues to dominate the fixed-line and broadband sectors. Competition has nonetheless driven investment in modern technologies with fibre and cable being leading technologies, with much of the competition coming from alternative platforms. In 2014, the EU reported fixed broadband covered 92 per cent of households in Latvia (97 per cent in the EU) and in rural areas covered 46 per cent of households, with Next Generation Access available to 90 per cent of households (68 per cent in the EU). In the mobile sector there are three network operators LMT, Tele2 and Bite. 2014 saw the roll out of 4G LTE services begin in earnest as all three operators began offering advanced mobile broadband services. However, despite the presence of three mobiles, Lattelecom and the leading mobile operator, LMT (whom Lattelecom have a shareholding in), hold more than 70 per cent of the market.

While electronic communications is an important contributor to the Latvian economy in itself, it is the sector’s role as an engine of growth and development across all sectors of the economy that makes continued implementation of the evolving EU framework critical as a means of attracting the investment necessary to install next generation technologies. Though EBRD is currently without any direct investments in the electronic communications sector in Latvia it is nonetheless keen to see a transparent, investment friendly and fully EU-compliant regulatory regime maintained as a means to enhance the attractiveness of the sector to private investors and the security of their investments.

In common with EU peers, among Latvia’s challenges into the future is keeping pace with the evolving EU framework and ensuring its effective implementation as part of the EU Digital Agenda, in particular addressing connectivity challenges. The Next Generation Broadband Electronic Communications Network Development Concept 2013-2020, recently approved by the government should help in this regard. While the increasing competition provided by wireless access technologies, chief amongst which being fourth-generation mobile, should propel sector development, efforts should nonetheless be made to ensure increased competition in the fixed sector.
Contract enforcement / judicial capacity

Latvia’s judiciary is comprised of the district (city) courts, which as the result of the 2013 reform became the only first instance courts, regional courts and the Supreme Court. An independent Constitutional Court carries out constitutionality reviews of new legislation and adjudicates on matters of constitutional conformity.

There are no separate commercial courts, however alternative dispute resolution methods are being introduced and promoted with the new Arbitration law, which came into force in January 2015, aiming at strengthening conditions for establishment of arbitration and the qualification requirements of arbitrators.\(^\text{13}\)

Self-governance of the judiciary is safeguarded by the Judicial Council, which is composed of 15 members (eight permanent and seven elected.) It is mandate to participate in strategy development and oversee organizational matters of the judicial system.\(^\text{14}\) Judges are appointed by the Parliament upon the recommendation of the Minister of Justice, for an initial period of three years, which then may be extended to an unlimited term.\(^\text{15}\) Initial and in-service training of judges is carried out in the Latvian Judicial Training Centre.\(^\text{16}\)

The quality of the judicial system and its efficiency have improved in the past years, which was evidenced, inter alia, by the 2013-2014 EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS). Electronic submission of claims is available in all courts, and court judgments are available online. The legislative amendments adopted in 2013 aimed to strengthen the independence of the judiciary by entrusting the power to nominate, promote, and evaluate judges within the judiciary itself.\(^\text{17}\)

One persisting criticism of the court system is the overly extensive duration of court proceedings, which continues to cause backlogs particularly for commercial cases.\(^\text{18}\) The amendments to procedural legislation expediting cases are yet to be implemented, and the same relates to the new policy for judicial evaluation. The role of the Judicial Council may also be strengthened.\(^\text{19}\)

Latvia should focus on making further improvements to the court system in order to accelerate the administration of justice.\(^\text{20}\)

Concessions/Public Private Partnerships (PPP)

The Ministry of Finance is the leading public administration institution responsible for PPP policy-making and coordination of PPP projects implementation. The Cabinet of Ministers, the line ministries and local governments are among the entities responsible for PPP project implementation on the public sector side. Latvia’s Cabinet of Ministers and Ministry of Finance have been fairly active in setting up the PPP objectives and policy framework such as Guidelines for promoting public private partnership stating the government’s policy, basic

http://likumi.lv/doc.php?id=62847
\(^{16}\) http://www.ejtn.eu/About-us/Members/Latvia/
\(^{19}\) ibid
\(^{20}\) http://www.state.gov/documents/organization/229134.pdf
principles, objectives and priorities for PPP promotion. The Ministry of Finance runs a website dedicated to PPP.

The 2009 Public Private Partnerships Law (the “PPP Law”) as amended is a detailed, modern and a fairly comprehensive piece of legislation governing concessions and non-concession forms of PPP. It regulates both contractual and institutional types of PPP.

The PPP Law following the EU legislation governs in the procedure for awarding concessions, including candidates selection and the winner determination procedures, establishes bodies involved, elaborates on a project agreement and sets out rules on the concession termination as well as compensation. It also provides for detailed and perhaps overly complicated monitoring rules involving quite a number of parties. According to the PPP Law the Ministry of Finance, the Procurement Monitoring Bureau and the Monitoring Institution (currently the Central Finance and Contracting Agency subordinate to the Ministry of Finance) shall all monitor the public-private partnerships process.

Unfortunately, the PPP Law does not provide for a possibility of arbitration, let alone international arbitration, the latter, however, may still be negotiated subject to international treaties. Disputes, according to the PPP Law, are subject to the consideration of Application Review Commission established by the Procurement Monitoring Bureau. Such decisions can be appealed before the Court only. One other area for possible improvement is the security interests rules which although touched upon are yet to be broadened and further detailed. For example, current limitations on the type of property, which the security interests could be created over, should be lifted and security rules expanded.