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EXECUTIVE SUMMARY

The Republic of Latvia continues to meet the conditions specified in Article 1 of the Agreement Establishing the Bank.

Latvia is an advanced transition country, which has implemented the EU body of market regulation and benefited from close integration into the EU’s internal market. However, as a small and very open economy, Latvia was exposed to the adverse effects of very high capital inflows and only belatedly reined in a dangerous credit boom. Moreover, its second largest bank, Parex, suffered from serious governance problems, adding to the banking sector’s significant pre-crisis vulnerabilities. These accentuated the impact of the global financial crisis and Latvia’s GDP dropped by as much as 23 percent in 2008-10, the largest GDP contraction in the transition region.

The associated social costs of the crisis in Latvia have been very high: unemployment exceeded 20 percent at the height of the crisis, with a large share of youth unemployment, shrinking to only 17 percent by end-2010. Over a quarter of the population is reported to be at risk of poverty, the highest proportion among EU countries. While the recovery from this deep recession began in the first half of last year, the legacy of the crisis with high unemployment, excessive private debt and delinquent loans continues to weigh on growth.

The scale of the economic crisis in Latvia has revealed a more realistic picture of the remaining transition challenges in Latvia, in particular in terms of building sound institutions and regulation and completing the privatisation agenda. The Latvian authorities are rightly committed to strengthening competitiveness and reforming the business environment. Accelerating structural reforms is key for preparing Latvia for Eurozone membership, the achievement of which will help Latvia to realise its significant growth potential.

According to the government’s strategy, gains in competitiveness will be based primarily on productivity growth through enhancing capital investment and developing more technology and skill-intensive products. Export-oriented manufacturing, infrastructure, and energy efficiency investments lie at the heart of the Government’s strategy, which in turn forms the basis for the Bank’s operational priorities. Overall, demand persists for Bank finance in areas where EBRD is highly additional and can continue to deliver transition impact through well-structured, bankable projects, supported by policy dialogue.

Strategic directions

While Latvia is expected to graduate during the CRR4 period (2011-2015), the Bank’s activities during this three-year strategy will continue to focus on selected areas where transition challenges remain, the recovery from the financial crisis still requires support, and where reforms can be accelerated to create sustainable and balanced growth.

- **Supporting investments in energy security and energy efficiency**: The Bank will continue to focus in particular on promoting and financing new renewable energy generation capacity and improving energy efficiency in both the municipal...
• **Strengthening the financial sector:** EBRD has played an important role in restructuring and turning around the systemically important Parex bank. Further engagement in the financial institutions sector will focus on strengthening financial sector stability, in particular through continued engagement with the Parex/Citadele bank, as well as supporting credit recovery, developing private equity and mezzanine capital financing, particularly to SMEs.

• **Improving the competitiveness of the export sector:** The Bank will prioritise support for export-oriented firms as well as for cross-border investments by Latvian companies elsewhere in the Baltics or CIS region. The Bank will pay particular attention to supporting investments designed to improve energy efficiency in order to further boost competitiveness.

• **Policy dialogue:** the Bank will conduct policy dialogue with the Latvian authorities with regard to ongoing reforms in the financial sector, in particular to support the restructuring of Parex/Citadele, in close cooperation with the European Commission. The Bank will continue to support the improvement of corporate governance in Latvia, particularly in unlisted and state-owned enterprises. In the public sector, policy dialogue will continue to focus on improving procurement and increasing transparency. Efforts will continue to encourage the development of PPPs and supporting legislation, in particular with regard to roads and other infrastructure, being mindful of the still precarious fiscal position of the country.
1. THE BANK’S EXPERIENCE AND PORTFOLIO

1.1. Overview of Bank activities to date

EBRD has signed 75 operations in Latvia to date with a net cumulative business volume of €550 million and a total project value of €1,892 million. Approximately 40 per cent of the investments have been in the Financial Institutions sector, 24 per cent in Power and Energy, 20 per cent in Industry, Commerce and Agribusiness and 16 per cent in Infrastructure.

Table 1: Portfolio in Latvia as of 31 December 2010

<table>
<thead>
<tr>
<th>SECTOR</th>
<th>NET CUMULATIVE BUSINESS VOLUME</th>
<th>CURRENT PORTFOLIO STOCK</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount in EUR million</td>
<td>No. of Projects</td>
</tr>
<tr>
<td>Power and Energy</td>
<td>3</td>
<td>502</td>
</tr>
<tr>
<td>Financial Institutions</td>
<td>21</td>
<td>392</td>
</tr>
<tr>
<td>Bank Equity</td>
<td>5</td>
<td>194</td>
</tr>
<tr>
<td>Bank Lending</td>
<td>15</td>
<td>140</td>
</tr>
<tr>
<td>Insurance &amp; Fin. Services</td>
<td>5</td>
<td>58</td>
</tr>
<tr>
<td>Industry, Commerce and Agribusiness</td>
<td>44</td>
<td>606</td>
</tr>
<tr>
<td>Agribusiness</td>
<td>1</td>
<td>65</td>
</tr>
<tr>
<td>Equity Funds</td>
<td>39*</td>
<td>141</td>
</tr>
<tr>
<td>Property &amp; Tourism</td>
<td>2</td>
<td>77</td>
</tr>
<tr>
<td>Telecom, Inform., Media</td>
<td>2</td>
<td>323</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>7</td>
<td>366</td>
</tr>
<tr>
<td>MEI</td>
<td>2</td>
<td>216</td>
</tr>
<tr>
<td>Transport</td>
<td>5</td>
<td>150</td>
</tr>
<tr>
<td>TOTAL</td>
<td>75</td>
<td>1866</td>
</tr>
</tbody>
</table>

* Equity Funds includes various regional funds with allocations to Latvia

The Bank’s cumulative business volume increased significantly during the financial crisis, reaching €219 million during the previous strategy period (3 years, from 2008-2010). The evolution of the portfolio since 2008 is illustrated in the following table.

Table 2: Portfolio Development in Latvia 2007 – 2010

<table>
<thead>
<tr>
<th>Amount in EUR million</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>Development over 2008-2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Cumulative Business Volume</td>
<td>335</td>
<td>341</td>
<td>455</td>
<td>557</td>
<td>+ 66%</td>
</tr>
<tr>
<td>Cumulative Number of Operations</td>
<td>62</td>
<td>60</td>
<td>68</td>
<td>75</td>
<td>+ 21%</td>
</tr>
<tr>
<td>Current Portfolio Stock</td>
<td>87</td>
<td>72</td>
<td>172</td>
<td>271</td>
<td>+ 211%</td>
</tr>
<tr>
<td>Number of Operations</td>
<td>26</td>
<td>23</td>
<td>29</td>
<td>35</td>
<td>+ 35%</td>
</tr>
<tr>
<td>Operating Assets</td>
<td>67</td>
<td>57</td>
<td>138</td>
<td>140</td>
<td>+ 109%</td>
</tr>
<tr>
<td>% Undrawn</td>
<td>23%</td>
<td>21%</td>
<td>20%</td>
<td>48%</td>
<td></td>
</tr>
</tbody>
</table>

Cumulative 2008 - 2010

| Annual Business Volume | 18   | 0    | 115  | 104  | + €219 mn                |
| Number of Operations   | 6    | 0    | 8    | 7    | + 15 projects            |
| Gross Disbursements    | 11   | 5    | 97   | 41   | + €143 mn                |
| Annual Cancellations   | 0    | 1    | 0    | 2    | + €3 mn                  |
| Active Pipeline Stock  | 35   | 155  | 203  | 44   |                          |
| Private Sector Share (% Portfolio) | 73% | 72% | 90% | 64% |                          |
| Non Sovereign (% Portfolio) | 97% | 98% | 99% | 99% |                          |

Notes: % Undrawn excludes guarantees. Current Portfolio includes active operations only. Active pipeline stock includes Regional projects.
The Financial Institutions and Energy sectors’ shares in the portfolio have increased as a result of the Bank’s active response to the financial crisis. This is also reflected in the increase in Latvia-specific (rather than regional) projects. At the end of 2008, regional projects represented approximately 50 per cent of the portfolio, whereas at the end of 2010 they represented only 25 per cent of the portfolio.


1.2. Implementation of the previous country strategy

The previous country strategy for Latvia was approved in September 2008, by which point the country’s recession was already well under way. The 2008 country strategy targeted the following operational objectives:

- Provide higher-risk products for local corporations to fund their growth and improvements in efficiency, with a focus on cross-border expansion.
- Provide capital and medium to long-term credit lines to selected financial institutions and strengthen their corporate governance and business practices. Selectively commit capital to new regional equity funds targeting SMEs.
- Promote investments to improve energy efficiency, to develop renewable energy, and contribute to energy security.
- Support the involvement of the private sector in the provision of public services in cooperation with structural and cohesion Funds.
- Actively manage the Bank’s portfolio to maintain its high quality.

During the strategy period all signed direct operations were part of the Bank’s crisis response in Latvia. None of these had a focus on cross-border expansion or were geared towards growth due to the immediate financing needs within the country during the financial crisis.

In 2009, following the nationalisation of the country’s then-second largest and systemically important bank, Parex Banka, EBRD became a shareholder in the bank and played an active role, including through policy dialogue, in the restructuring and split of Parex Banka into Citadele Banka and Parex Banka. Through its investment, the Bank was able to support the Latvian banking system and facilitate continued lending to the Latvian corporate sector. EBRD remains a shareholder in Parex Banka, albeit with a decreased share, and is a 25 per cent shareholder in Citadele Banka. Since 2008 the Bank has signed investments in several regional equity funds with
expected allocations to Latvia of €24 million. No investments out of these funds have yet been made into Latvia.

In 2010 EBRD signed a loan to Latvenergo supporting new efficient generation capacity to improve energy security in the wake of the closure of Ignalina Nuclear Power Plant in Lithuania. The investment is co-financed by the EIB and a syndicate of commercial banks. In the renewables sector, the Bank was unable to sign any operations partly due to expected changes in the legal framework and subsidy structures.

EBRD has engaged in policy dialogue with the Latvian authorities in order to develop public-private partnership (PPP)-type structures. However these have not yet materialised as a result of concerns by the IMF over associated fiscal risks. Policy dialogue was also active under the Vienna Initiative, under which parent banks, primarily from Sweden, coordinated their exposures and recapitalised their subsidiaries.

1.3. Transition impact of the Bank’s portfolio

Since the previous strategy was adopted in September 2008, five operations in Latvia were signed for which the transition impact was rated. Four of these operations were in the Financial Institutions sector (bank equity) and one in the Power sector. The four new projects in the financial sector were ex ante rated as having “Good” transition impact potential, which is in line with the institution-wide target of 80 per cent of projects to be assessed “Good” or better. The one operation in the Power sector was assessed as “Satisfactory” due to the relatively limited impact of the project on commercialisation of the sector.

While these sectors are characterised by medium transition gaps, the financial crisis has been an important driving factor for the Bank’s activities in Latvia’s financial sector: the four operations represent investments to one client which was significantly affected by the crisis. These projects aimed to demonstrate to the market a successful restructuring by supporting the renationalised Parex Bank and making significant adjustments to its business strategy and business model. All operations signed in Latvia since 2008 also targeted improvement in corporate standards and supporting efforts to expand markets amid the financial crisis.

The transition objectives of projects signed during the strategy period reflect the Bank’s response to the main challenges brought to light by the financial crisis that characterised this period. As Figure 1 illustrates, key transition objectives across projects have focused on market expansion, improving corporate governance standards and demonstration effects related to corporate restructuring.
All projects in the portfolio are on track to achieving their transition potential. As of end-April 2011, four active operations in Latvia have a rank in the range from 4 to 5 – in other words, are on the way to achieving their transition objectives. One operation is currently ranked 3, which indicates that it has mostly achieved its desired transition impact.

2. OPERATIONAL ENVIRONMENT

2.1. Political context

The full impact of the economic crisis hit Latvia in late 2008, resulting in policy divisions and precipitating the collapse of the government. Latvia’s President Valdis Zatlers nominated Valdis Dombrovskis to the premiership. PM Dombrovskis formed a five-party coalition government with a comfortable majority in parliament. The coalition quickly agreed a revised budget with major cuts to public expenditures, including a 15 per cent reduction in public sector wages. Implementing across-the-board public sector wage cuts proved to be politically difficult to sustain, and one party left the coalition in March 2010, leaving a minority government. Nevertheless, the coalition partners were able to maintain sufficient unity of purpose to keep the IMF/EU stabilisation programme on track.

Despite the difficult austerity measures, in the October 2010 elections the Latvian electorate maintained their support for PM Dombrovskis and his coalition partners, who subsequently formed a government with a solid majority. The government survived its first major test in December 2010 when parliament approved the 2011

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1 Rank is a combination of the relevant rating for transition impact potential and risks to transition impact. Expected transition of operations is usually monitored once a year and is ranked numerically from 1 to 8, with 1 to 3 indicating the mostly realised impact, 3 to 6 – generally on track to achieve transition objectives, and 7 to 8 – minimum transition impact or excessive risks.
budget, which includes further tax rises and spending cuts. The opposition parties strongly criticised the government’s proposals but attracted little public backing, reflecting continued strong public support for the Dombrovskis government.

However, on 28 May 2011 President Zatlers called for a national referendum on the dissolution of parliament and the holding of fresh elections. Zatlers’ decision to invoke this presidential prerogative – for the first time in Latvia’s post-Soviet history – was triggered by a parliamentary vote in May 2011 to retain parliamentary immunity for an MP under investigation for corruption. As Zatlers explained at the time, the May 2011 parliamentary vote was the latest in a series of events which had led the Latvian public to question the integrity of the parliamentary decision-making process.

Zatlers’ move came only days before the scheduled indirect election of the president by parliament, in which Zatlers hoped to secure a second term in office and had secured the backing of the ruling Unity Alliance. Despite support from the ruling Unity bloc, Zatlers lost the indirect election for the presidency, which was won by Andris Bērziņš, a member of parliament and successful businessman nominated by the minority coalition party Union of Greens and Farmers.

Despite Zatlers’ departure from the presidency, the parliamentary dissolution referendum took place on 23 July 2011, and the Latvian electorate voted overwhelmingly in support of the referendum, with 94.6 per cent in favour and only 5.5 per cent against. Zatlers then launched a political party, the ‘Zatlers Reform Party’, to contest the election on an anti-corruption platform.

The early parliamentary elections took place as scheduled on 17 September. As in 2010, five parties crossed the electoral threshold to enter parliament. Harmony Centre once again took a plurality of votes, increasing its seat share slightly to 31 from 29. Zatlers’ Reform Party came in second place, with 22 seats. Electoral support for the two former coalition partners, PM Dombrovskis’ Unity Alliance and the Alliance of Greens and Farmers, fell significantly, while the conservative nationalist National Alliance increased its seat share significantly. Latvia’s First Party/Latvian Way received just 2.4 per cent of the vote, thus failing to cross the electoral threshold.

While coalition negotiations are still underway, the tensions within the ruling elite that have resulted from the presidential election and dissolution of parliament are likely to result in a significant shift in the constellation of political forces in the next government. More importantly, recent events have thrust the issue of the longstanding relationship between some of Latvia’s successful businessmen and certain political parties firmly into the national spotlight, and provided a much-needed boost to Latvian efforts to root out corruption at the highest levels of the political system.

See Annex 1 for a more detailed political assessment.

2.2. Macroeconomic context

Following Latvia’s dramatic economic contraction in 2009 (by 17.7 per cent, the sharpest drop of any emerging market), economic activity began to gradually recover from end 2009. Overall, the small contraction in GDP in 2010 conceals a strong
rebound in exports and weakness in government consumption and investment. In early 2011 exports grew by about 35 per cent in value terms on a year earlier, and growth in export market shares confirms the continued potential. The economy has hence emerged from recession, and based on external demand is likely to grow at around 3 per cent in 2011.

At the same time, weak growth figures in the first quarter of 2011 again underlined that the recovery is fragile and as yet not self-sustaining. The initial recovery was largely based on inventories and exports to dynamic markets such as Germany and Sweden. A more durable growth in productive capacity and, subsequently, in domestic demand is yet to come. The lack of business investment is a concern, given that a number of manufacturing sectors, in particular the significant wood processing sector but also clothing and metals, have now reached capacity utilisation levels close to those seen prior to the crisis, limiting their growth going forward. The inability to revive credit to the corporate sector hence represents the key threat to sustaining growth. Bank loans shrank by about 8 per cent of GDP in 2010, with all banks tightening lending standards and primarily focusing on a small subset of customers with very safe cashflows. Credit growth is also being hampered by still very high levels of debt of some corporates as well as a high level of non-performing loans.

Unemployment has eased to about 16.2 per cent in the second quarter of 2011, down more than three percentage points year-on-year, although at this level unemployment is likely to weigh on domestic consumption and bank asset quality for some time. Latvia nevertheless continues to suffer from net emigration of skilled workers, though the government does not expect that the recent abolition of German and Austrian labour market restrictions will materially aggravate that trend.

Latvia has continued to perform well under the EU/IMF programme. A further programme review was completed in April 2011 following which the two institutions complemented the authorities for taking early additional fiscal measures taken in the 2011 budget and on the various financial stabilisation measures taken. While approval by the two institutions will make a further EUR 970 million available, the current account has improved to an extent that the government does not need to draw the majority of these funds. Following further fiscal corrections in 2011, the authorities will seek to comply with the Maastricht criteria for Euro adoption, although imported inflation remains a key risk in this regard. These developments underpinned a more positive assessment by sovereign rating agencies and, in June 2011, a return of Latvia to the international bond markets with the successful issuance of a US dollar bond.

2.3. Structural reform context

The deep recession of 2008-09 and the ensuing EU/IMF financial programme stimulated some wide-ranging reforms in the tax system, large expenditure cuts and a streamlining of the public administration. In the education and health care sectors, savings were achieved through wide-spread layoffs and closing underused facilities. While these reforms were painful and motivated by the immediate need to contain public sector financing requirements, many may have been needed in any case. Recent revenue measures have helped, but the overall tax burden remains relatively high, in particular on labour.
A clear reform need became evident in the financial sector where the government significantly strengthened the powers of the supervisors, including through seeking stronger coordination with other authorities in the home countries of foreign bank subsidiaries. Latvia is a signatory of the joint banking sector crisis resolution framework for the Nordic region introduced in August 2010. The liquidity and credit risk management regulations have been revised and the independence of the deposit insurance system has been strengthened. A core element in returning the financial sector to health was of course the restructuring of Parex Bank, and the subsequent division of a recapitalised ‘good’ bank (Citadele) that now has the capacity to generate fresh lending, and for which the return into full private ownership is progressing as planned.

The authorities have undertaken commendable efforts to facilitate market-based household and corporate debt restructuring, a matter of considerable urgency, thereby avoiding the need to call on public funds. Incentives for debt forgiveness or speedy out of court restructuring have been strengthened, and the corporate and personal insolvency regime were reformed, and these efforts are beginning to show early results.

There has also been significant progress in the power market, in part motivated by the closure of the Ignalina nuclear power plant in Lithuania, which underlined the need to develop alternative energy sources. Efforts to upgrade the existing power facilities, such as the recent modernisation of Latvenergo’s plant in Riga, are improving generation efficiency. The regulatory framework for renewables has been significantly strengthened with the introduction of a feed-in tariff and a mandatory off-take mechanism in 2007. The feed-in-tariff is valid for 10 year after which point there is a reduced rate. Companies are only eligible for the tariff if they sell their energy to the public electricity supplier, Latvenergo. This framework is, however, being revised and a new renewables support scheme is expected to be in place by the end of the year.

Recent government announcements underline the clear intention to restructure the economy in support of a more sustainable growth model. The government is pursuing a ‘competitiveness agenda’, including through a study that will make specific recommendations on appropriate workforce skills, and seeks to improve the business environment by targeting measurable indicators. Priority sectors are export-oriented manufacturing, logistics and infrastructure, and supporting energy efficiency investments.

See Annex 2 for a more detailed assessment of transition challenges.
2.4. Business environment

Latvia’s business environment is among the best in the transition region. The World Bank’s 2011 *Doing Business* survey ranks Latvia 24th globally, up from 27th in 2010, the lowest of the three Baltic countries but still relatively high when compared to other CEB countries. Moreover, progress has been made in recent years in areas such as closing a business and registering property, insolvency and out-of-court settlement procedures, and the registration of real estate. Latvia also reduced export and import times by introducing electronic submission of customs declarations.

Despite these improvements, a number of challenges remain. Corruption remains a problem: Transparency International’s 2010 Corruption Perception Index ranks Latvia 59th out of 178 countries and 25th amongst 30 European countries. According to *Doing Business*, construction permits and closing a business were flagged as the most problematic areas. In the 2009 EBRD/World Bank Business Environment and Enterprise Survey, tax rates and political instability were identified as significant impediments to business, followed by tax administration and an inadequately trained workforce. In addition, some important sectors of the economy continue to be under the influence of dominant, state-owned companies. The grey economy remains substantial: in 2007 the World Bank estimated that this accounts for almost 42 per cent of GDP, the highest proportion in the European Union.

The Cabinet of Ministers has recently adopted an action plan to improve the business environment, which aims to simplify the procedures for starting a business, improve the tax administration, strengthen investor protection and develop e-government. In the action plan on combating the shadow economy, the authorities also foresee a number of measures to tackle the grey economy, including a simplification of administrative controls for companies meeting specified transparency criteria. The
implementation of these measures will be key to tackling the grey economy and thus ensuring a level playing field for all market participants.

2.5. Social context

Latvia has experienced a substantial improvement in living standards since the beginning of transition, notwithstanding a serious setback due to the crisis. The UN Human Development Index (a measure of general wellbeing) has been improving since 1995 and ranks the country at 48th place in 2010. However, the country performs worse than other CEB countries on most indicators. Life expectancy at birth was 72.2 years on average in 2009 which is considerably lower than the EU and OECD averages (both around 79). Inequality is relatively high in Latvia, which has the highest Gini coefficient amongst EU countries. According to Eurostat, 25.7 per cent of the population was at risk of poverty in 2009, the highest proportion among EU countries.

Over the next fifty years Latvia is projected to show the second largest relative drop within the EU in total population (by 26 per cent) and in the total workforce (by 43 per cent). These developments will put acute pressures on the public pension system, given that the dependency ratio (population aged 65 and over relative to the workforce aged 15-64) is expected to deteriorate rapidly from the current 25 per cent to 54 per cent in 2050.

At present health outcomes are good in relation to OECD averages, albeit slightly worse than in other CEB countries. Total health care expenditure stood at about 6.5 per cent of GDP in 2009, of which public health spending was about 3.6 per cent of GDP. Population ageing and cost pressures will raise public expenditures on health and old-age care over the next 20 years by between 1 and 1.5 per cent of GDP unless mitigating measures are taken.

Unemployment rates in Latvia increased significantly during the crisis, peaking at 20.1 per cent at end-2009, then the highest rate in the EU. Unemployment has since fallen but remains high at 17.2 per cent at end-2010. Youth unemployment at 30.4 per cent at end-2010 has decreased since its peak but is still considerably higher than the EU average. Long-term unemployment has also increased substantially to 9.3 per cent and is second only to Slovakia in the CEB region. In addition, employment rates have fallen from 76 per cent in 2008 to 65 per cent in 2010, well below the EU-wide target of 75 per cent.

Education levels in Latvia are average in comparison to other countries in the region. However, tertiary enrolment was high at 69.2 per cent in 2008, having increased from 56.3 per cent in 2000. The mean years of schooling in 2010 was 11.5, slightly above the OECD average of 11.4 years. However, in the 2009 OECD Programme for International Student Assessment, Latvia ranked 30th out of 66 countries with a below OECD-average rating for all three subjects, although the country has made considerable progress in closing this gap.

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2 World Bank, World Development Indicators.
5 IMF, Macro-fiscal implications of health care reform in advanced and emerging economies.
2.6. **Legal context**

The Bank’s recent assessments of commercial and financial laws in the region show that Latvia has a relatively advanced set of commercial laws when compared to other transition countries.

In 2010 a new law on insolvency was adopted which addressed many of the deficiencies of the existing legislation on insolvency, including easier access to insolvency and restructuring procedures, faster procedures for selling the debtor’s asset and for liquidation. However, banks have raised concerns about the new personal bankruptcy regime, which they perceive to be too debtor-friendly.

Although some technical improvements could still be made to registration procedures, the country’s pledge law is reported to function well in practice, which will help support the Bank's lending activities, in particular in the SME sector. In addition, the 2009 legislation on public private partnership provides a good basis for the Bank's efforts to promote PPPs in Latvia.

As is often the case in transition countries, investors have reservations about the ability of Latvian courts to implement laws and resolve commercial disputes. In addition, the 2008-2009 global crisis has seriously put to the test the judiciary’s capacity to deal with foreclosures related to non-performing loans. The Latvian authorities should continue to turn their attention to improving the technical skills and integrity of the judiciary.

See Annex 3 for a more detailed assessment of the legal environment.

2.7. **Energy efficiency and climate change**

Latvia has made significant progress in realising its sustainable energy potential and is now a leader among the EBRD countries in both energy efficiency and renewable energy. The share of renewable energy has traditionally been high in Latvia’s energy supply and in 2008 it comprised 29.9 per cent of the total final energy consumption, although this represented a reduction of 2.6 per cent compared with 2005. Some 44.7 per cent of electricity generated in 2010 was from renewable sources. Latvia has committed under the EU 20/20/20 targets to produce 40 per cent of its energy 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.

Relative energy intensity in Latvia has already exceeded the EU-15 average. This reflects remarkable progress since the beginning of the transition process, when energy intensity was almost double the EU-15 average. This decrease took place as a result of more efficient use of energy, but also due to structural changes and a general growth in the national economy. As an EU member, Latvia has committed to 20 per cent energy efficiency reductions by 2020, participates in the EU emissions trading scheme (EU ETS) and will also need to implement the requirements of other EU Directives, such as on Large Combustion Plants, Combined Heat and Power, and

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6 *The Low Carbon Transition*, EBRD 2011.
Energy Services. Thus, energy efficiency improvements continue to be key, including for the competitiveness of the economy.

Despite this significant progress, the challenge going forward is to continue to improve energy efficiency and increase the supply of renewable energy in line with the targets set by the EU. Increasing sources of and access to financing for investment, particularly for smaller renewable energy and energy efficiency projects and those with longer payback periods, will be key in meeting these targets. Supporting the expansion of renewable and sustainable energy and promoting energy efficiency across all sectors thus remains vital, especially as Latvia seeks to comply with its significant EU targets and to diversify its energy supplies.

3. STRATEGIC ORIENTATIONS

3.1. Transition challenges

Latvia is an advanced transition country, which has implemented the EU body of market regulation prior to its EU accession in 2004, and which has benefited from integration into the EU internal market through substantial inflows of foreign direct investment and a reorientation of its trade. However, as a small and very open economy, Latvia has been very vulnerable to the adverse effects of excessive capital inflows, in particular those directed to the local real estate market and the subsidiaries of foreign banks with the associated credit boom in the domestic financial system.

The crisis has revealed a more realistic picture of a number of significant transition challenges in terms of market institutions and market structures. The 2010 assessment of transition challenges, as presented in the Transition Report, identified on the whole small or negligible gaps in terms of market institutions but medium gaps in the roads and private equity sectors. Market structures also showed ‘medium’ gaps in a larger number of sectors, importantly in power, banking, MSME finance and private equity. Addressing these transition challenges will be key for Latvia to prepare for successful entry into the Eurozone.

In this context, the authorities’ commitment to strengthening competitiveness and reforming the business environment is appropriate. Over the course of the crisis the government successfully adopted the difficult model of ‘internal devaluation’ in support of the adjustment needed to defend the currency peg – essentially a drastic cut in public and private wages. Going forward, further gains in competitiveness will be needed not only through cost cutting but on the basis of gains in productivity – primarily through reigniting capital investment and completing the remaining structural reform agenda, areas in which the Bank continues to be additional. Moreover, Latvia faces significant challenges in developing more technology intensive exports. Further efforts are needed to facilitate businesses developing new products in manufacturing, and of associated services. This will diversify export revenues and foster further innovation within Latvia.

The government’s stated goals in developing export-oriented manufacturing, logistics and infrastructure, and supporting energy efficiency investments are encouraging and form the basis for the operational priorities identified in this strategy.
3.2. Bank's priorities for the strategy period

While Latvia is expected to graduate during the CRR4 period (2011-2015), the Bank’s activities during this three-year strategy will continue to focus on selected areas where transition challenges remain, the recovery from the financial crisis still requires support, and where reforms can be accelerated to improve the competitiveness of the country’s industrial sector, the availability of finance to the SME sector and increased energy security. In that connection, the Bank will engage in areas that will underpin Latvia’s ambitious plans to enter the Eurozone, which requires not only adherence to the Maastricht criteria but also the further strengthening of financial stability and improvements to the competitiveness of the Latvian economy to create sustainable and balanced growth.

In light of the severe impact of the recent crisis, the external environment, and the remaining transition challenges outlined above, the Bank’s activities in Latvia will focus on the following strategic priorities:

- **Supporting investments in energy security and energy efficiency**: The Bank will focus in particular on promoting and financing new renewable energy generation capacity and improving energy efficiency in both the municipal and industrial sectors. EBRD will seek to support energy market integration within the Baltic and wider Central European region and investments into private energy generation, particularly to facilitate the production of electricity from renewable sources.

- **Strengthening the financial sector**: Further engagement in the financial institutions sector will focus on financial sector stability, including through continued engagement with Parex and Citadele banks, as well as supporting credit recovery through developing modern forms of private equity and mezzanine capital financing particularly to SMEs. The Bank will continue to strengthen governance and transparency among its clients and maintain a dialogue with the authorities on the implementation of best international practice with regard to regulation and anti-money laundering standards, which are indispensable conditions for Latvia to be able to establish itself as a successful regional banking centre.

- **Improving the competitiveness of the export sector**: The Bank will prioritise support for export oriented firms and cross-border investments by Latvian companies in the manufacturing and agribusiness sectors, and will pay particular attention to supporting improved energy efficiency investments in order to further boost competitiveness. Latvia’s competitiveness will also depend on further improvements in the business environment, and the Bank will therefore continue to provide policy dialogue to support the Latvian authorities’ efforts to reduce red tape and reduce the size of the grey economy, to make Latvia a more attractive destination for foreign direct investment.

- **Policy dialogue**: the Bank will conduct policy dialogue with the Latvian authorities with regard to ongoing reforms in the financial sector, in particular to support the restructuring of Parex/Citadele, in close cooperation with the European Commission and the IMF. The Bank will continue to support the improvement of corporate governance in Latvia, particularly in unlisted and state-owned enterprises. In the public sector, policy dialogue will continue to focus on improving procurement and increasing transparency. Efforts will continue to
encourage the development of PPPs and supporting legislation, in particular with regard to roads and other infrastructure.

3.3. **Sectoral challenges and the Bank’s operational response**

The potential range of the Bank’s activities will be confined to those sectors where the transition gaps are ‘medium’, demand for the Bank’s finance and technical assistance is strong and the Bank is additional to other sources of finance, including from the European Union. The sectors and operational priorities listed below meet that description; however, it is not anticipated that the Bank would necessarily find suitable projects in all market segments during the strategy period.

3.3.1. **Infrastructure and Energy**

**Sectoral challenges**

- **Strengthen energy security and improve energy efficiency.** Resilience to possible disruptions in energy supply remains a concern for the government, due to concentrated sources of supply. The promotion of domestic competition in sustainable power generation and supply, coupled with effective cross-border links, will serve to improve energy markets and thus deliver an appropriate mix of generation companies. Operating costs for municipally owned heating networks are excessive due to heat losses, and many buildings and privatised industrial enterprises have poor energy efficiency. In order to meet national targets on renewable energy, further development of this market is still needed.

- **Complete liberalisation and unbundling of the power sector.** The dominant position and vertical integration of state-owned companies in the power sector remains a concern, in particular with regard to Latvenergo, and this is holding up participation in the regional energy market.

- **Increase private sector participation in municipal sectors.** Private sector participation in district heating, water and sewage, and urban transport, and also in state transport infrastructure remains low.

- **Strengthen regulation and maintenance in the road sector.** The road agency (State Joint Stock Company “Latvian State Roads”) needs further development, competition in road maintenance and introduction of performance-based contracts and development of PPP projects in line with international best practice are all at an early stage.

**Bank’s operational response**

To strengthen energy security and improve energy efficiency, the Bank will support Latvia’s ambition to promote resilient, flexible and competitive electricity markets by supporting projects that promote private ownership and the development of market-based electricity generation and supply. Particular emphasis will be placed on support for renewable electricity generation. EBRD will seek to support energy market integration within the (Baltic) region through strengthening of the grid where necessary, and will work with corporate or municipal clients directly or through selected financial institutions, as well as with the authorities, in order to complement existing support programmes for energy efficiency and renewable energy investment. With municipalities, this will include working with local utilities (water and heating)
to improve their energy efficiency. Recognizing the importance of investments linked to introduction of new technologies, energy services and improving demand side energy, EBRD may also pursue projects in the area of ESCOs and smart grids/smart metering. The Bank also stands ready to play an active role in the development of a regional Liquefied Natural Gas terminal, in case the authorities decide to pursue this.

**To promote liberalisation and unbundling of the power sector**, the Bank will consider financing investments in the power sector through structures that would facilitate the separation of transmission, distribution and generation assets.

**To increase private sector participation in municipal sectors**, the Bank will actively seek to finance projects in the municipal transport sector and help to develop PPP structures more broadly, in line with a renewed commitment to PPP structures on the part of the Latvian authorities, while remaining mindful to avoid any increase in fiscal risks associated with such structures.

**To strengthen regulation and maintenance in the road sector**, the Bank will contribute to economically viable road sector development through its support for PPP project preparation.

In the energy and infrastructure sectors opportunities to co-finance grants from EU structural funds in co-operation with the EIB may arise, in particular given the constrained capacity of the Latvian banking sector to extend the needed long term credit. This could also be in relation to complex PPP structures (so-called ‘hybrid’ models that draw on commercial, state and EU grant funds). The Bank will examine these opportunities for consistency with the above operational priorities and its transition mandate, and offer funding on its usual terms where the grant element is appropriately calibrated.

### 3.3.2. Financial Institutions

**Sectoral challenges**

- **Reduce the state’s role in the banking sector.** Following the separation of assets between Parex Banka and Citadele, state involvement in Citadele will need to be gradually reduced, with a view to complete ultimate privatisation. Citadele will at that point be fully prepared to play its erstwhile role as pre-eminent creditor to the corporate sector.

- **Strengthen financial sector governance and regulation.** For Latvia to establish a role as a regional financial centre there is a continuing need for the financial sector to comply with the highest standards of financial integrity and adopt best international practice with regard to governance and transparency.

- **Develop local capital markets.** Opportunities for the development of local capital market instruments will remain inherently limited given their small size. Nevertheless, development of mandatory and voluntary pension funds, as well as of other asset managers, are required to help address Latvia’s severe demographic challenges. Given the projected extremely low pensions under existing indexation rules, rebuilding an additional mandatory and voluntary pension fund industry remains a particular challenge in a rapidly ageing society.
- **Enhance innovative sources of finance to the real economy.** Access to credit is a serious constraint for SMEs, as banks continue to tighten lending criteria, and shy away from what remain highly leveraged enterprises. The availability of private equity and mezzanine capital to support the capital in and growth of SMEs remains limited. Significant opportunities exist in the private equity sector, including through partnering with EU and EIB funds, such as Jeremie.

**Bank’s operational response**

**To help reduce the state’s role in the banking sector,** the Bank will continue its involvement in the development of Citadele Banka and will assist in the preparation of Citadele’s return to fully private ownership.

**To assist in the strengthening of financial sector governance and regulation,** the EBRD will through its continued involvement in Citadele Banka further improve the bank’s corporate governance. In this context, the Bank will also continue its dialogue with the Latvian authorities on banking sector regulatory issues.

**To promote the development of local capital markets,** the Bank stands ready to work with financial institutions, assisting in securitisation of banking and other assets. The EBRD will also seek to develop asset management and pension fund operators, including through the subsidiaries of Citadele Banka.

**To enhance innovative sources of finance to the real economy,** the Bank will continue to cooperate closely with local private equity investors, will investigate the use of risk-sharing facilities and search for other opportunities to facilitate increased lending to the corporate sector, particularly SMEs.

In addition there could be an important opportunities to partner with, and thereby leverage, EU structural funds, if the Bank can bring further value-added relative to other sources of finance.

### 3.3.3. Industry, Commerce and Agribusiness

**Sectoral challenges**

- **Improve export competitiveness and cross-border investment.** Latvia’s exports are relatively undiversified, and technology intensive products account for only a small share, a discrepancy that is particularly stark in trade with Western Europe. Latvia therefore under-utilises one of its key endowments – its skilled workforce – thereby jeopardising sustainable export-led growth. Improvement of export-sector competitiveness and promotion of cross-border investments are appropriate objectives of the government, and important goals in transition. Efficiency improvements and upgrading of hygiene standards would increase international competitiveness of the agribusiness sector.

- **Complete the privatisation process.** A number of state-owned enterprises that fulfil essentially private market functions remain. In these companies, and in the corporate sector more broadly, there is still a need to strengthen governance standards. A management concept for state-owned enterprises is being developed by the government and this is expected to enhance corporate governance in these
Bank’s operational response

To improve export competitiveness and cross-border investment, the Bank will support export-oriented firms in all sectors and cross-border investments of Latvian companies elsewhere in the Baltics or CIS. The Bank will pay particular attention to supporting investments designed to improve energy efficiency in order to further boost enterprises’ competitiveness. This can be achieved through financing of investments in effective energy solutions, in efficient new capacity either in Latvia or cross-border, particularly in companies that are operating close to full capacity and through financing of improved infrastructure in Latvia. Investments in the agribusiness sector to improve efficiencies and hygiene standards will also be considered. Finally, where possible, the Bank will support enterprises that offer knowledge-intensive export products.

To help complete the privatisation process, should opportunities arise in relation to the privatisation of state-owned enterprises, the EBRD will work with the authorities and market participants to facilitate the privatisation of those firms.

3.4. Environmental and social implications of the Bank’s proposed activities

As a European Union member, Latvia has adopted environmental and social legislation that meets EU requirements and is aligned with EBRD’s Environmental and Social Policy and Performance Requirements.

The Bank’s Environmental and Social Policy will apply to all projects in Latvia. The focus on energy security and efficiency, financial institutions and export competitiveness will raise the normal range of issues associated with these sectors. Energy efficiency and security will require EBRD to assess, and where possible, reduce greenhouse gas emissions. Any new power generating capacity will have to meet EU IPPC Best Available Techniques (BAT) requirements for emissions and carbon intensity.

In the context of the implementation of the EBRD’s Gender Action Plan, the Bank will endeavour to support women’s entrepreneurship through Financial Institutions projects, and will try to encourage private sector clients in other priority sectors to adopt gender balanced approaches in their human resources policies and practices (e.g., equal opportunities in recruitment and career development).

For a more detailed assessment of gender issues see Annex 7.

4. ACCESS TO CAPITAL: PRIVATE AND PUBLIC SOURCES OF FINANCE

4.1. Access to capital from commercial sources

Over the course of the financial crisis Latvia suffered a number of downgrades in its sovereign credit rating, in good part sparked by fears over the ramifications of a
devaluation that was widely feared at the time. The much improved fiscal outlook motivated an upgrade by Fitch Ratings in March 2011 back into investment quality (BBB- with a positive outlook). The rating of S&P remains one notch within ‘speculative’ grade, also with a positive outlook. Costs of insuring against a sovereign default reflect this assessment, with the 5-year CDS spread having declined markedly to about 200bps in May, about level with Lithuania. These more positive assessments helped the country to access the Eurobond markets in June 2011, the first such issue since 2008, underlining a growing normalization in capital market access.

With the onset of the financial crisis and the correction in Latvia’s excessive external imbalance the country saw a dramatic reversal in its capital account position, with the gross flows of bank loans to Latvia swinging from an inflow of about 25 per cent in 2007 per cent of GDP to an outflow of about 12 per cent of GDP in 2009. These outflows are still continuing on a more modest scale, given the continued contraction in domestic credit and as foreign banks seek to reduce their exposure to their subsidiaries.

Net foreign direct investment has seen only a slight recovery to about 1.5 per cent of GDP in 2010, however this is now primarily oriented towards manufacturing and infrastructure, with previous flows into the banking and real estate sector essentially having disappeared.

Commercial bank financing continues to be challenging in Latvia. The resident corporate loan stock has been falling since 2009 when it shrunk by 6.8 per cent, followed by a further 7.3 per cent reduction in 2010. Outstanding loans to all corporates, both resident and non-resident have fallen another 3.8 per cent during the first 3 months of 2011. New corporate loan issuance to Latvian companies has been very weak during the first 3 months of 2011 with only € 124 million of new loans issued.

Private equity – which could be instrumental seed capital for young and innovative firms – remains underdeveloped. Although ten regional fund managers include Latvia in their investment universe, capital actively deployed to the country remains negligible, with most investee companies in the export sector.

4.2. Official sources of finance: cooperation with other IFIs and multilateral donors

The international support programme for Latvia over roughly EUR 7.5 billion was adopted in 2008 and is broadly judged a success, with the authorities only drawing some of the funds in the final year of the programme. The programme was funded by the EC (with the largest share), the IMF and a number of Nordic countries, and separate programmes were established by the World Bank.

In addition to this balance of payments support Latvia is also eligible for substantial amounts of EU cohesion funds over up to EUR 4.53 billion. This consists of 71 per cent from the European Regional Development Fund and the Cohesion Fund for Infrastructure investments, 17 per cent from European Regional Development Fund for entrepreneurship and innovations and 12 per cent from European Social Fund for
human resources development and employment. Latvia’s absorption rate is reasonably good and at end of March 2011 stood at 31 per cent.

Other IFIs are clearly focused on the financial and infrastructure sectors, particularly energy related infrastructure, and emphasize large financings aimed at better rated borrowers.

- Since end-2007 the **European Investment Bank** (EIB) has signed twelve loans totalling €1.211 billion in Latvia. Five operations are to co-finance EU cohesion funds during 2007 to 2013, five are to Latvian banks and two for Latvenergo. The €100 million loan to Latvenergo signed in 2009 is financing new heat and power generation capacity in Riga and is co-financed by EBRD and a syndicate of commercial banks. This was the first co-financing with an IFI in Latvia since 2000. In 2008 the Latvian Government signed a financing contract for EUR 500 million with the EIB for EU funds co-financing in the programming period 2007-2013. The following year the amount of this financing contract was increased to EUR 750 million.

- Since end-2008 the **European Investment Fund** has signed a guarantee agreement for €30 million with the Mortgage and Land Bank of Latvia under the Competitiveness and Innovation Framework Programme and four agreements with financial intermediaries under the Latvian Jeremie Holding Fund with a total committed capital amount of €86.7 million.

- The **Nordic Investment Bank** (NIB) has signed three loans in Latvia since end-2007 totalling €171 million: a €50 million loan to Latvenergo, a €100 million loan to Hipoteku Banka and a €21 million loan to the Latvian Railways.

- Since the end of 2007 the **Council of Europe Development Bank** (CEB) has approved three loans totalling €250 million in Latvia: a €100 million loan to SEB to be used for construction and modernisation of municipal infrastructure, SMEs and social housing in all three Baltic countries; a €100 million loan to Swedbank for similar purposes; and a €50 million loan to the Latvian Government, also for improvement of urban and rural infrastructure.
ANNEX 1 - POLITICAL ASSESSMENT

Overview

The Republic of Latvia continues to meet the conditions specified in Article 1 of the Agreement Establishing the Bank.

Latvia has made substantial progress with the transition to and consolidation of multiparty democracy since regaining independence in 1991. The country has held six parliamentary elections, six local elections and five major national referenda, all of which have been deemed free and fair by international observers. The Latvian media are pluralistic, competitive and increasingly depoliticised, civil society is vibrant and the non-governmental sector is increasingly professional and self-sustaining.

Impact of the crisis

The economic crisis hit Latvia with overwhelming force in late 2008, resulting in policy divisions and precipitating the collapse of the government. Latvia’s President Zatlers nominated the economist and serving Member of the European Parliament, Valdis Dombrovskis, to the premiership. PM Dombrovskis was able to form a five-party coalition government with a comfortable majority in parliament. The coalition quickly agreed a revised budget with major cuts to public expenditures, including a politically sensitive 15 per cent reduction in public sector wages. Implementing across-the-board public sector wage cuts proved to be politically difficult to sustain, and one party left the coalition in March 2010, leaving a minority government. Nevertheless, the coalition partners were able to maintain sufficient unity to keep the IMF/EU stabilisation programme on track.

Political accountability

Latvia’s political institutions provide for popular representation as well as an effective system of checks and balance on political power. The Saeima is a unicameral parliament with 100 members elected for four-year mandates on a purely proportional representation basis with a threshold of five per cent for parties to enter parliament. The prime minister serves as head of government. Formal executive power is vested in the president, who is elected by parliament (the Saeima) for a four-year term. The presidency is relatively powerful, with responsibility for appointing the prime minister who then appoints the government, which is then subject to approval by the Saeima. The president also has the power to call a national referendum to dissolve parliament – a power which has only been invoked once, in May 2011.

In the run-up to the regularly scheduled October 2010 parliamentary elections, PM Dombrovskis’ New Era Party formed an electoral alliance with two smaller parties, the Civic Union and the Society for Other Politics, who jointly contested the elections under the banner of the Unity Alliance. Despite the difficult austerity measures for which the Unity parties were largely responsible, the Alliance increased its share of seats to 33 in the 100 seat parliament. Unity was then able to reform its coalition partnership with the Union of Greens and Farmers (ZZS), who had also increased their vote share to 22 seats, providing a stable majority for the reformed, Dombrovskis-led government. The left-leaning Harmony Centre bloc, which includes
the Social Democrats, Socialists and Social Democrats, also increased their seat-share from 17 to 29 seats, becoming the second largest electoral bloc in parliament, and reflecting the ongoing consolidation of the political party system in Latvia.

The Dombrovskis government survived its first major test two months after its reformation when parliament in December 2010 approved the 2011 budget, which includes further tax rises and spending cuts. The opposition parties, led by Harmony Centre, strongly criticised the government’s proposals. However, their calls to reject further fiscal austerity measures attracted limited public backing, reflecting continued public support for the Dombrovskis government and its economic stabilisation and reform programme.

**Integrity issues**

Low-level (or ‘administrative’) corruption is not a significant problem in Latvia: according to the second Life in Transition Survey (LiTS II), Latvia has one of the lowest levels of administrative corruption in the transition region, on a par with neighbouring Estonia and Poland as well as a number of Western European countries. Moreover, the levels of administrative corruption have fallen over recent years from the already-low levels reported in LiTS I in 2006.

However, the relationship between some successful businessmen and certain political parties, the transparency of the political decision making process, the nature of political party financing and the resulting low levels of public trust in parliamentary and governmental institutions remain areas of concern. These concerns have been highlighted in recent months as corruption investigations have been opened against three senior political figures: Ainars Slessers and Andris Skele, the joint leaders of the For a Better Latvia party, and the leader of the coalition partner ZZS, Aivars Lembergs.

In May 2011, the Saeima voted against a proposal to lift Slessers’ parliamentary immunity to facilitate the police investigation. This parliamentary vote prompted President Zatlers, who had pledged to ‘clean up’ the Latvian political system, to call a national referendum on the dissolution of parliament and the holding of early elections – the first time that this presidential prerogative was invoked in Latvia. As Zatlers explained at the time, the May 2011 parliamentary vote was only the latest in a series of events which had led the Latvian public to question the integrity of the political decision-making process.

The regularly scheduled indirect election of the president by parliament was held on 2 June 2011, five days after Zatlers’ presidential decree calling for the dissolution referendum. Zatlers stood in the election and had the backing of the ruling Unity Alliance, but lost to the nominee from the smaller coalition party ZZS, Andris Bērziņš. Bērziņš, an MP who entered parliament on the ZZS list in October 2010, had previously been a successful businessman, having served as president of Unibanka, Chairman of the Board of Latvenergo and president of the Latvian Chamber of Industry and Commerce.
Despite Zatlers’ departure from the presidency, the parliamentary dissolution referendum took place on 23 July 2011, and the Latvian electorate voted overwhelmingly in support of the referendum, with 94.6 per cent in favour and only 5.5 per cent against. Zatlers then launched a political party, the ‘Zatlers Reform Party’, to contest the election on an anti-corruption platform.

The early parliamentary elections took place as scheduled on 17 September. As in 2010, five parties crossed the electoral threshold to enter parliament. Harmony Centre once again took a plurality of votes, increasing its seat share slightly to 31 from 29. Zatlers’ Reform Party performed very strongly for a new political force, coming in second place with 22 seats. Electoral support for the two former coalition partners, PM Dombrovskis’ Unity Alliance and ZZS, fell significantly, while the conservative-nationalist National Alliance increased its seat share significantly. Latvia’s First Party/Latvian Way received just 2.4 per cent of the vote, thus failing to cross the electoral threshold.

While coalition negotiations are still underway, the tensions within the ruling elite that have resulted from the presidential election and dissolution of parliament are likely to result in a significant shift in the constellation of political forces in the next government. More importantly, the issues of transparency and accountability in Latvia’s political system and ethics in political life have been thrust firmly into the national spotlight. Opinion polls confirm that Latvians are deeply dissatisfied with the longstanding relationship between some successful businessmen and Latvia’s political system, and the election results reflected these public concerns. One of the top priorities for the next government must be to introduce reforms at all levels of the state and political system to address these concerns.
ANNEX 2 - ASSESSMENT OF TRANSITION CHALLENGES

The table and the supporting text below provide an overall assessment of Transition Challenges by sector, based on Transition Report 2010. There are two separate scores for each sector, rating market structures and market-supporting institutions. Scores range from negligible, small, medium and large. “Negligible” means that the remaining challenges are minor and that the sector is well advanced in moving towards the standards of a well-functioning market economy. “Large” means that the remaining challenges are major and that this dimension of the sector is at an early stage of reform.

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<th>Sectors</th>
<th>Market Structure</th>
<th>Market-supporting institutions</th>
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<td><strong>Industry, Commerce and Agribusiness</strong></td>
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<td>Agribusiness</td>
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<td>Manufacturing and Services</td>
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<tr>
<td>Capital Markets</td>
<td>Medium</td>
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INDUSTRY, COMMERCE AND AGRIBUSINESS

Agribusiness

*Market structure: Small*

*Institutions/policies: Medium*

Since accession to the EU in 2004, Latvia has been integrating into the EU’s CAP. As an EU member, the country is receiving substantial EU agricultural support, though this is considerably less than in some other EU member states. The land market continues to function poorly. Over 80 per cent of arable land belongs to private farms, but restructuring of farms is still necessary, particularly with numerous very small land plots and highly fragmented ownership. Agribusinesses have been fully privatised, but as in other new EU member states new owners still have to
reduce costs, improve efficiency and upgrade hygiene standards in order to become internationally competitive. The traceability of produce is still low, particularly by regional CEB standards. More efficient food production would also alleviate supply pressures which have increased in recent years. However, the availability of credit to the sector has been negatively impacted by the financial crisis.

**Manufacturing and Services**

*Market structure: Negligible*

*Institutions/policies: Small*

Although Latvia has small remaining gaps in the Manufacturing and Services sector, the financial crisis has highlighted the need for further reform. The government has taken important steps in the aftermath of the crisis to accelerate reform and the restructuring of enterprises. Incentives for market-based debt restructuring have been improved and existing legislation on foreclosure procedures have been amended, which is helping the rehabilitation of viable firms and corporate liquidation proceedings. An annual action plan to improve the quality of the business environment, focusing on the doing business indicators, is being implemented, including measures to simplify tax administration and procedures for starting a business. The authorities have also proposed a number of measures to tackle the grey economy, which need to be implemented in order to stimulate export-oriented FDI and firm restructuring. Moreover, expenditures on R&D, the quality of corporate governance legislation and the adaptation of ISO standards remain low in regional comparison and are key challenges.

**Real estate**

*Market structure: Small*

*Institutions/policies: Negligible*

The real estate sector has significantly developed over the past decade. The financial crisis has strongly affected the sector, in particular the office segment, as it was characterised by a large number of speculative projects. The retail and warehouse sectors are nearing saturation. The quality of the legislative framework is high, and property rights and contracts are enforced. There is little state interference in the sector and access to land is not a major obstacle. The State Land Service sped the registration of property by introducing an online database that allows registry employees to check the cadastral value of the real estate. Primary and secondary legislation supporting the sustainability of real estate (energy efficiency, impact on environment) is well developed and public awareness of the sustainability issues is also good.

**Telecommunications**

*Market structure: Small*

*Institutions/policies: Negligible*

Telecommunications regulation is already well developed in Latvia, although the independence of the regulator has recently been questioned by the EC and has been subject to an official probe. Lattelecom, the state-controlled fixed-line incumbent, continues to dominate the market, despite the liberalisation of the market in 2003 and the presence of about 40 alternative operators. The latter have complained about the
high installation charges levied by the incumbent. Entry of the third GSM operator, Bite, and introduction of mobile number portability in 2005 has increased competition in the mobile market, with penetration rates growing significantly as a result. The state still keeps its stake in the leading mobile operator, LMT. The internet market is dominated by Lattelecom, but alternative operators provide competition. Broadband internet penetration is well above the EU average, at 61 per cent of the population having access to broadband connections over 2 Mbps, compared to an EU average of 51 per cent.

**Private equity**

*Market structure: Medium*

*Institutions/policies: Medium*

The commercial private equity market remains underdeveloped. There are no country dedicated fund managers, although over ten regional fund managers have been identified to include Latvia in scope. Estimated active capital and capital available for investment amounts are 0.2 and 0.6 per cent of GDP, respectively. Only venture capital, buyout and mezzanine funds are reasonably well represented in the market, with small cap, growth, restructuring and infrastructure funds negligible. Local institutional and private investor participation is very limited. There is reasonable conformity with the OECD Principles of Corporate Governance.

**ENERGY**

**Natural Resources**

*Market structure: Medium*

*Institutions/policies: Negligible*

Latvia is a net oil importer, depending almost entirely on Russia for its energy supply. It imports coal and coke from Poland and other nearby countries. There are small upstream exploration activities, in partnership with the state. Oil distribution is carried out by Latvijas Nafta, state-owned, and by private companies (Neste, Lukoil, Statoil etc). Gas storage, distribution and supply activities are carried out by JSC Latvijas Gaze (LG), which is vertically-integrated and privately owned by E.ON Ruhrгаз (47.23 per cent), Gazprom (34 per cent), Itera-Latvija (16 per cent), and other minority shareholders. Gas market liberalisation is blocked by a clause contained in the privatisation agreement of LG sealed in 1997 that grants the company the monopoly on the distribution- storage- transportation and sale of natural gas in Latvia until the year 2017. Institutions and policies are otherwise supportive of the energy market structure and tariffs are cost reflective.

**Power**

*Market structure: Medium*

*Institutions/policies: Negligible*

Progress has been made in improving the market structure of the power sector. The liberalisation of the power sector is currently being completed according to EU requirements. As a result, industrial consumers and rival suppliers gained free access to the vertically integrated state-owned power utility Latvenergo's transmission grid. As of July 2007, Latvian consumers are able to freely choose an electricity supplier.
The quality of institutions has improved but can still improve further. In February 2009, the regulatory framework for renewables was significantly strengthened with the introduction of a feed-in tariff and a mandatory off-take mechanism. The feed-in-tariff is valid for 10 year after which point there is a reduced rate. Companies are only eligible for the tariff if they sell their energy to Latvenergo. This framework is, however, being revised and a new renewables support scheme is expected to be in place by July 2011. A regulator for the power sector is in place and tariffs are supposed to be cost-reflective. In June 2009, Baltic countries signed MoU on the Baltic Energy Market Interconnection Plan (BEMIP) aiming to further integrate Baltic electricity market and with the EU market.

The privatisation of Latvenergo is prohibited by legislation, and Latvenergo is still organised as a holding company having majority ownership in subsidiaries engaged in power generation, transmission and distribution. However, the legal and functional unbundling of Latvenergo is currently being undertaken with both distribution and transmission assets being transferred to a fully owned subsidiary of Latvenergo. Those assets will be leased out to Independent System Operators, which will be owned by the Republic of Latvia and are yet to be created. There is still relatively little private sector participation, mainly in the generation segment of the market where state-owned companies remain dominant.

Sustainable Energy

Market structure: Small
Institutions/policies: Small

An adequate legal and institutional framework for sustainable energy is in place. Energy pricing encourages energy efficiency investments, but project activities in the residential sector and SMEs continue to be burdened by institutional barriers. Support systems for energy efficiency and renewable energy are in line with EU practices, although outcomes are still lagging behind EU average. Although Latvia has a relatively high proportion of generation from renewable sources, this is predominantly from hydro power. Since February 2009, Latvia applies a feed-in tariff for renewable power generation, with a cap on total generation licences issued. A Climate policy is in place and geared to achieve EU 20/20/20 targets. The country is among the pioneers in credibly designed green investment schemes associated with International Emissions Trading. Remaining challenges are related to enhancing project development especially in housing and SME sectors, including small renewable energy plants.

INFRASTRUCTURE

Urban Transport

Market structure: Small
Institutions/policies: Small

Full decentralisation and corporatisation of urban transport companies has taken place. Urban bus companies operate within a liberalised bus market in the capital. In Riga four municipal transport companies have merged into a single municipal urban transport provider (trolley, tram and bus services as well as parking). The company relies on substantial subsidies from the municipality due to low fares and extensive
capital investment programme. There is a substantial private sector participation and competitive pressure in public transport sector. Some transport routes are serviced by privately operated mini-buses. Remaining challenges include a more holistic planning and regulation of the urban transport sector in Riga and well as increased private sector involvement, modern parking management and improved contractual arrangements with clear operational targets, particularly in the smaller cities.

**Water and wastewater**

*Market structure: Small*

*Institutions/policies: Small*

Full decentralisation and corporatisation of municipal utility companies has taken place. Major water and wastewater utilities are profitable with adequate billing and collection procedures. Private sector participation is not very common in the water sector. There is a good contractual setup between utilities and the municipality of Riga. However, outside the capital sub-optimal contractual regimes still prevail. Better defined service levels and performance targets would enhance the incentives and accountability of the management of municipal companies in the smaller cities. Tariffs are approved by a multi-sector regulator and local authority regulators and are set to cover all costs for different consumer groups. However, localised tariff setting can at times result in political interference in setting appropriate tariff levels.

**Roads**

*Market structure: Medium*

*Institutions/policies: Medium*

The privatisation of road construction and maintenance companies took place in early 90’s although the state sector retained some shares. There are about 20-30 companies. The majority major work (e.g. construction and major rehabilitation) is currently outsourced by the Latvian State Roads through open tendering. But majority of routine maintenance work is done by one state owned company (i.e. Latvian Road Administration) without tendering. There is no motorway agency and motorways are also managed by Latvian State Roads (state-owned company). Road user charges have increased and are sufficient to cover the marginal costs in the road sector. PPP legislation was adopted in June 2009. The first road PPP project, Riga-Senite E77/A2 expressway, was launched in May 2008, but eventually cancelled as no bidders were interested. Transition challenges remain in the following areas: (i) enhancement of competition in road maintenance and introduction of performance based contracts; and (ii) development of PPP projects in line with international best practice.

**Railways**

*Market structure: Small*

*Institutions/policies: Negligible*

In railways, operating and policy setting functions have been separated and core railway businesses have been partly unbundled, while ancillary services have already been divested. The restructuring plan for the Latvian railways was approved and the company was divided into three independent companies (infrastructure, freight and passenger) in 2005. Infrastructure access is granted and some independent operators have been licensed and are operating (i.e. increased competition in the market). A
number of regulatory agencies (licensing, pricing and safety issues) are involved in railway regulation. Railway labour productivity is one of the highest in the transition region. The remaining transition challenges are identified in the following areas: (i) further enhancement of private sector participation; (ii) further liberalisation and enhanced competition in the market; and (iii) development of multi-modal transport networks and operations.

FINANCIAL INSTITUTIONS

Banking

Market structure: Medium
Institutions/policies: Small

Assets of the Latvian banking sector at the end of 2010 amounted to close to 173 per cent of GDP. There are 21 banks, 11 of which are foreign owned, as well as a further 8 foreign bank branches operating in Latvia. The market is highly concentrated, with the top five banks accounting for just under 60 per cent of assets. In recent years, a combination of low interest rates and intense competition led to rapid credit growth, exposing the sector to heightened risks. Domestic credit to the private sector rose to just over 100 per cent of GDP in 2010. At the same time, deposits-to-GDP stand at 87 per cent at the end of 2010. 73 per cent of these deposits and just over 93 per cent of loans are in foreign currency. The crisis had a significant effect, requiring a bail out of the country’s second largest bank Parex in December 2008 (it was subsequently split into a ‘good bank’, Citadele, and a ‘bad bank’, Parex). The share of state ownership in the sector following the crisis increased from 4.2 per cent to around 16 per cent, although privatisations that are expected over the next 1-2 years will bring the state ownership down. In terms of regulations, progress has been made in the context of depositor rights, legislation on foreclosure legislation, and efforts to remove tax disincentives to debt restructuring are under way. The stability of the sector post-crisis was improved by signing of a regional financial stability agreement with the Nordic States in 2010. The agreement introduced cross-border crisis management and resolution in order to handle crisis situations more efficiently and including the establishment of a Nordic-Baltic Cross-Border Stability Group.

Micro, Small and Medium-sized enterprises

Market structure: Medium
Institutions/policies: Small

Although opportunities to receive external financing have considerably increased in recent years, access to current and capital financing is still an obstacle for some MSMEs and start-ups. While MSMEs account for about 76 per cent of employment and 74 per cent of value added of non-financial enterprises, credit to this sector accounts for about 44 per cent of total credit to the private sector in 2010. Guarantees and investment instruments are not sufficiently developed yet, and difficulties in the field of external finance availability are more pronounced in enterprises located outside Riga. SMEs and business start-ups with insufficient collateral and other risks find it problematic to obtain commercial bank finance. Access to credit to MSMEs was further restricted due to negative impact of the crisis on the financial sector. According to BEEPS 2009, about 28 per cent of MSMEs perceive access to finance as a major or severe obstacle to doing business. Government subsidised programmes
might increase market distortions and delay the development of sustainable market based solutions for MSMEs. Further training of SME credit officers and advice services for MSMEs on how to best present their financials and business ideas, might help develop this market segment.

**Insurance and other financial services**

*Market structure: Small*

*Institutions/policies: Small*

Insurance legislation and regulation almost fully meet the IAIS standards. Insurance penetration, however, remains relatively low at 2.1 per cent of GDP, lagging behind the majority of the CEB region with only Lithuania showing even lower penetration levels. The market is almost entirely operated by the privately-owned companies. Latvia’s insurance sector shows adequate availability of non-life products, however, the market for life products remains insufficient. There is also a shortage of skills required in the sector. In terms of the pension provision sector, privately managed pension funds operate both mandatory and voluntary pension schemes, with Pillar II legislation still to undergo some changes. As part of Latvia’s fiscal consolidation package, contributions to Pillar II have been temporarily cut by 6 percentage points to 2 per cent of salaries. The envisaged gradual rise in payments again in 2011 and 2012 has been delayed. The leasing sector is well-developed and legislation in place is fairly advanced. Leasing penetration is high even by EU standards, whereby the leasing portfolio amounts to close to 10 per cent of GDP.

**Capital markets**

*Market structure: Medium*

*Institutions/policies: Small*

Following the adoption of the EU *acquis communautaire*, securities market legislation complies with high international standards. The single financial markets supervisor is seen as effective. However, public equity market capitalisation remains low at 5.2 per cent of GDP, and there are only 32 listed companies on the Riga segment of Nasdaq OMX. Latvia has a fairly developed market for government bonds, although secondary trading lacks liquidity. Money markets remain inadequate. Liquidity in the inter-bank and the currency forward markets is low.
ANNEX 3 - LEGAL TRANSITION

Overall assessment

The Bank’s recent assessments of commercial and financial laws in the region show that Latvia has a relatively advanced set of commercial laws when compared to other transition countries.

Until recently, a serious source of concern for investors was the very poor quality of insolvency legislation, but the relevant piece of legislation has now been completely overhauled with the adoption of a new law in 2010 (see below).

As is often the case in transition countries, investors have reservations about the ability of Latvian courts to implement laws and resolve commercial disputes. In addition, the 2008-2009 global crisis has seriously put to the test the judiciary’s capacity to deal with non-performing loans. The Latvian authorities should continue to turn their attention to improving the technical skills and integrity of the judiciary.

Through its Legal Transition Programme, the EBRD helps create an investor-friendly, transparent and predictable legal environment in transition countries. Programme activities may include policy dialogue, assessment of legislation and technical cooperation with the country’s authorities. However, given the scarcity of funding resources allocated for legal technical assistance in EU member states, the Bank is not planning any specific technical cooperation activities in Latvia during the coming strategy period.8

Below is a review of legal developments in areas important for the Bank’s investment strategy for Latvia.

Investment climate / private sector

Impact of new insolvency law

The new insolvency law9 introduced a number of positive features, including easier access to insolvency and restructuring procedures, faster procedures for selling the debtor’s asset and for liquidation. However, the new liberalised personal bankruptcy regime introduced by the new law has been very controversial and was criticised by the banking community as being too debtor-friendly and detrimental to the lending business.

Further improvements required to pledge and corporate governance legislation

A well-functioning pledge law is crucial to the Bank’s plan to continue lending to the corporate sector, particularly SMEs, possibly through risk-sharing facilities or any other structures that would be attractive for the Bank’s clients. In this context, the new law adopted in 1998 provided for a market-oriented, flexible and transparent

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8 Exceptions could be made if there was a highly compelling case for legal technical assistance in a specific area, coupled with available funding.
9 Law on Insolvency of Companies and Business Entities, of November 2010
which is reported to be functioning well in practice. Further improvements could still be considered, including the simplification of procedures for registration of commercial pledges and mortgages by moving to a notice system whereby pledge agreements do not need to be presented.

The country’s corporate governance legislation, which when analysed by the Bank in 2007 was found in ‘Medium Compliance’ with the OECD Principles of Corporate Governance, has since then benefited from reforms linked to the transposition of the EU Acquis Communautaire. In addition, the Corporate Governance Principles and Recommendations on their Implementation issued by the Riga Stock Exchange (also known as Nasdaq OMX Riga) in June 2010 are expected to have a significant impact on corporate governance practices of listed companies. In that respect, for the purposes of further reforms the Latvian authorities should focus on the analysis of statements submitted by listed companies under the ‘comply or explain’ mechanism.

**Infrastructure and energy**

The adoption of a new Public Private Partnerships Law in 2009 and its amendments in 2010 provides a solid basis for the Bank’s effort to support public-private partnerships in the country. Although it remains to be tested in practice, the new legislation has been a serious improvement to the previous regime set out in the Concession Law of 2000. However, there is still room for improvement; for example, the new law should be amended to expressly provide for a possibility to resolve disputes by way of arbitration (including international arbitration).

The 2010 EBRD Public Procurement Assessment established that the Latvian public procurement laws were in high compliance with international standards of best practice. Similarly, public procurement practice was found to be transparent, competitive and well managed, especially when conducted electronically. This high quality national regime may provide a basis in specific cases for the Bank to consider conducting public procurement in EBRD-financed projects under local procurement rules.

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ANNEX 4 - TECHNICAL ASSISTANCE

TC COMMITMENTS BY DONOR THROUGH EBRD, 2008-2010

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<tr>
<th>Donor</th>
<th>TC Commitments (€)</th>
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<tr>
<td>EBRD Shareholder Special Fund</td>
<td>421,100</td>
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<td><strong>Total</strong></td>
<td><strong>421,100</strong></td>
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TC COMMITMENTS BY SECTOR THROUGH EBRD, 2008-2010

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<th>Sector</th>
<th>TC Commitments (€)</th>
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<td>Financial Institutions</td>
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<td>Legal Transition</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>421,100</strong></td>
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### ANNEX 5 - SELECTED ECONOMIC INDICATORS

#### Output and expenditure

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<td><strong>Industrial gross output</strong></td>
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<td><strong>Agricultural gross output</strong></td>
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#### Employment

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<td>Employment (end-year)</td>
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#### Prices and wages

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<td>Consumer prices (annual average)</td>
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<td>Broad money (M2, end-year)</td>
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#### Interest and exchange rates

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<td>Refinancing rate</td>
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<td>Gross reserves, excluding gold (end-year)</td>
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#### Memorandum items

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<td>Population (end-year, million)</td>
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<td>GDP (in millions of lats)</td>
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<td>GDP per capita (in US dollars)</td>
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<td>Share of industry in GDP (in per cent)</td>
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<td>Share of agriculture in GDP (in per cent)</td>
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<td>Current account/GDP (in per cent)</td>
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<td>External debt - reserves (in US$ million)</td>
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<td>External debt/GDP (in per cent)</td>
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<td>External debt/exports of goods and services (in per cent)</td>
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**Source:** National Sources and Eurostat

1. According to Eurostat
2. General government expenditure includes net lending
3. Weighted average interest rates in the interbank market
4. Includes non-resident currency & deposits, liabilities to affiliated enterprises and liabilities to direct investors
ANNEX 6 - GENDER EQUALITY

The Gender Inequality Index of the UNDP 2010 Human Development Index (HDI) paints a positive picture of gender equality in Latvia, which is ranked 22nd out of 169 countries with regard to reproductive health, education, political and labour dimensions of gender equality.

<table>
<thead>
<tr>
<th>Index/ % (1.0 max)</th>
<th>Ranking (of 169)</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Human Development Index</td>
<td>.769</td>
<td>48</td>
</tr>
<tr>
<td>Gender Inequality Index</td>
<td>.369</td>
<td>22</td>
</tr>
</tbody>
</table>

Source: UNDP Human Development Index 2010

As a result of the economic crisis Latvia now has one of the highest unemployment rates in the EU, which has affected both men and women, although the unemployment rate currently is significantly higher for men. Labour force participation rates for women peaked in 1980, at 78.7 per cent, then decreased sharply during the last years of the communist period and throughout the early 1990s and did not rise above 70 per cent again until 2008 (70.6 per cent). Women’s labour force participation is limited by the lack of part-time work options on the labour market. Russian-speaking women, as well as women from ethnic minorities, such as the Roma, face additional difficulties in the labour market. They also suffer from higher unemployment rates.

<table>
<thead>
<tr>
<th>Female</th>
<th>Male</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>69.6</td>
<td>78.9</td>
<td>2009</td>
</tr>
<tr>
<td>14.0</td>
<td>20.4</td>
<td>2009</td>
</tr>
</tbody>
</table>

Source: ILO Key Indicators of the Labour Market 2009

Despite the increased range of opportunities in the market following transition, gender occupational segregation remains prevalent. While a high percentage of women are active in the labour force, men still tend to dominate sectors with higher salaries, including construction, wood processing and transport, while women are often employed in lower paid sectors, such as education, healthcare, culture and hospitality. Once employed, women tend to face discrimination based on age and family status, especially in the private sector, as well as a high incidence of sexual harassment in the workplace, according to the UN.

The gender pay gap in 2010, at 13.4 per cent, is currently lower than the EU average of 17.5 per cent, according to the European Commission. However, the pay gap is much higher in the banking sector (women earn 44 per cent less than men) and in the retail sector (women earn 25 per cent less than men).

Women hold a strong position in the Latvian labour market: 51 per cent of managers in Latvia were women in 2009, higher than in any other EU member states. EU sources also report that, although women are less well represented than men among leaders of businesses (36.4 per cent compared to 63.6 per cent), they are more represented in this category than their European counterparts (32.6 per cent).
According to the Swiss research consortium Global Entrepreneurship Monitor (GEM), Latvia was the only country in the EU in 2008 in which women were significantly more likely than men to have education and training on starting a business, but women’s rates of entrepreneurial activity remained low compared to those of men. GEM also found that Latvian women seem to favour entrepreneurship less than men: 46 per cent of women in Latvia would prefer entrepreneurial activity over paid employment, compared of 57 per cent of men.