# Comment on "The Global and Regional Outlook in the Baltics," by Piritta Sorsa

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Latvia is the geographical centre of the Baltics, but the question of regional and sub-regional integration is not only a question of geography. The regional integration of the Baltics should be considered in a very broad context. I would like to comment briefly on Latvia, focusing on some macroeconomic and legal aspects of its integration into the European Union.

Important preconditions are the prospects for macroeconomic and legal convergence. When I compare what I know about Latvian macroeconomic performance, as an insider, with what has been drafted in various papers at this conference, the discrepancies are quite substantial. This is not meant as a criticism because even in Latvia the available statistical information is contradictory, which does not facilitate gaining a coherent view of the situation. Therefore, I would like to fill in to some extent the information gap about Latvian prospects in ensuring sustainable growth.

The income gap with the European Union is a crucial problem for Latvia. Latvia has a low GDP per capita coupled with low growth. After a downward trend in 1995 (-1.6 per cent in real terms) in 1996 GDP growth is expected to be around 2.5 per cent. The Ministry of Finance has worked out a prognosis of Latvia's economic and financial development up to the year 2002. Possible development is projected within two scenarios: base scenario and accelerated structural reform (ASR) scenario. The ASR scenario assumes that the government is able to promote the necessary private sector development and industrial restructuring. What are the factors driving growth? Higher level of investment and particularly FDI allow an increased growth of export and output. GDP growth accelerates from 3.8 per cent in 1997 to 5.6 per cent in 2002.

The main challenges for policy are to promote growth through investment. FDI in Latvia has increased since 1992, but remains relatively low (in 1996 the cumulative per capita FDI inflows amounted to $239). The main impediments to FDI inflows are of a structural nature. Privatisation must be accelerated, restructuring should continue and some restrictions should be eliminated, especially in bureaucratic procedures. The increase in FDI will be facilitated by:



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- The establishment of the Baltic free trade zone (after 1 January 1997) and Latvia's joining of WTO (planned for 1997);
- The BBB (investment grade) credit rating assigned to Latvia by *Standard Poors* will encourage FDI both directly and indirectly.

Low interest rates and a more soundly-based banking system may encourage domestic investment. The limited availability of capital is perhaps the most binding constraint on the economic growth. With regard to lending processes, bank lending rates are falling dramatically. In 1994, lending rates were 70 per cent, in 1995 they fell to 40 per cent and in 1996 lending rates were around 25 per cent. Still, structurally related microeconomic problems, such as difficulty with arranging collateral for loans, have caused the contraction in lending and this is in spite of commercial banks' extra reserves.

To my mind the convergence criteria will not play a major role in the accession process. I think the Union will not look so much at quantitative indicators, but primarily at qualitative improvements, i.e. the capacity of the country to correct macroeconomic distortions with policies and instruments that are compatible with the market mechanism in general and EU rules in particular.

If one takes a look at the actual state of Latvia's compliance with the Maastricht criteria, bearing all these qualifications in mind, a rather positive picture emerges (low fiscal deficit, reasonable state debt, low inflation, etc.)

However, more interesting than the actual state are the prospects for macroeconomic convergence. Most recent economic forecasts within the ASR scenario contain a positive prognosis with fairly high growth, slowly falling inflation and further fiscal improvement.

Any problems Latvia has experienced with fiscal deficit can be related to 1995 when Latvia faced an internal banking crisis. At that time, the general government fiscal deficit reached its peak (3.5 per cent of GDP) which is, in fact, not critical. In 1996 the fiscal deficit is even below IMF targets and the Latvian government has already adopted a zero-balanced government basic budget for 1997 in terms of fiscal deficit. Both base and ASR scenarios show that the fiscal deficit will be maintained up to 2002 within the limits that are set in the Maastricht treaty, thus reducing the likelihood of any increase in the external debt.

Foreign debt in Latvia in 1996 amounted to 16 per cent of GDP (internal debt 7 per cent and external debt 9 per cent). Compared with a number of EU member states, these figures are encouraging. As a result of fiscal discipline, the debt will decline as a proportion of GDP.

It is clear that a series of problems will have to be tackled on the road to further convergence with respect to inflation. It should be stressed that



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inflation has been substantially reduced and come close to single-digit levels in Latvia. The 1996 inflation rate was 13.1 per cent (December to December) or 17.6 per cent (year to year), which is low by transitional economy standards. A significant further lowering of inflation will, however, be a difficult task, taking into account in particular the persistence of several elements of cost-push inflation (e.g. the full adjustment of energy prices to cover costs and allow for adequate profit margins or with respect to nominal wage pressures).

I agree with Piritta Sorsa that the reason for inflation was and will be the adjustment to international price levels. By IMF estimate, the Latvian price level in 1996 may be around 60 per cent of the US price level. The space for the adjustment of prices is in the non-tradable sector, particularly in transport services, housing and energy.

It is instructive to note that in spite of price rises and the dramatic appreciation of CPI-based nominal exchange rates, the margins for competitiveness still remain, and there are two clear indicators of this: low wages (around $200) and accumulation of foreign reserves. Considering the very strict budget and conservative growth, the wages continue to be low by Western standards.

Let me stress the importance of Legal Convergence. Economic and monetary union embodies a set of institutional and legal provisions, particularly in the fields of central bank independence and the prohibition on budgetary financing by central banks. A related issue is full convertibility, which not only constitutes a main element of Stage One of economic and monetary union, but is also a precondition for joining the EU internal market.

The prohibition on budgetary financing by the central bank (Article 104 EC Treaty) has been met. Lending to the Government is strictly limited in terms of amount and maturity. The Bank of Latvia is not involved in budgetary financing any more. Fiscal deficits weremainly covered by T-bills. In the area of convertibility, current and capital account transactions have already been fully liberalised. Latvian currency is convertible according to Article VIII of the IMF's Articles of Agreement.

Integration into the EU as the central goal of Latvia's foreign policy helped us to mobilise all our efforts to achieve the necessary institutional and legal changes, that, in turn, contributed to the overall stabilisation of the economic and political situation of the country. The new Customs Law expected to come into force by the middle of this year will better serve both state and private business needs. Also, a capital market is developing quickly. To a large extent this is a merit of a well-organised securities market, which is considered as one of the best in the transition economies from a legal and institutional point of view. In addition, banking and insurance sector regulations were considerably strengthened and meet so-called "Stage I" requirements.

Finally, let me stress that the European Commission has suggested to work out a project on the medium-term economic strategy in cooperation with local experts. The importance of this project cannot be underestimated. Currently, the IMF approach is dominant among Latvian politicians. The elaboration of an alternative medium-term economic strategy with the assistance of DGII will play an important role for Latvia on its way to joining the European Union.


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