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ECONOMY (1990–2004)**



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INTRODUCTION

With the Supreme Soviet of the Latvian SSR adopting the Declaration On the Restoration of Independence of the Republic of Latvia on 4 May 1990, a period of national rebirth set in, during which the country was transformed from a centrally planned economy to a market economy; this transition also entailed an exit from the economic space of the USSR and an ever deeper involvement in the economic and financial system of Western Europe.

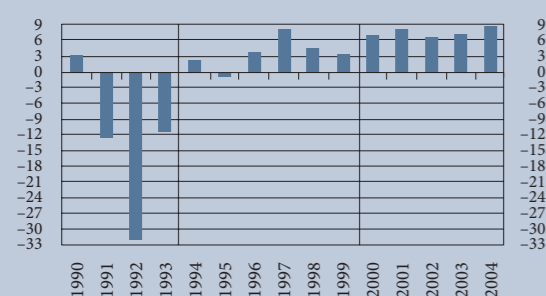
Similar to Latvia, the neighbouring Estonia and Lithuania departed from the planned economy rather fast and at an early stage; the majority of other former USSR republics followed the suit, albeit at a somewhat slower pace. The further 20-year-long history of economic development of some "dinosaurs" that were still kept captive in the planned economy proved that the transition to market economy had been the right option. Despite recent economic difficulties and remaining challenges and notwithstanding the depth of the latest economic crisis in Latvia, the way of economic transformation had been chosen correctly.

The phase of economic transformation concluded with Latvia's accession to the EU on 1 May 2004. This 15-year period can be conditionally divided into three stages characterised by quite different economic growth trends (see Chart 1).

The period between 1990 and 1993 was marked by inflation surging to the level of hyperinflation and the economic downturn reducing the economic activity by almost one third in 1992. In 1994–1999, macroeconomic stabilisation of the economy took place, thereby triggering a return to economic growth, with the reforms initiated and launched at that time laying the foundation for the economy for many years to come. However, the banking crisis of 1995 and the Russian financial crisis of 1998 hampered the implementation of country's economic potential.

In 2000–2004, when Latvia was getting ready for the EU accession, a gradual harmonisation of economic and legislative frameworks with the EU requirements was under way. With confidence in irreversibility of the reform process strengthening, the inflow of investment in the economy increased and enabled Latvia to fully manifest its economic potential. This period of economic growth has been the most important development phase in the history of renewed Latvia so far.

Chart 1. RATE OF CHANGES IN LATVIA'S REAL GDP (%)



Source: CSB.

TRANSITION FROM PLANNED TO MARKET ECONOMY (1990-1993)

Following the declaration of independent statehood, the task of comprehensive transformation of country's economic system, i.e. discarding the administratively centralised state management of national economy and introducing a market-mechanism-based economic system, was vested in the newly established Council of Ministers. The most important reforms envisaged price liberalisation, the establishment of a private sector, the reduction and eventual discontinuation of state budget subsidies to enterprises, relaxing restrictions on foreign trade and financial flows, the creation of a national currency system, including a two-tier banking system, and the operation of a viable central bank. Such reforms were to be launched in the circumstances when the legislative framework of the new country was practically non-existent or did not operate, the economic relations with former USSR republics loosened rapidly, and the formation of new economic ties took some time. The needed economic transformations were so comprehensive in scope and depth that their implementation, if attempted by the country on its own, would last unnecessarily long.

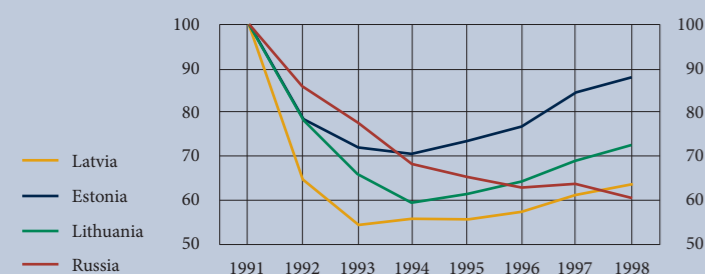
Therefore, on 19 September 1991, the government of Latvia applied for IMF membership, and, on 30 September 1991, the IMF informed Latvia about the commencement of entry negotiations with Latvia.¹ The first IMF mission under mission chief Leif Hansen arrived in Latvia on 10 November 1991.² The ability of a country's central bank to comply with the IMF rules and to implement best practices of central bank operation is an essential precondition for IMF membership; hence, on 25 November 1991, the first mission of the IMF Central Bank Department under Erik Niepoort began assessing the performance of the Bank of Latvia.³ The mission comprised staff members of Nordic central banks. Statistics and monetary analysis, foreign currency operations, accounting and payment systems were the priority areas of central bank's operation, which had to be improved by the Bank of Latvia to become a full-fledged central bank.⁴ The IMF entry process was a challenge for both the Bank of Latvia and the IMF staff: the former had to get an insight into the IMF requirements and operational framework, while the latter had to grasp statistics of the planned economy and its compatibility with the analysis of market economy processes. In general, the smooth procedure of the IMF accession process enabled to plan its accomplishment in the first half of 1992.⁵ On 19 May 1992, Latvia gained IMF membership⁶, which opened up fund borrowing opportunities for Latvia to pursue the needed reforms and to apply for IMF's technical assistance; it, likewise, demonstrated to the world the irreversibility of reform process and feasibility of investment in Latvia. Latvia accepted the proposal to join the Nordic-Baltic Constituency to represent Latvia's interests in the IMF administration.⁷

With a comprehensive shift in the system of ownership rights, the country's foreign trade system underwent the most profound changes. The republics of the former USSR had mainly traded with each other. According to the World Bank data, Latvia's exports to former USSR republics accounted for 95.7% of the total in 1990, while its imports from them constituted 83.5% of the total.⁸ The trade flows were, however, administratively regulated, and export and import prices largely differed from those of free market. This referred particularly to the prices of energy and other resources, which were notably lower than in the global market. This opened up industrial production opportunities in those USSR republics, including also Baltic States, where energy and other resources were scanty.

Meanwhile, when these countries regained their independence, the foreign trade regime also changed. The prices of imported resources and energy were in line with global market prices, thus rendering many small and formerly effective production units, which had depended on the low resources prices, non-competitive in export markets. Consequently, liberalisation of foreign trade flows brought about substantial price fluctuations adversely affecting the economic development. Thus, for instance, according to the World Bank estimates, the losses of the Baltic States due to transition from the former USSR trade and pricing system to market economy and prices were among the heaviest in the republics of the former USSR. Latvia's losses from the shift in terms of foreign trade accounted for more than 11% of GDP in 1990 (slightly below 10% in Lithuania and almost 13% in Estonia)⁹. By contrast, in Russia, which ranked among energy and resources exporters, the transition to market prices resulted in substantial gains (around 18% of GDP). Moreover, following the demise of the USSR, export and import relationships among enterprises had to be created practically from zero, because in the USSR a special institution had been responsible for foreign trade and the companies often were not aware of the purchasers of their output. Thus it is the liberalisation of foreign trade and the subsequent price changes that were responsible, to a large extent, for a more dramatic GDP decline in the Baltic States than elsewhere (see Chart 2).

Meanwhile, the differences in terms of decelerating economic activity among the Baltic States can be explained, to a large extent, by their contrasting economic structures inside the USSR. Unlike Lithuania, the Latvian economy was more focused on industrial production, including the performance of large all-union-scale factories (e.g. the State Electrotechnical Factory VEF, the Riga Semiconductor Factory Alfa, the Radiotehnika Factory, the Riga Carriage Building Plant, etc.). In 1990 overall, VAT from industrial output of Latvia contributed 34% to GDP, whereas the figures for Lithuania and Estonia were 21% and

Chart 2. REAL GDP INDEX (1990 = 100) IN THE BALTIC STATES AND RUSSIA



Sources: CSB and Havrylyshyn, O., Wolf, T., Berengaut, J. et al. Growth Experience in Transition Countries 1990–98. IMF Occasional Paper, No. 184, Washington DC, April 2000.

Table 1. ECONOMIC REFORM INDEX IN THE BALTIC STATES AND RUSSIA

	1990	1991	1992	1993	1994
Latvia	0.13	0.29	0.51	0.67	0.71
Lithuania	0.13	0.33	0.55	0.78	0.79
Estonia	0.20	0.32	0.64	0.81	0.83
Russia	0.04	0.10	0.49	0.59	0.67
Price liberalisation					
Latvia	0.25	0.42	0.67	0.75	0.75
Lithuania	0.25	0.42	0.67	0.75	0.75
Estonia	0.25	0.42	0.75	0.75	0.75
Russia	0.00	0.08	0.5	0.58	0.75
Emergence of private sector					
Latvia	0.10	0.20	0.30	0.40	0.63
Lithuania	0.10	0.30	0.40	0.60	0.75
Estonia	0.20	0.20	0.40	0.60	0.81
Russia	0.10	0.10	0.40	0.50	0.63
Trade liberalisation					
Latvia	0.0	0.2	0.5	0.8	1.0
Lithuania	0.0	0.2	0.5	0.9	1.0
Estonia	0.1	0.3	0.7	1.0	1.0
Russia	0.0	0.1	0.5	0.6	0.8

Source: Havrylyshyn, O., Wolf, T., Berengaut, J. et al. Growth Experience in Transition Countries 1990–98. IMF Occasional Paper, No. 184, Washington DC, April 2000.

42% respectively.¹⁰ Hence, in the years of soviet rule, Latvia managed to attain one of the highest welfare levels in the former USSR. However, in the context of liberalisation of the economy, the predominance of industrial production was a significant factor contributing to deceleration in Latvia's economic activity, particularly so because industrial production was hit by price liberalisation effects more than other sectors.¹¹

The pace of the economic reform process was also affecting the growth in the republics of the former USSR. According to an IMF research paper, Estonia excelled in the highest speed of economic reform process, while Latvia lagged behind Lithuania and Estonia in terms of privatisation and trade liberalisation (see Table 1). This may also underpin relatively poorer growth indicators of the Latvian economy.

In general, the Baltic countries ranked among the most active reformers of the former USSR. To some extent, it was determined by a rather limited set of alternative policies. With the transition to a market-mechanisms-based economic model, macroeconomic stability had to be achieved: without it, the economic decline could not be stopped and growth recovery commenced; in addition, a sooner return to the West European economic space was highly desirable for political reasons as well. Along with the strong fall in domestic activity, the sharply strengthening inflationary pressures that were a direct consequence of the extensive printing of money gave rise to the most serious macroeconomic problem. As such practically uncontrolled monetary expansion was triggered mainly by the need to finance government spending, one of the priority tasks of the renewed Latvia's government, along with the re-establishment of the lats, was the pursuit of fiscal discipline. Therefore, as early as January 1991, Latvia launched its own tax system and prepared its national budget independently of the USSR, notwithstanding the fact that the ruble of the USSR was still in circulation in the territory of Latvia.

The Law of 28 December 1990 "On Taxes and Fees in the Republic of Latvia"¹² established the basic principles of determining taxes and fees, among them types of taxes and fees, taxable objects, taxpayers, liability for tax law violations, dispute settlement procedure as well as basic principles of drafting specific tax laws. The law stipulated that, irrespective of the form of ownership, all legal entities and natural persons engaged in economic activities and doing business in the territory of Latvia should pay taxes and fees. However, not all enterprises operating in Latvia paid taxes to the state budget. Several companies of all-union significance, located in Latvia but directly subject to various USSR institutions, continued to transfer tax payments to Moscow. This problem was resolved on 24 August 1991 when the Supreme Council of the Republic of Latvia

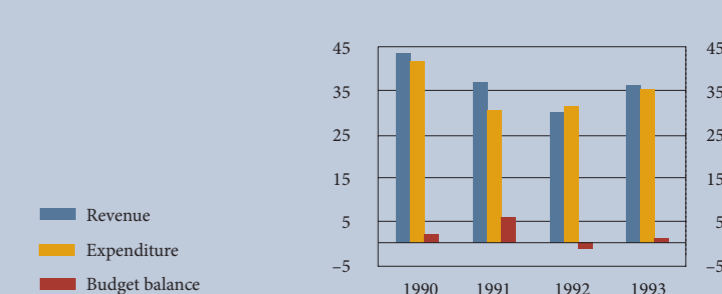
passed the decision "On the Economic Basis for the Sovereignty of Latvia"¹³ which according to the Constitutional Law "On the Statehood of the Republic of Latvia"¹⁴ stipulated that all enterprises and other civil objects located or registered in Latvia and formerly in all-union subordination should come under Latvia's jurisdiction as property of the State of Latvia, if not otherwise stipulated in intergovernmental agreements.

Like the other Baltic States, Latvia was net creditor to the USSR state budget, paying more money to the budget than drawing from it, therefore with the independent budget and discontinuation of payments to the USSR state budget, Latvia's state budget recorded a sizable surplus. Thus, for instance, in 1991, the budget surplus was more than 6% of GDP. It provided a very useful reserve cushion and helped avoid large budget deficits even amid the significant drop in the economic activity, thus alleviating economic stabilisation efforts of the government (see Chart 3).

Taking into account the need for expanding foreign currency circulation and creating a foreign exchange market, the Resolution passed on 29 November 1990 by the Supreme Council of the Republic of Latvia "On Measures for Creating Foreign Exchange Market of the Republic of Latvia"¹⁵ played a crucial role. It stipulated that all legal entities and natural persons in Latvia can possess foreign currency, and free circulation of foreign currency in Latvia became legal as of 1 January 1991. By this resolution, foreign exchange operations, i.e. buying and selling foreign currencies, were accepted as a type of business, and market exchange rates were used in these transactions. Meanwhile, the Bank of Latvia was vested with the task to set average exchange rates on the basis of foreign exchange buying (bid) and selling (ask) rates quoted for the previous day by institutions engaged in foreign exchange. At the same time, legal entities – parties in foreign economic relations – were allowed to pay a part of their staff salaries in foreign currencies earned via their foreign economic activities. The said resolution largely legalised the foreign currency circulation in Latvia, at the same time promoting external economic relations and the inflow of foreign currency into Latvia from less liberal neighbouring countries.

However, the introduction of the national currency remained the priority of macroeconomic stabilisation, for the USSR ruble emissions could not ensure immediate normalisation of the situation. A precondition for the attainment of this goal was a currency-issuing bank that would be independent of the USSR. The origins of the restoration of the Bank of Latvia operation go back to the initial days of awakening, and the passing of the Law "On Banks"¹⁶ by the Supreme Soviet of the Latvian SSR on 2 March 1990 was an important attainment towards an independent economic system of Latvia and the restoration of the Bank of Latvia operation.¹⁷

Chart 3. LATVIA'S STATE BUDGET REVENUE, EXPENDITURE AND BALANCE (1990–1993; % of GDP)



Source: Valdivieso, L. M. Macroeconomic Developments in the Baltics, Russia, and Other Countries of the Former Soviet Union, 1992–1997. IMF Occasional Paper, No. 175, Washington DC, January 1999.



By this law, the function of banking supervision and control was vested in the Bank of Latvia. Along with the currency issuing function, the Bank of Latvia continued to meet its obligations of financing the economy. Restricted money supply amid macroeconomic stabilisation contradicted the central bank's function of providing financing to the economy, which, in turn, required an increase in money supply. On 2 March 1990, the Supreme Soviet of the Latvian SSR passed also the Resolution "On the Bank of Latvia"¹⁸, which stipulated the establishing of a central bank of the Latvian SSR and giving it an official name of *Latvijas Banka*. As the USSR ruble was sole legal tender in circulation in Latvia, an independent policy of currency issuance was not feasible, and the Bank of Latvia did not actually commence operation as issuing bank.

As the legislation passed on the central bank of Latvia was perceived a temporary solution unsustainable to serve for longer-term economic needs of the country, its improvement went on. As early as 31 July 1990, the Supreme Council of the Republic of Latvia adopted the Law "On Amendments to the Law of the Latvian SSR "On Banks"¹⁹ and the Resolution "On the Establishment of the Bank of Latvia"²⁰, and also approved the Regulation "On the Bank of Latvia"²¹. The amendments to the Law "On Banks" specified that the Bank of Latvia was an independent state bank, with its operation regulated by the Law "On the Bank of Latvia" (prior to the enactment of this law, the said Regulation was in force).

The Supreme Council of the Republic of Latvia passed the Law "On the Bank of Latvia" on 19 May 1992²², and it differed substantially from the legislation regulating central bank operation in the USSR times or in the 1920s and 1930s of independent Latvia (see Box 1). In fact, this new legislative act, both in terms of style and content, followed the pattern of the respective regulatory framework of *Deutsche Bundesbank*, because the latter provided technical assistance to the Bank of Latvia in its efforts to improve the legislative framework.²³ In addition, the IMF experts also voiced their opinion about the draft of the Law "On the Bank of Latvia".²⁴ This enabled Latvia to follow the best world practices in central banking and implementation of monetary policy from the very outset of the reform process. By the Law "On the Bank of Latvia", a number of so far unprecedented practical elements were introduced in public administration which notably contributed to achieving macroeconomic stability in the country in the years to come.

First, the Law "On the Bank of Latvia" detached the function of issuing currency from that of commercial banking, defining the maintenance of price stability, attainable through an independent monetary policy, as the priority goal of the Bank of Latvia. In such a way, the responsibility areas were distinctly

separated, with the Bank of Latvia being vested with the responsibility for price stability, leaving the economic development to the government. Formerly the vesting of the two objectives in the central currency-issuing bank had resulted in an excessive issuance of currency; hence this strict distinction between the two functions was the most significant and most substantial effect of this law. Those structural units of the Bank of Latvia which were engaged in commercial banking had to be restructured into independent credit institutions by the end of 1992.²⁵

Second, for the Bank of Latvia to operate as an effective currency-issuing state bank, it had to be saved from the influence of politicians who focused on achieving short-term goals that could pose risks to sustainable development of the country over longer horizons. That is why the Law "On the Bank of Latvia" imposed substantial binding restrictions on the Bank of Latvia's direct financing to government operations (with a complete ban by 1998²⁶); it, likewise, ruled that the Bank of Latvia should neither seek nor take instructions from the government and should not be subject to government decisions. The law strengthened the financial, institutional and operational independence of the Bank of Latvia, with the new provisions differing cardinally from the previous practice in all these areas. It was supported by the fact that the Bank of Latvia could use the experience of *Deutsche Bundesbank*, which was ranked among the most independent central banks of the world.²⁷

Commencing its operation in the new status, the Bank of Latvia faced a major problem of dual circulation: along with the Latvian ruble put into circulation as an official currency a couple of weeks prior to the adoption of the Law "On the Bank of Latvia" (as of 7 May 1992), the banknotes of the USSR ruble, i.e. money notes of the USSR State Bank, were also in circulation. This dual circulation practically rendered invalid the pursuit of Latvia's law-stipulated monetary policy and the control over the amount of currency in circulation, as the USSR rubles were replaced in Latvia at a rate 1 : 1. As long as the conversion rate remained unchanged, the Bank of Latvia had no control over the money supply in Latvia.

With the pace of currency issuance in Russia and other republics of the former USSR accelerating in an uncontrolled manner, the massive money flows from the ruble zone countries also triggered a rise in the issued amounts of Latvian ruble, which brought about a steep escalation of inflation in Latvia (to almost 1 000% in 1992). With the aim to prevent the money supply from growing uncontrollably in Latvia, the Latvian ruble was declared sole legal tender as of 20 July 1992, special correspondent accounts were opened for all settlements with the republics of the former USSR as of 24 July, the fund transfer across

these accounts was banned on 4 August, but the exchange of the Latvian ruble against the Russian ruble at rate 1 : 1 was discontinued on 7 August 1992. In setting the exchange rate of the Latvian ruble against the currencies of republics of the former USSR, the Bank of Latvia used the exchange rates of these currencies against the US dollar. The rate of the Russian ruble as a foreign currency was first set by the Bank of Latvia for the period from 27 July to 2 August 1992. Initially, the rate was 1 : 1, yet, already on 17 August, the Russian ruble was equal to 0.9 Latvian rubles and rapidly continued to depreciate with every coming month afterwards, to stabilise at slightly below 0.4 Russian rubles per 1 Latvian ruble in November–December (see Chart 4).

However, these measures did not stop money inflows from the republics of the former USSR. In contrast to Latvia and the other Baltic countries where the national currencies were freely convertible against the US dollar and other "hard" currencies, free currency conversion was practically non-existent in the remaining part of republics of the former USSR. Consequently, the official exchange rate of these currencies against the US dollar used by the Bank of Latvia in setting the respective rates against the Latvian ruble, with the former rate starting to depreciate after the Latvian ruble was allowed to float, still did not mirror their real market value (which actually was much more below the officially set rate). On the other hand, the possibility to exchange such rapidly depreciating Russian rubles for Latvian rubles and afterwards to freely exchange these "soft" currencies for "hard" foreign currencies was in fact a legal way to get rid of the amassed worthless non-convertible rubles, easily transforming them into convertible foreign currency reserves. Taking into account the continuous depreciation of such soft (or non-convertible) currencies and the inconsistency between official and actual exchange rates, this strategy earned additional profit for businesses with access to credit resources in Russian rubles and other non-convertible currencies. Hence it is not surprising that even after the revoking of fixed rate of 1 : 1 in Latvia at the close of 1992, a substantial inflow of Russian rubles continued, and the Bank of Latvia kept on exchanging them for Latvian rubles (see Chart 5).

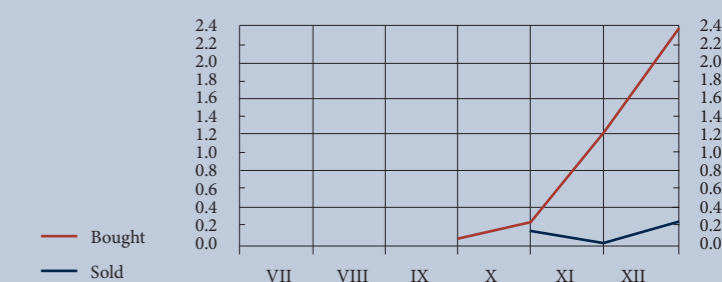
As a result, the Bank of Latvia incurred several problems. First, due to free exchange of non-convertible currencies, the amount of Latvian rubles in circulation continued to rise rapidly, while inflationary pressures did not ease notably enough. Second, because of the dual currency exchange (Russian rubles for Latvian rubles, Latvian rubles for convertible foreign currencies), the Bank of Latvia lost part of its convertible currency reserves, instead of which stocks of non-convertible Russian rubles, not

Chart 4. FOREIGN EXCHANGE RATES SET BY THE BANK OF LATVIA IN 1992 (Latvian rubles per foreign currency unit)



Source: Bank of Latvia.

Chart 5. PURCHASE AND SALE OF RUSSIAN RUBLES BY THE BANK OF LATVIA IN 1992 (millions of SUR)



Source: Bank of Latvia Annual Report 1992.

Box 1

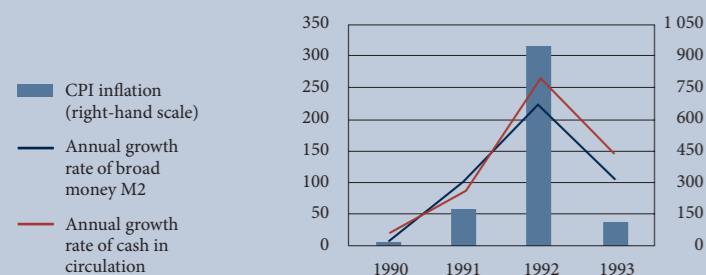
COMPARISON OF CENTRAL BANK STATUTES AND LEGISLATION

Indicators	Bank of Latvia Statutes (edition of 19 September 1922)	USSR State Bank Statutes (edition of 1 September 1988)	Law "On the Bank of Latvia" (edition of 19 May 1992)	Deutsche Bundesbank Law (edition of 22 October 1992)
Goals	Not specified	Ensure centrally planned management of the state currency and credit system.	Control over money supply to maintain price stability in the country.	Maintain price stability
Tasks	Control currency circulation in the country; promote trade, industry and agriculture by issuing short-term credits; alleviate domestic and foreign payment process; conduct state treasury operations.	Organise and control currency circulation in the country; increase purchasing power of ruble; boost lending and settlement efficiency; coordinate banking activities; accumulate budget funds and transfer them to banks to enhance lending; attract deposits.	Issue national currency; set official exchange rates for the national monetary unit against foreign currencies; act as advisory body of the Saeima and Cabinet of Ministers on monetary policy and banking operation policy; organise and ensure the operation of the clearing and payment systems; conduct foreign exchange operations; conduct supervision and audit of other credit institutions; issue licences for foreign currency purchase and sale as business activity; collect, process and publish statistical data.	Execute domestic and international payments; issue national currency; provide advice to the government on most important monetary policy issues.
Foreign exchange regime	Exchange money notes for gold at request, calculating 0.2903226 g pure gold for one lats.	The State Bank sets exchange rates binding on all banks in the territory of the USSR.	The Bank of Latvia sets the official exchange rate for the national monetary unit against foreign currencies.	Not specified.
Currency issuance	Money notes shall be issued in lats, the backing of their full nominal value shall be: 1) for the amount not exceeding 100 million lats – no less than 50% with gold or secure foreign currency, the rest – with secure short-term bills of exchange; 2) for the amount exceeding 100 million lats (to 150 million lats) – 75% with gold or secure currency, 25% – with secure short-term bills of exchange; 3) for the amount exceeding 150 million lats – 100% with gold or foreign currency.	The amount of money issued is determined by the USSR Council of Ministers.	The Bank of Latvia shall be the sole bearer of the right to issue the national currency, banknotes and coins, and these shall be sole legal tender in the country.	The sole issuer of banknotes as sole legal tender in the country. The banknotes of denomination below 10 German marks shall be issued only upon government's consent.
Operations	Discount of bills of exchange and other maturing liabilities; issue credits and short-term loans; accept money deposits and other valuables; buy and sell bills of exchange, foreign currencies and other valuables; execute money transfers; execute various transfers at the expense of state institutions.	Financing of the economy in cooperation with other specialised banks of the USSR. Credit interest rates are set by the USSR State Bank upon the approval of the USSR State Plan and Ministry of Finance. Profit as basic indicator of state bank's business activities.	Opening of accounts for the government of Latvia, foreign banks, international organisations, Latvian banks and other credit institutions; purchase and sale of foreign currencies and precious metals, acceptance of deposits, bank operations and transactions with foreign countries, their central banks, financial institutions and international organisations; issuance of short-term loans to credit institutions, pawn transactions; granting of short-term credit to the government in the amount not exceeding one twelfth of the current budget revenue; operations with securities.	Engage in transactions with banks, other market participants and the government.

Indicators	Bank of Latvia Statutes (edition of 19 September 1922)	USSR State Bank Statutes (edition of 1 September 1988)	Law "On the Bank of Latvia" (edition of 19 May 1992)	Deutsche Bundesbank Law (edition of 22 October 1992)
Bank administration	The Council consists of Chairman, Deputy and 11 members, including a representative of Ministry of Finance. Board consists of chief director, a deputy and 3 directors. Bank's Council and Board are appointed by the Cabinet of Ministers from candidates nominated by the Minister of Finance.	Council chairman (equal status with ministers determined by law), deputies and council members. Council Chairman appointed by the USSR Supreme Council, deputies and council members – by the Council of Ministers. Managers of the USSR State Bank Republican Offices appointed by the Council Chairman of USSR State Bank.	The Council consists of 8 persons: governor, deputy governor and 6 council members. To execute practical work and to ensure efficient management of the Bank of Latvia, the Council of the Bank of Latvia shall establish a permanent Board of the Bank of Latvia consisting of six members. The Governor of the Bank of Latvia is appointed by the Supreme Council of the Republic of Latvia upon the recommendation of the Chairman of the Supreme Council. The Deputy Governor and members of the Council are appointed by the Supreme Council of the Republic of Latvia upon the recommendation of the Governor of the Bank of Latvia. The Chairman of the Board is confirmed in the office by the Council of the Bank of Latvia upon the recommendation of the Governor of the Bank of Latvia. The members of the Board are approved by the Council of the Bank of Latvia upon the recommendation of the Chairman of the Board.	The Council of the Bank comprises the President and Vice-president, the other members of the Directorate and the Presidents of the Land Central Banks. The Directorate is composed of the President, Vice-president and no more than six members. valdība un apstiprina federālais The president of the Bank, Vice-president and the members of the Directorate are recommended by the government and they are approved by the Federal President.
Council members' term of office	3 years	Not specified.	6 years	8 years
Council independence	Bank's Council resolutions are to be submitted to the Minister of Finance who enjoys veto power. If Bank's Council sticks to its decision, the Minister of Finance submits the disputable issue to the Cabinet of Ministers for settling.	The USSR State Bank is subject to the USSR Council of Ministers. Where disputes arise between the Chairman and other Council Members, the Chairman is entitled to implement his own decisions upon giving notice to the Council of Ministers. Council Members can appeal to the Council of Ministers.	In its practical tasks and control activities the Bank of Latvia shall not be subject to the decisions and instructions of the government or its institutions. Meetings of the Bank's Council can be attended by the Minister of Finance of the Republic of Latvia without the right to vote. Where the Minister of Finance objects to the Bank of Latvia Council resolution, he/she is authorised to request a 10-day postponement for the enactment of the resolution; if the Council does not alter its resolution within this period, it shall be implemented. The Bank of Latvia is independent in the adoption of its decisions and their practical implementation.	In its execution of the task prescribed by law the Bank is independent of the government. Members of the government are entitled to attend Bank's Council meetings without the right to vote.

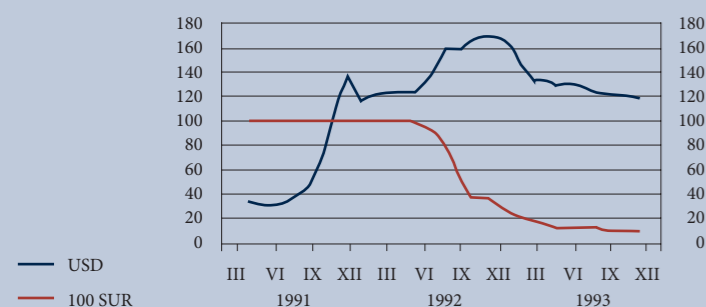
Sources: Valdības Vēstnesis. Nr. 213, 1922, 22. sept., 1. un 2. lpp.; Устав Государственного Банка Союза Советских Социалистических Республик. Утвержден Постановлением Совета Министров СССР от 1 сентября 1988 г., No. 1061; Latvijas Republikas Augstākās Padomes un Valdības Ziņotājs. Nr. 22/23, 1992, 4. jūn., 12. lpp.; Bekanntmachung der Neufassung des Gesetzes über die Deutsche Bundesbank vom 22. Oktober 1992. Available: http://www.bundesbank.de/download/aufgaben/mitteilungen/recht/92_1005.mitteilung.pdf.

Chart 6. CASH ISSUANCE RATE AND INFLATION IN LATVIA (1990-1993; %)



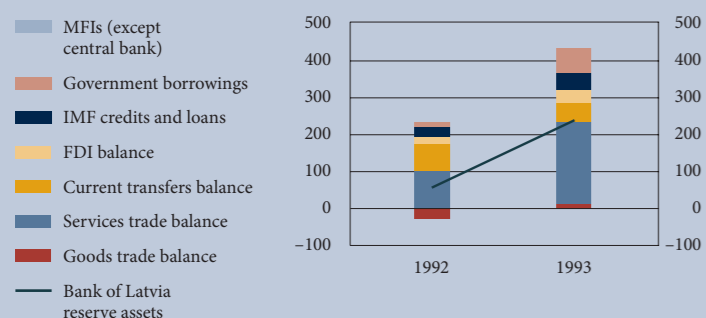
Sources: CSB and Bank of Latvia.

Chart 7. EXCHANGE RATE OF LATVIAN RUBLE AGAINST US DOLLAR AND RUSSIAN RUBLE



Source: Bank of Latvia.

Chart 8. MAIN COMPONENTS OF LATVIA'S BALANCE OF PAYMENTS IN 1992 AND 1993 (millions of lats)



Source: Bank of Latvia.

suitable for the backing of issued Latvian rubles, were piling up, increasing cash storing costs for the Bank of Latvia.²⁸

In order to stabilise the speed at which currency was issued, the Council of the Bank of Latvia made a decision to end the purchase of non-convertible currencies as of 22 January 1993.²⁹ At this juncture, the "umbilical cord" with the monetary system of the former USSR was cut completely, and Latvia could commence the pursuit of really independent monetary policy. With the uncontrollably issued Russian ruble inflows in Latvia and their exchange for Latvian rubles phased out, the excessive issuance of the Latvian rubles also ceased. Accordingly, within a year, the inflation level declined substantially (see Chart 6), thus creating a more benign environment for macroeconomic stabilisation in Latvia.

The strengthening of Latvian ruble against convertible foreign currencies also contributed to disinflation. It was essential for the new currency to gain credibility at an early stage, and the best way of consolidating it was to convince the population and businesses that in the foreseeable future the Latvian ruble would preserve its purchasing power both domestically and vis-à-vis foreign hard currencies. Attempting to consolidate the trust in the Latvian ruble, the Bank of Latvia commenced selling the US dollar to banks at a slightly lower rate than the market rate in September 1992. When the peg of the Latvian ruble to the Russian ruble was abandoned and the money growth decelerated accordingly, the exchange rate of the Latvian ruble against convertible currencies became stable and began to strengthen (see Chart 7).

This nominal appreciation was well-supported by positive dynamics of the balance of payments: the Bank of Latvia's foreign reserves grew substantially, thus enabling the central bank to use them for further strengthening of the national currency via interventions in the foreign exchange market. Due to rapid depreciation of the national currency in the previous years, the value of the Latvia ruble in 1992 and 1993 fell notably below the level that was economically justifiable. On the one hand, it had an upward pressure on inflation, while, on the other hand, the balance of foreign trade in goods and services improved notably (trade balance was also positively affected by the falling income levels). The positive foreign trade balance ensured that inflows of foreign currency in Latvia exceeded outflows. The foreign reserves of the Bank of Latvia were also boosted by Latvia's foreign borrowings (e.g. G24 and IMF loans). Foreign direct investment played a relatively minor role, and bank borrowing from abroad was practically non-existent at that time (see Chart 8).

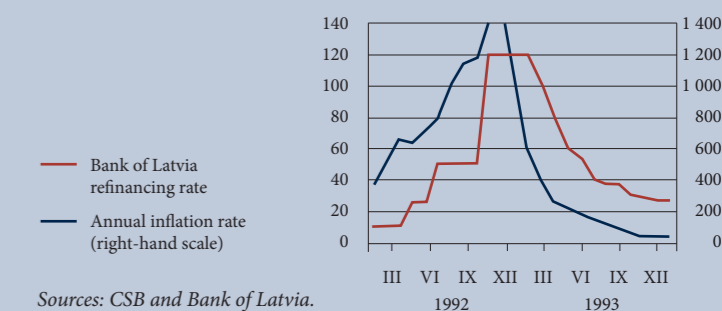
In its efforts to render monetary policy more effective and keep money supply under control, the Bank of Latvia also raised

interest rates on loans to banks. In early 1992, i.e. at the time when the central bank had not yet started real operation, the interest rates applied to bank loans were at a 10% level, although the inflation rate was approaching 400%. Thus the imposed interest rates were not consistent with the economic situation, and Latvia was spared from an even steeper inflation surge only by its weakly developed banking sector. It should be acknowledged, however, that the potential of bank borrowing at such rates was rather limited due to the lack of eligible collateral and other reasons. In order to minimise the possibility of extra amounts of money going into circulation via banks and, consequently, rising inflation, in 1992, the Bank of Latvia started to apply higher interest rates on credits as well, and by the close of the year, its refinancing rate had already amounted to 120% (see Chart 9). When inflation abated, interest rates set by the Bank of Latvia began to act as a brake on lending (see Chart 10). A further decline in inflation in 1993 enabled the Bank of Latvia to lower these rates without threatening price stability.

Overall, the stabilisation of the Latvian ruble vis-à-vis foreign currencies, the restricted money supply and the subsequent easing of inflationary pressures suggest that the inhabitants of Latvia and market participants abroad had begun to trust in the new Latvian money. Consequently, the Latvian ruble had fulfilled its mission of paving the way to the introduction of the lats, a full-fledged national currency unit. The first lats banknotes were put into circulation on 5 March 1993. The exchange rate at which Latvian rubles were exchanged for lats was not of essential macroeconomic importance. The assumption that the real income levels of people in Latvia declined just because of the exchange of Latvian rubles and lats at a rate 200:1 is delusive (see Chart 2).

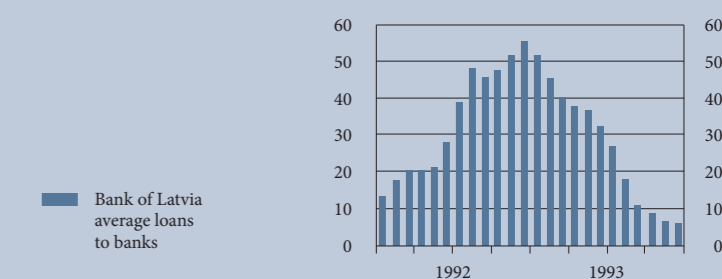
In general, Latvia's exit from the Russian ruble zone and the introduction of national currency unit proceeded successfully and contrary to sometimes gloomy predictions about the collapse of domestic monetary system and the entire economy before long. The goal of price stabilisation was attained in a comparatively short time. It was supported by the independence the central bank enjoyed, fully separating the functions of money issuance and lending to the economy and substantially curbing the possibilities of budget deficit financing with direct central bank loans, and by the effectively implemented monetary reform. Among major measures underpinning macroeconomic stability mention should be made of the tight budget policy of the government, leading to budgets with small deficits or even surpluses, and the actions taken by the Bank of Latvia, e.g. immediate disassociation from the Russian ruble, stabilisation of the national currency and restricted lending to banks via raising interest rates on credit.

Chart 9. ANNUAL INFLATION RATE AND BANK OF LATVIA REFINANCING RATE IN 1992 AND 1993 (%)



Sources: CSB and Bank of Latvia.

Chart 10. BANK OF LATVIA LENDING TO BANKS IN 1992 AND 1993 (millions of lats)



Source: Bank of Latvia.

Box 2

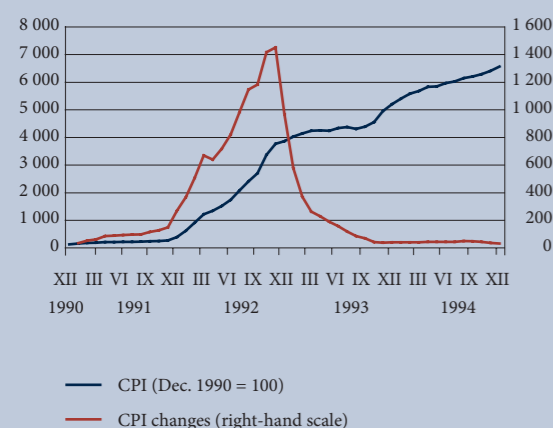
EXCHANGE RATE OF THE LATS (LVL 1 = LVR 200) AND CHANGES IN POPULATION'S PURCHASING POWER

For many people in Latvia, the introduction of the national currency, the lats, was associated with the assumption that, similar to many monetary reforms in soviet times, this one was again launched at the expense of forced reduction of population's purchasing power. This belief is as if reinforced by the fact that the amount of lats exchanged for Latvian rubles at the official rate 1:200 could buy considerably less goods than a similar amount of the USSR rubles some years ago. However, this assumption is deceptive and not true, and blaming the introduction of the lats for the reduced purchasing power of population is likewise wrong.

The actual exchange rate of the lats in no way affected the population's purchasing power, because along with the income denomination at the rate 1 : 200, goods and services prices changed automatically. For instance, if prior to the introduction of the lats a loaf of bread cost 20 Latvian rubles and 200 Latvian rubles could buy 10 such loafs, after the changeover to the lats the price of bread automatically dropped to 10 santims (20 LVR/200 = LVL 0.10) and the equivalent of 200 Latvian rubles or 1 lats could again buy 10 loafs of bread, i.e. exactly the same amount as before the money reform.

The significant loss of the purchasing power of the national currency and the subsequent, almost complete loss of people's cash savings in Latvia at the beginning of the 1990s is an undeniable fact. It was driven neither by the Bank of Latvia's monetary policy and the introduction of the lats nor by its exchange rate against the Latvian ruble, but rather by the unreasonable policy of excessive money printing conducted by the Bank of Russia, due to which money supply expanded rapidly, resulting in hyperinflation and dramatic depreciation of currency (see Chart 11).

Chart 11. INFLATION-BASED CURRENCY DEPRECIATION IN LATVIA (1990-1994; %)



Source: CSB.

The results presented in Table 2 show dramatic depreciation of currency due to hyperinflation. Until 20 July 1992, when the Latvian ruble became sole legal tender in Latvia, it was the Bank of Russia that actually implemented monetary policy in Latvia, and the Bank of Latvia did not have any monetary policy instruments to remedy the situation. In 1991, due to an upsurge in inflationary pressures, the currency started to depreciate sharply, and within a year, people's money savings lost 72.4% of their value. The process continued and even intensified in 1992. For instance, in June 1992, the population faced the fact that almost 90% of their previous year's money savings had been lost. This was before the Bank of Latvia commenced implementation of an independent monetary policy. In fact, when such policy was finally launched in July 1992, the monetary savings of the population had been almost completely destroyed by hyperinflation of the previous years: of each 100 USSR rubles saved by the end of 1990 only 4.89 Latvian rubles remained (in terms of real purchasing power). Thus over 95% of the population's cash savings were lost due to money issuances conducted by the Bank of

Russia. With the introduction of the lats in March 1993 and the exchange at the rate above, only 2.37 Latvian rubles remained (in terms of real purchasing power) of each 100 USSR rubles amassed in 1990.

Hence the population's sentiment of those days about their lost cash savings was absolutely reasonable and unbiased. It should be noted, however, that these losses were not caused by the rate at which the lats were exchanged for the Latvian rubles; they were rather a result of the worthlessness of the Latvian ruble due to massive money emissions conducted by the Bank of Russia.

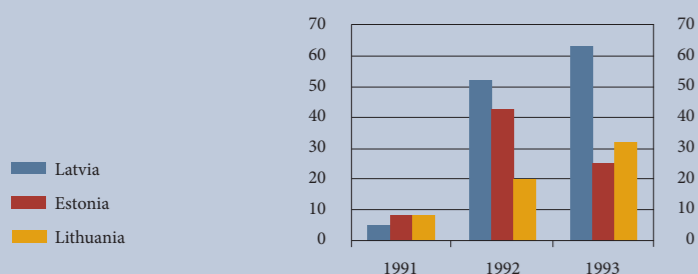
From an objective point of view, the introduction of the lats did not cause a loss of accrued cash but rather decelerated the decline in its value and, hence, helped preserve the value of money that had "survived" during 1991 and 1992. It is confirmed by the fact that in March 1994, i.e. one year after the introduction of the lats, the value of savings made one year earlier were eroded by inflation to a significantly lesser extent than before (by 25.5% against up to an 89.2% loss in previous periods).

Table 2. LOSS OF REAL PURCHASING POWER OF SAVINGS DUE TO PRICE RISES IN 1991-1994

	100 USSR rubles accrued in December 1990		100 currency units (rubles, lats) accrued 12 months ago	
	Purchasing power	Loss of purchasing power since accrual (%)	Purchasing power	Yearly loss of purchasing power (%)
December 1991	27.62	72.4	27.62	72.4
July 1992	4.89	95.1	10.83	89.2
March 1993	2.37	97.6	28.09	71.9
March 1994	1.77	98.2	74.54	25.5

Source: Authors' calculations.

Chart 12. NUMBER OF BANKS IN THE BALTIC STATES (1991-1993)



Source: Berengaut, J., Lopez-Claros, A., Le Gall, F. et al. The Baltic Countries: From Economic Stabilization to EU Accession. IMF Occasional Paper, No. 173, Washington DC, November 1998.

Following the separation from the Bank of Latvia of the commercial banking function and creation of the two-tier banking system, the banking sector began to evolve fast. With some exceptions, e.g. the state JSC *Latvijas Universālā banka* (the Universal Bank of Latvia, established in 1993 on the basis of 21 privatised former branches of the Bank of Latvia) and the specialised state JSC *Latvijas Hipotēku un zemes banka* (Mortgage and Land Bank of Latvia, established in the same year), this evolution was primarily driven by the private sector, (of 15 former Bank of Latvia branches, eight new banks were formed by attracting private capital, while 11 of its former branches were sold at auctions to already operating banks).³⁰ Even though the functions of supervising and auditing banks and other credit institutions were vested in the Bank of Latvia, the legal framework for bank operation was the responsibility of the government and parliament and was drafted in line with the political priorities of those days foreseeing quite liberal attitudes towards banks.³¹

On the one hand, it shortly ignited a buoyant growth of the financial sector but, on the other hand, increased the exposure to various such risks related to the sector's stability which could not be averted by only monitoring the compliance with the requirements of the bank regulatory framework. For instance, in 1992, the report to the government of the Ministry of Finance of the Republic of Latvia openly stated the opinion that "the majority of them [banks] are economically and professionally weak financial institutions"³² with low equity capital levels. To found a bank, the minimum amount of start-up capital was increased to 50 million Latvian rubles in March 1993, but already in May of the same year, this amount was set to 100 thousand

lats in accordance with the Law "On Stock Companies". The latter was amended in 1994, when the minimum start-up capital was increased to 2 million lats, but in 1995, consistently with the provisions under the Law "On Credit Institutions"³³, this amount was raised to ECU 5 million, with a transition period for reaching this level ending at the close of 1999.

Such liberal attitudes to the operation of the banking sector were driven by the government's objective to attain a fast economic growth, which according to all national development scenarios was unthinkable without a banking sector evolving similarly fast. The banking sector development plan prepared by the Ministry of Finance of the Republic of Latvia ranked financial industry groups, i.e. banks that extend credits primarily to the enterprises that simultaneously are their shareholders and large owners, as one of the most effective means of banking: "A new trend has already emerged in Latvia, where a number of commercial banks are closely linked with a certain group of industrial enterprises that often are the founders of these banks. It is particularly pronounced in the private sector, where commercial banks (...) provide financial servicing and investment to a limited circle of businesses (owners). This practice explicitly shows that when the banking capital and management are brought together with the business capital, a financial industry (trade) group, a very strong microeconomic structure, emerges."³⁴

The activities of banks and other financial intermediaries in Latvia intensified fast and buoyantly in a rather short time due to the relatively liberal legal framework and low capital requirements for banks. Moreover, Latvia started to grow as a significant financial centre for interstate settlements of the former USSR republics (spurred by a liberal foreign exchange market and free convertibility of currency). As a result, the number of banks in Latvia grew by leaps, and in 1993 there were over 60 banks, which was more than in Lithuania and Estonia taken together (see Chart 12). Although the pace of the process was consistent with the development of a country on its road to market economy, it amplified risks of a potential crisis at the same time.

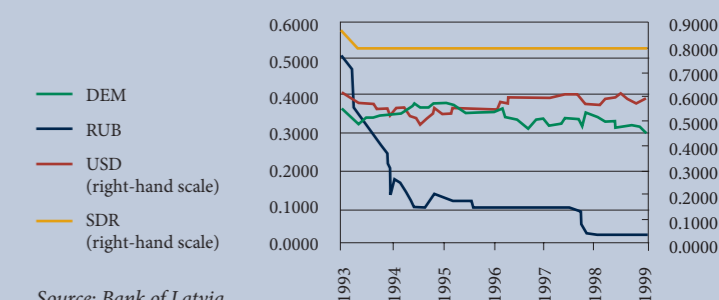
MACROECONOMIC STABILISATION AND CRISES (1994-1999)

As the Latvia's national currency was gaining ever larger confidence locally and among foreign market participants, and with foreign capital coming in the country at a robust rate, the exchange rate of the lats continued to strengthen. This helped the Bank of Latvia meet the price stability goal, as nominal appreciation was conducive to lower inflationary pressures. Furthermore, a stronger lats helped enhance the purchasing power of Latvian population abroad (also providing better opportunities for purchasing foreign-produced equipment and technologies). The rising purchasing power was a factor contributing to better confidence in the national currency, and was in contrast to constantly dropping purchasing power in the years of the soviet economic system. The positive effects apart, this strengthening in national currency made exports from Latvia more expensive and less competitive. That is why the Bank of Latvia resolved in February 1994 that a further strengthening of the lats exchange rate for the purpose of boosting confidence was no longer necessary and pegged the lats to the SDR, the currency unit used by the IMF. The SDR basket of currencies, comprising such important currencies as the US dollar (the main currency for foreign trade settlements with the republics of the former USSR), the German mark (a settlement currency for many trade transactions with countries in Western Europe) and the British pound sterling (the UK, Latvia's third largest export market, for example, received 9.7% of total exports in 1994), was the most suitable structure for Latvia's economic relations. Moreover, the peg to the SDR basket of currencies ensured maintaining and sustaining a stable exchange rate vis-à-vis all major world currencies, because, free fluctuations of these currencies against each other in the global financial market notwithstanding, they were mutually offsetting with respect to the lats: when the US dollar depreciated against the lats, the German mark appreciated, and vice versa (see Chart 13). In such a way, the lats peg to the SDR basket of currencies created favourable conditions for further expanding and bolstering foreign trade relations.

Subsequent developments confirm that the Bank of Latvia's conjecture about further easing of inflationary pressures without currency appreciation was right, as inflation indeed kept declining sharply. It enabled the Bank of Latvia to lower interest rates on loans to banks, which, in turn, had a positive impact on interest rates in the money market, and on loans to non-financial corporations and households (see Chart 14).

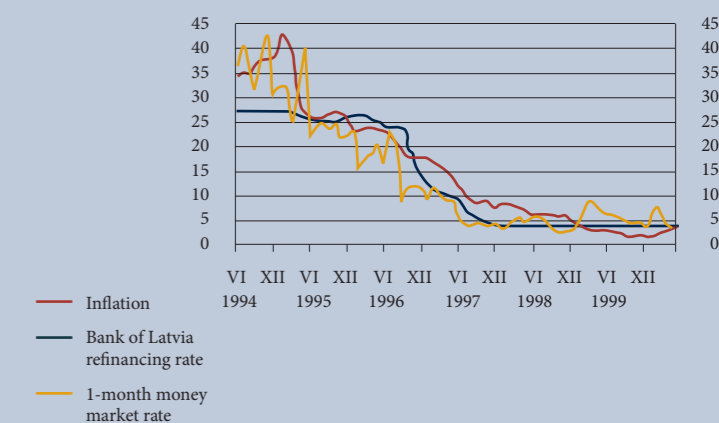
Macroeconomic stability is an important precondition for economic growth; therefore, with the macroeconomic situation in Latvia improving, a rapid economic expansion was anticipated. This did not materialise, however, and, till 2000 at least, the country's economic development was rather unbalanced. The bank-

Chart 13. DYNAMICS OF LATS EXCHANGE RATE (1993-1999)



Source: Bank of Latvia.

Chart 14. BANK OF LATVIA REFINANCING RATE, INFLATION AND MONEY MARKET INTEREST RATE (1994-1999; %)



Sources: CSB and Bank of Latvia.

ing crisis of 1995 and the Russian financial crisis of 1998 played a decisive role.

In 1991-1994, the amount of deposits attracted by banks and the bank assets increased 2-3 times. As alternative investment opportunities were absent, businesses and households placed increasing sums of money into banks (in the second half of 1994, the volume of domestic deposits was close to 500 million lats). Meanwhile, the possibilities for the banks to further invest this money profitably were limited, for the banking sector was growing faster than the real economy.

Latvia quickly and effectively coped with hyperinflation, liberalised the prices and foreign exchange regime, re-oriented foreign trade, restored private property rights and implemented privatisation of small enterprises. In the meantime, adjusting of

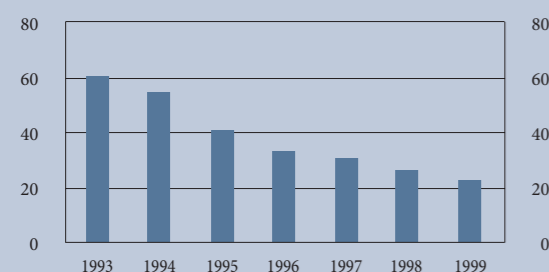
legal and tax frameworks and privatisation of large enterprises were delayed. For all that, the liberal bank licensing framework and foreign exchange policy promoted buoyant development of banks, while the economic reform process lagged substantially behind. It soon became evident that the growth of several banks stemmed from precarious foundations: their assets were unsafely invested and capital artificially boosted via circumvention. The overall loss incurred by banks in 1994 amounted to 7.8 million lats.³⁵

Dubious asset allocation was, in part, associated with the overall economic situation, because creditworthy borrowers with realistic business plans, able to secure a bank loan with collateral and provide guaranties to the bank as well as having a verifiable past credit history were in scanty numbers in Latvia.

Operating efficiency of banks was impaired by the absence of national development strategy, including a structural policy for economic development and a regional policy. The utilisation of most foreign funding also proved inefficient, for instead of industrial growth and investment it went to consumption and budget financing.

At that time, the Bank of Latvia was responsible for the supervision of the banking sector; since regaining independence, it had strived to align the requirements and regulations for Latvian banks with the legal framework existing in West European countries. As the regulatory framework in Latvia was the legacy of the former USSR, which cardinally differed from the banking principles in the market economy, such system had to be developed from scratch. The basic regulations for the operation of banking sector had been approved by the Bank of Latvia by the close of 1994.

Chart 15. NUMBER OF BANKS IN LATVIA (1993–1999)



Source: Bank of Latvia.

The banking crisis of 1995 and its implications

The financial problems of banks aggravated in early 1995. Several banks did not submit their financial statements for 1994 approved by international auditors by the established deadline. Even though insolvency of some banks did not cause a systemic crisis, it adversely affected the operation of other Latvian banks.

In 1995 overall, licenses of 14 banks were revoked.³⁶ JSC *Ban-ka Baltija* undeniably was the largest of them; yet some other banks with their licences cancelled also ranked among the ten top Latvian banks, e.g. JSC *Latvijas Depozītu banka* and JSC *Centra banka*. In general, the number of banks decreased 2.4 times in 1995–1999 (see Chart 15).

The Bank of Latvia's view on the 1995 banking crisis is well-characterised by the statement of E. Repše, the Governor of the Bank of Latvia, at the session of the Saeima (Parliament) of the Republic of Latvia on 19 May 1995: "If due to irresponsibility or by deliberate malicious conduct of bank officials the bank goes bankrupt, both the shareholders who had been urged and forced by the bank management, and the bank administration who have undersigned such transactions – in fact everybody somehow involved in it, shall be called to account. It is quite possible that the legislative framework is not perfect enough to have such proceedings go fast and smoothly. (...) Unfortunately, the Bank of Latvia is not entitled to perform acts in accordance with criminal proceedings, including detention, arrest and examination, under issued warning about liability for giving false testimony, of offenders or suspect persons. (...) The Bank of Latvia did ensure supervision, yet we did not ensure direct and absolute control over the conducted banking operations. Apparently (...), in Latvia's situation it was this absolute control and interference into banking operations that was needed, although, in fact it would not mean the supervision of this bank but rather the managing of it. For sure, it is not done in such a way anywhere in the world. (...) At the Bank of Latvia, there are 30 employees in the Department of Commercial Banking Supervision, and it is enough for normal supervision consistently with the world standards. Apparently, this proportion had to be different, and we had to employ 120 people to allocate 2 officials for permanent job per each of 60 banks who would literally keep a strict eye on bank managers. Of course, dear colleagues, even this would not ensure complete non-vulnerability of the banking sector, for two persons can also prove unable to supervise an operating bank, and there always is an opportunity to conduct financial operations in neighbouring premises, unnoticed, hiding them. We had a good instance with the *Latgales akciju komercbanka*. When upon the termination of this bank's operation the Bank of Latvia team arrived in it simultaneously with a special unit of Ministry of the Interior representatives coming from Riga, and the bank officials

were presented a ban on conducting any transactions, which had been in effect since the morning of that date, and all bank premises and means of communication were taken under control, the officials of this bank, to settle payments of a customer, managed to execute a payment order worth several million US dollars from another telex equipment all the same. Formally speaking, it was forbidden, yet, apparently, the fear of this client and of failing to carry out its order was intense enough for the bank management to violate these explicit prohibitions. You cannot insure against it hundred percent."³⁷

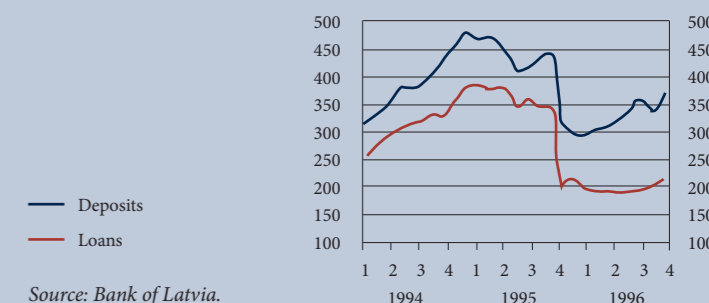
Consequently, the banking problems were not caused by objective factors; in most cases, these causes were subjective and bank-performance-related, among them inefficiency of management, inability to predict the course of developments and to adjust to the circumstances (e.g. long-standing expectations of the lats devaluation, retaining large open foreign exchange positions, wrong interest rate policy, with 90% interest on deposits in the situation of 30% annual inflation). Nevertheless, bank insolvency was most often caused by the activities of dishonest bank staff and deliberate fund squandering to serve personal business interests on behalf of shareholders. Despite such an attitude being typical for the so-called pocket banks, in the 1990s, it spread among large banks in Latvia as well.

The most characteristic negative feature of the 1995 banking crisis was the substantial loss of funds deposited with the failing banks. The amount of blocked assets in distressed banks exceeded 200 million lats or 40% of total attracted deposits. The respective share of households was even higher, because 53% of their bank deposits were affected. A drop in overall bank confidence determined also contractions in deposits with operating banks, yet the outflow of deposits was not disastrous, and in 2–3 months their volumes started to expand again, at first slowly and later gaining momentum, to reach the pre-crisis level in the middle of 1997 (see Chart 16).

The currency composition of deposits changed, too. Prior to the crisis, deposits in lats made up 60% of the total, while in the post-crisis period the respective share had contracted to 45%–50%. The so called dollarisation process was well-characterised by the share of deposits in foreign currencies in total money supply, which from 27% prior to the crisis amounted to 32% after it. Anxiety aroused by the banking crisis and worries how it would evolve further urged inhabitants to invest in short-term money instruments, reflected by shifts in deposit maturity profile. Of all non-bank deposits, the demand deposits, i.e. the most liquid ones, accounted for 61.5% at the end of June and 81.5% in December 1995.

Due to the factors above, in 1995, broad money shrank by 23%, back to the 1994 spring level. Deposits withdrawn from

Chart 16. DYNAMICS OF RESIDENT LOANS AND DEPOSITS (1994–1996; millions of lats)



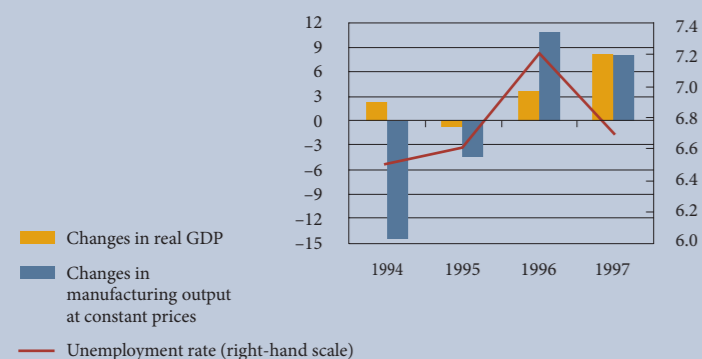
Source: Bank of Latvia.

banks were mostly held by the population in cash (primarily in foreign currencies). As a result, the cash foreign currency component of money supply grew, albeit it was practically impossible to assess its amount accurately. In total money supply, a sharp increase was also recorded for the lats share in currency in circulation (from 31% at the end of 1994 to 40% at the end of 1995). This pointed to the lack of confidence in banks, which, in turn, reduced the basis of available credit resources for the economy and confined its further growth.

When the banks that had survived the crisis started to assess lending-related risks more carefully, the number of financially viable lending projects contracted sharply. That is why, by the end of 1996, the credit portfolio of the Latvian banking sector had not increased overall, despite the observed declining trend in interest rates. Lending to trade fell particularly sharply (by more than 20%), giving also rise to shrinking in the domestic trade turnover. Lending to domestic enterprises and private borrowers went on falling also after the crisis, suggesting that banks were not willing to assume private sector risks but rather preferred to make use of investing in low-risk government securities.

Overall, the implications of the banking crisis for the financial sector were delayed and dispersed. The entire Latvian monetary system was undermined by the termination of operation of several banks. It was due to the weakening confidence in banks and the national currency, on-going dollarisation, outflows of foreign financing, the weakening bank role in financial intermediation, worsening monetary aggregates and strengthening currency in circulation to deposits ratio, contracting private sector deposits, blocked deposits, the narrowing domestic interbank market, shrinking lending, reduced government securities market and rising securities discount rates.

Chart 17. DYNAMICS OF LATVIA'S GDP, MANUFACTURING AND UNEMPLOYMENT INDICATORS (1994-1997; %)



Source: CSB.

The suspension of the operation of JSC *Banka Baltija*, the largest bank of Latvia, triggered rumours about financial problems in other banks and allegedly inevitable devaluation of the national currency. The Latvian currency market responded promptly: in May 1995, the Bank of Latvia sold 1.9 times more foreign currency than in the first quarter of 1995. The real economy was adversely affected by low liquidity associated with company accounts frozen in those banks whose operation was discontinued or suspended. As roughly one third of all company funds with banks were blocked, a significant part of businesses found their development prospects encumbered and were encouraged to resort to cash in their business activities more often.

Meanwhile, the economy was affected by several positive factors, which alleviated the effects of banking crisis. First, despite financial problems of several major banks, the rest operated effectively enough in Latvia; the total profit earned by the banking sector exceeded 5 million lats in 1995 and recorded a six-fold increase in 1996. Second, with inflation pressures abating and the national currency remaining stable, foreign direct investment inflows continued, enhancing the demand and employment. Third, the external environment was likewise supportive of the economic growth in Latvia: the expansion in Latvia's exports of goods exceeded 24% in 1995 and 15% in 1996.

Hence, somewhat contracting domestic demand resulting from the banking crisis notwithstanding, the overall decline in economic activity, albeit significant, was relatively short-lived. The volume of manufacturing output increased as early as 1996 for the first time after the restoration of Latvia's independence.

In 1997, unemployment hovered at about the same level as before the crisis (see Chart 17).

The relatively good economic performance enabled the government to restore fiscal discipline in a short time. The budget deficit, which in 1995 exceeded 3% of GDP (1.6% of GDP in accordance with the ESA 95 methodology), was cut down to 1.2% of GDP (0.6% of GDP in accordance with the ESA 95 methodology) in 1996, allowing for ending the year 1997 with a budget surplus (which was crucial in the context of the Russian financial crisis of 1998).

A major part of regulatory requirements for bank operation set by the Bank of Latvia were incorporated in the Law "On Credit Institutions" passed on 5 October 1995 (replacing the Law "On Banks")³⁸. The law stipulated that all banks of Latvia should abide by the International Accounting Standards and submit annual financial statements audited by internationally acknowledged auditors. The Bank of Latvia was one of the first central banks in Eastern and Central Europe to introduce this requirement. By passing this law, the regulatory framework of credit institution performance was substantially aligned with the requirements under EU directives.

Legal responsibility of credit institutions, their shareholders, managers, staff and customers for deliberately providing false or incomplete information and for a breach of binding rules was reinforced by the amendments to the Republic of Latvia Administrative Violations Code and Criminal Procedures Code. Consequently, the number of inspections at Latvia's financial institutions increased notably: the Bank of Latvia conducted 65 on-site examinations in 1994, 95 in 1995, and 123 in 1996.³⁹

The Russian financial crisis of 1998 and its consequences

Owing to the tightened supervisory measures, cases of intentional malevolence in the Latvian financial sector were practically ruled out in subsequent years. Nevertheless, it did not spare the country from impending crises. When in August 1998 the Russian government announced that it would be unable to make settlements for its securities in due time and in full amount, and these securities rapidly depreciated, the asset value of many Latvian banks also dropped markedly. For the financial system of Latvia, it triggered serious financial problems, which aggravated due to deposit outflows from a number of Latvian banks amid the environment of overall uncertainty (see Chart 18).

Although in most cases banks addressed these problems independently and efficiently, even managing to conclude the year with profit, serious problems were surfacing for two of them due to their assets blocked in Russia. On 27 August 1998, the Bank of Latvia suspended the operation of JSC *Latvijas kapitālbanka* on the basis of insolvency application filed by the bank. Still, this

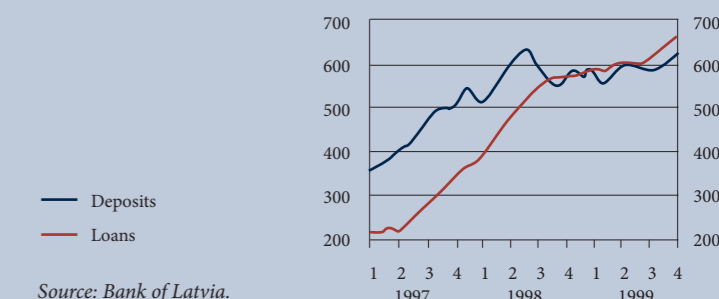
bank was relatively small and did not greatly affect the banking sector's stability overall. The second bank, which was rather deeply involved in the Russian securities market, was JSC *Rīgas Komercbanka* (RKB), the fifth largest Latvian bank. Its liquidity shortages were so critical that it had to stop operating and apply for assistance to the government and the Bank of Latvia.⁴⁰ This bank was pronounced insolvent as of 9 March 1999, yet, in contrast to the previous case of the systemically important JSC *Banka Baltija*, the RKB did not go bankrupt but was rehabilitated. In October 1999, the court ruled to stop the insolvency proceedings, and the RKB resumed operation under a new name of JSC *Pirmā Latvijas Komercbanka*. Meanwhile, the search for strategic investor was going on, and in summer of 2000, it was found in the person of *Norddeutsche Landesbank* (Germany).

However, the impact of the Russian financial crisis of 1998 on Latvia's economy was stronger than that of the 1995 crisis, because the former affected not only the financial sector but also most economic sectors due to quickly contracting market. The structure of foreign trade in Latvian goods changed substantially. Latvian exports to the EU countries expanded, while to Russia and other CIS countries exports had already been on a gradual descending trend since 1997 (see Chart 19). When in August 1998 the insolvency of the Russian government and devaluation of the Russian ruble were announced, exports from Latvia contracted particularly sharply: within a year, exports to Russia and other CIS countries shrank by around a half (see Chart 20). This was underpinned by the depreciation of Russian ruble, the subsequent decline in income levels and, hence, also the demand in Russia, and the financial sector problems that encumbered the smoothness of trade operations.

At that time, some market participants' and economists' calls for devaluation of the national currency rang out loud.⁴¹ Yet the Bank of Latvia managed to withstand the pressure. It considered that, first, devaluation of the lats would counteract the central bank's goal to maintain price stability, as at the end of 1998 inflation began to stabilise within 2%-3% range and devaluation would make it bounce in an unwelcome direction. Second, devaluation of the lats would strike a serious blow to the national economic policy, which was aimed at attaining and sustaining macroeconomic stability, and would weaken foreign investors' confidence in the country, thereby cutting off the inflow of investment. Third, devaluation of the lats would prevent diversification of export markets, thus retaining Latvia's excessive economic dependence on Russia.

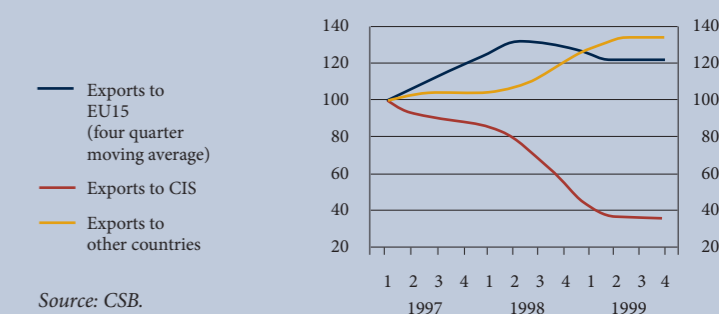
The subsequent events confirmed that the Bank of Latvia had been right and the decision not to devalue the lats amid implications from the Russian financial crisis had been made correctly. Despite Latvian exports to CIS countries contracting notably,

Chart 18. DYNAMICS OF RESIDENT LOANS AND DEPOSITS (1997-1999; millions of lats)



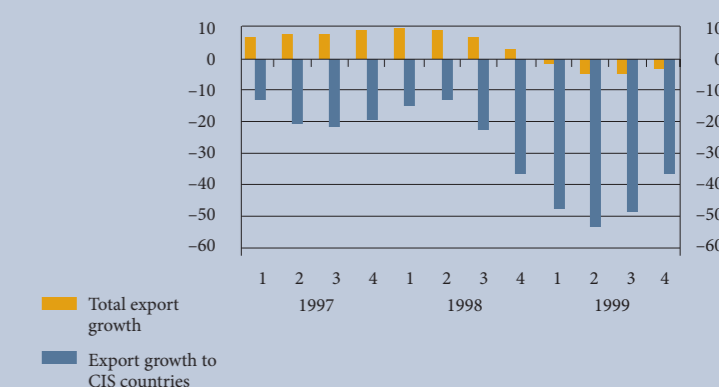
Source: Bank of Latvia.

Chart 19. VOLUME CHANGES OF LATVIAN GOODS EXPORTS (Q1 1997-Q4 1999; Q1 1997 = 100)



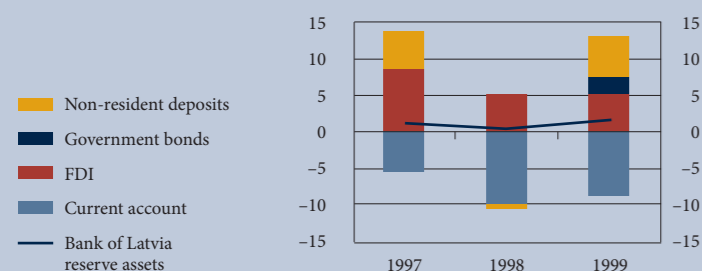
Source: CSB.

Chart 20. VOLUME GROWTH CHANGES OF LATVIAN GOODS EXPORTS (Q1 1997-Q4 1999; %)



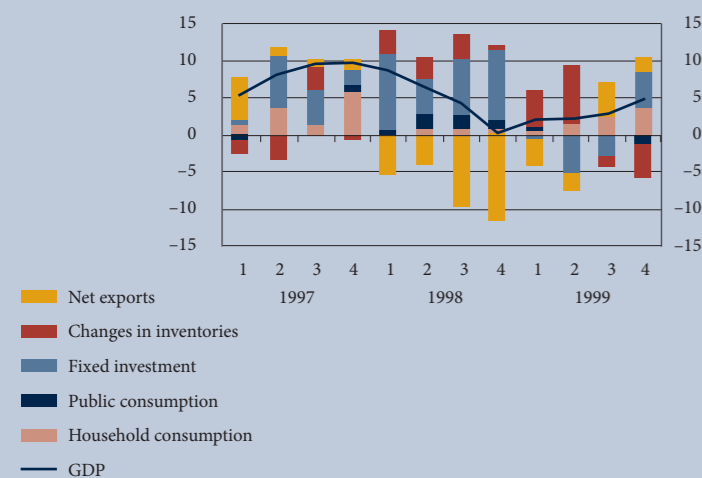
Source: CSB.

Chart 21. MAIN COMPONENTS OF LATVIA'S BALANCE OF PAYMENTS (1997-1999; % of GDP)



Source: Bank of Latvia.

Chart 22. CHANGES IN LATVIA'S GDP IN BREAKDOWN BY DEMAND COMPONENT (1997-1999; %)



Source: CSB.

exports to other economies declined to a lesser extent and to some, the other Baltic States in particular, even grew. Consequently, the overall volume of Latvian exports shrank only slightly, the substantially smaller export share to Russia notwithstanding, and the deceleration of export volume growth was short-lived. Invariable peg of the lats made Latvian exporters re-focus from the CIS market to the EU market, which they managed to do quite well: exports to the EU accounted for 49% of total Latvian exports in 1997 and for 63% in 1999 (the respective decline in exports to CIS countries was from 30% to 12%).

Likewise, the impact of Russian financial crisis of 1998 on the capital account of the balance of payments was temporary and transitory. In 1998, non-resident deposits flew out of Latvian banks, to renew again at previous levels in the following year. In addition, the sustained macroeconomic stability served as a good foundation for the attraction of foreign direct investment. Moreover, the country's stable macroeconomic situation encouraged the government to issue securities and borrow from international financial markets. As a result, the on-going inflow of foreign currency outpaced its outflows from the country despite a deficit in the current account of the balance of payments, and the Bank of Latvia foreign reserves continued to rise (see Chart 21).

Foreign capital inflows in Latvia were turned into new investment, and their growing volumes figured as the main reason why the economy could escape losing momentum even amid an adverse external environment (see Chart 22). Still, the economic development was not steady overall. Manufacturing and agriculture recorded an on-going downturn, while financial intermediation and real estate activities as well as commercial services, by contrast, were on a steep upward trend (see Chart 23).

On the fiscal side, a relatively sharp contraction in tax revenues and a rise in expenditure amid the Russian financial crisis of 1998 were observed, hence the budget balance worsened. In 1997, the budget surplus stood at 1.5% of GDP, while in 1999 the budget deficit amounted to almost 4% of GDP. Such deterioration of the budget balance is, as a rule, typical for periods of economic downturn and can be explained by the government attempts to alleviate the negative effects of external environment on the economy. A simultaneous balance between boosting the economy and maintaining macroeconomic stability is, likewise, important. As at the onset of the Russian financial crisis Latvia's fiscal indicators had been very good, the government could pursue an expansionary fiscal policy without any worries about the public debt growing too fast. This enabled the government to borrow from international financial markets to finance its budget deficit. On the other hand, the experience gained in 1998 and 1999, when softening of fiscal

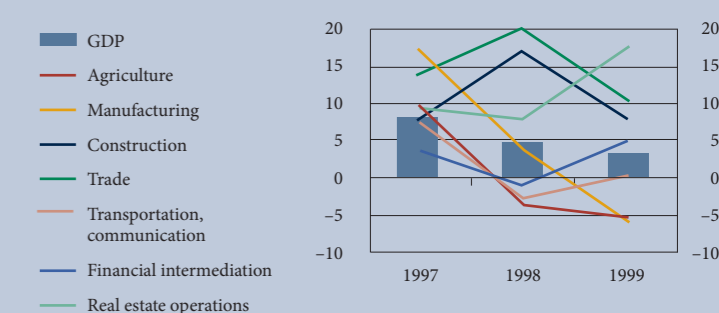
stances helped offset the effects of external factors on the Latvian economy, created an illusion that a budget deficit is a simple way to boost the economic activity in the country. Yet it turned out in the subsequent years when the economy advanced and the need for additional economic stimulus faded away that even a balanced budget, not to speak about a budget with a surplus, was politically too difficult a task to accomplish.

The Russian financial crisis of 1998 made it possible to assess the efficiency of financial sector's supervisory framework and specify the measures for minimising adverse effects of pending financial crises on the Latvian banking sector. In order to protect the interests of depositors and minimise the risk of unfounded outflows of finance, the Saeima of the Republic of Latvia adopted the Law "On Natural Person Deposit Guarantees" on 3 June 1998.⁴² This law stipulates that banks have to make payments to the Deposit Guarantee Fund, and, in the event of bankruptcy, bank depositors – natural persons – are entitled to receive a guaranteed compensation (which initially was prescribed in the amount of 500 lats, but over 10 years gradually increased to 13 thousand lats). Furthermore, the Russian financial crisis of 1998 forced the re-assessment of the existing assumption that investing in government securities was absolutely sound and did not require any provisions. The Bank of Latvia approved the bank capital requirement, ruling to apply a 50% risk weighting, in respective currencies, to claims against central banks and central governments in non-OECD countries (previously, 0%).⁴³

In general, the financial system of Latvia survived the Russian financial crisis of 1998 and its aftermath rather effectively, yet, for some Latvian banks, the asset value had depreciated and performance indicators decreased quite substantially due to the crisis. In these circumstances, further effective operation required both improving of bank management and investing of additional capital. In the meantime, the prospects for attracting domestic capital had deteriorated. The Scandinavian financial institutions acquired some of the largest Latvian banks, thus expanding their activities in a market with a good future outlook for growth, particularly considering Latvia's anticipated accession to the EU.

In 1998, *Skandinaviska Enskilda Banken AB* bought the shares of JSC *Latvijas Unibanka*, one of the largest Latvian banks, acquiring 23% of its capital. By end-2000, the SEB group had increased its stake in this bank to 98%. Likewise, in November 1998, *FöreningsSparbanken AB (Swedbank)* acquired JSC *Hansabank-Latvija*, the second largest Latvian bank, with its stake in bank's capital initially slightly below 50% and already at 52% in 1999. Foreign investors also obtained several small banks or their parts, so at the end of 1999 they possessed 66.2% of paid-up share capital in Latvian banks. In 2000, the Bank of Latvia

Chart 23. CHANGES IN LATVIA'S GDP IN BREAKDOWN BY SUPPLY COMPONENT (1997-1999; %)



Source: CSB.

issued a credit institution operating licence to the Riga Branch of *Merita Bank Plc.* (Finland), the German *Norddeutsche Landesbank Girozentrale* acquired shares of the restructured RKB, and the non-residents' share in paid-up capital of Latvian banks rose to 69.9%.⁴⁴

The predominating position of major Latvian banks gradually became more pronounced. The share of three largest Latvian banks in total bank assets amounted to 38.7% in 1997 and rose to 51.1% in 2000. According to the data of the Bank of Latvia, the shares in total bank assets of five largest Latvian banks were 51.2% and 62.8% respectively.

BUOYANT GROWTH AND FIRST SIGNS OF INSTABILITY (2000-2004)

The Latvian banks with foreign capital had access to financial resources of their parent banks, often available on more favourable terms than borrowing directly in the interbank market. Furthermore, the Swedish banks that held control over major Latvian banks resolved to expand operation in all Baltic States, and when the latter acceded to the EU these banks looked upon their markets as a part of their own domestic market.⁴⁵ In the meantime, with Latvia preparing for the EU accession, the aligning of its legislation with the EU requirements was taking place, strengthening ownership rights, bankruptcy proceedings and similar areas important for the operation of the banking

sector. Moreover, the low-level public and private sector debt enabled banks to anticipate a rapid market expansion and good profit opportunities in the near future.

All the above factors gradually spurred up lending which gained momentum particularly starting with 2002. The expansion of foreign bank activities in Latvia was accompanied by a robust acceleration in lending rate, as alongside with the growing demand spurred by falling interest rates, the Latvian banks with Swedish capital were void of the former supply restrictions, which had depended on the limited amount of domestic deposits. Empowered to borrow the lacking funds from parent banks, a number of Latvian banks now were able to extend loans in larger amounts than the attracted domestic deposits. Other banks, i.e. those without parent bank financing, had to either adjust to this new practice by seeking additional financing in foreign markets (via issuing bonds or borrowing from foreign banks or their syndicates) or take the risk of losing their market power.

In accordance with the Law "On the Financial and Capital Market Commission" adopted on 1 June 2000⁴⁶, the process of a uniform supervision of the financial and capital market initiated as early as 1997 was accomplished by merging, as from 1 July 2001, the Bank of Latvia Credit Institutions Supervision Department, the Securities Market Commission and the State Insurance Supervision Inspection. In such a way, the Bank of Latvia got void of the bank supervision and control function, which was now vested in the newly-formed Financial and Capital Market Commission (FCMC), which also supervised the operation of insurance and securities market and took over the responsibility for forming, managing and using the Deposit Guarantee Fund. The FCMC did not introduce substantially new restricting requirements for bank operation, because formally the whole supervisory framework for banks was already consistent with the EU standards. In line with the central objective of Latvia's foreign and economic policy, i.e. integration in the EU, in the first year of its existence the FCMC continued the aligning of legal acts regulating the activities of finance and capital market participants with the EC directives and recommendations.

In the period between 2000 and 2004, loans to residents increased from around 20% of GDP to 50% of GDP, with a simultaneous annual rise in the loan to deposit ratio from around 1.0 2000 to almost 1.7 in 2004 (see Chart 24). It suggests that as early as 2004 close to 40% of all bank-extended loans came from foreign financial sources. This acceleration in the pace of lending soon started to spill over to the other economic sectors, becoming more pronounced over time.

First, it negatively affected items on Latvia's balance of payments (see Chart 25). When capital inflows started to grow,

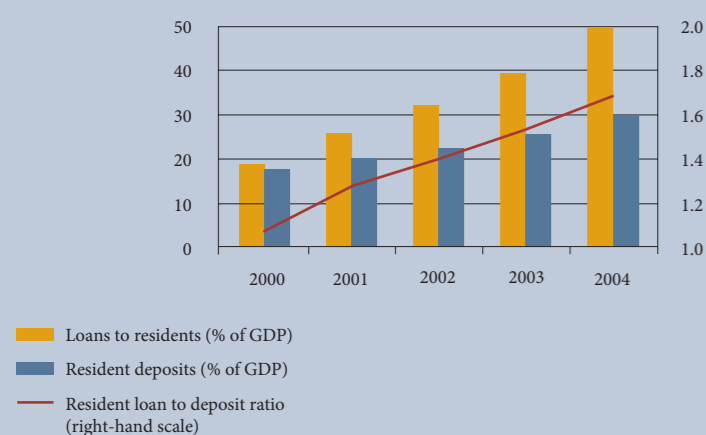
Latvia's current account balance deteriorated, and, in 2004, the current account deficit crossed the psychological margin of 10% of GDP. Moreover, if in some previous years foreign direct investment and government borrowing figured important in financing the current account, over time their place was more often taken by foreign borrowings of the banks. On the one hand, this type of financing was less stable than foreign direct investment due to its potentially easier outflow triggered by eventual changes in Latvia's economic situation or external environment. On the other hand, as most of these borrowings actually resulted from the redistribution of financial flows within one financial group (from parent bank to daughter bank), they did not pose so strong and obvious risks as did the traditional borrowings between non-affiliated enterprises.

Second, the increase in lending ensured substantial economic expansion, with GDP annually growing by 7.5% on average in 2000-2004. Following legal adjustments and the on-going liberalisation of trade (Latvia joined the World Trade Organisation on 10 February 1999⁴⁷), Latvia's exports expanded; however, as imports also increased, the overall contribution of foreign trade to changes in GDP had been negative since 2001. Consequently, the economy grew primarily on account of the robust expansion in private consumption and rapidly increasing investment (see Chart 26).

In the meantime, investment in domestic-consumption-oriented sectors became more substantial, while that in branches supporting Latvian export growth and external competitiveness diminished. In 2004, the sector of real estate activities and other commercial activities became the central and largest Latvian sector accumulating foreign direct investment (see Chart 27). For a small and open economy, such developments were unsustainable in the long run. In the short run, however, the results were good and convincingly testified to the resilience of economic progress. Amid intensifying economic activity, the unemployment rate slid down notably; yet, with spare and excess capacity gradually drying out and availability of high-quality workforce diminishing, rises in labour costs were impending. Initially, businesses could use various labour process improvements to offset the rises in labour compensation, and labour productivity increased. Over time, however, the buoyant economic growth and insufficient investment in productive sectors of the economy resulted in stronger inflationary pressures (see Chart 28).

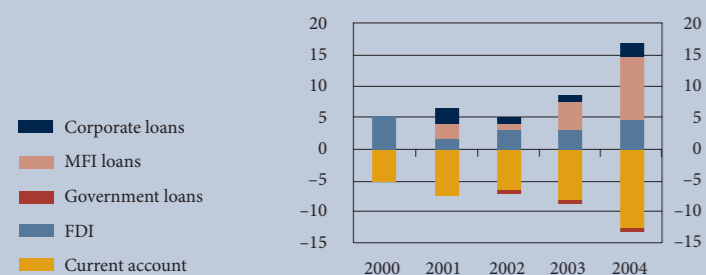
In addition, when Latvia acceded to the EU in 2004, inflation hiked due to several one-off factors (e.g. excise tax rate increases to the minimum level admissible under EU law, which in the case of Latvia implied a rather notable elevation in fuel prices). As a rule, such supply-side-ignited price hikes are transitory, because a price increase automatically exerts a downward pressure on demand and excludes further price rises. Still, amid the

Chart 24. DYNAMICS OF RESIDENT LOAN AND DEPOSIT CHANGES (2000-2004)



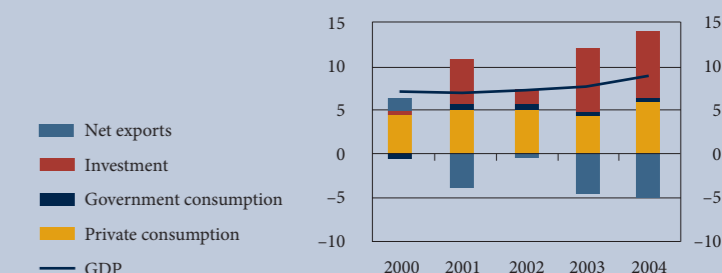
Sources: CSB and Bank of Latvia.

Chart 25. MAIN ITEMS OF LATVIA'S BALANCE OF PAYMENTS (2000-2004; % of GDP)



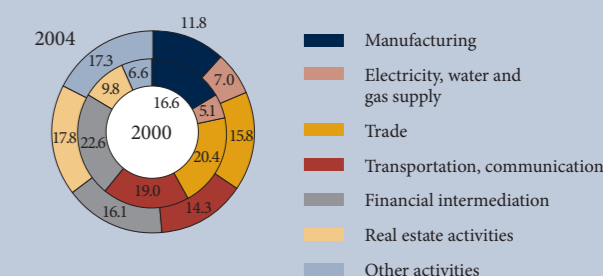
Source: Bank of Latvia.

Chart 26. LATVIA'S GDP AND CHANGES IN DEMAND-SIDE COMPONENTS AFFECTING IT (2000-2004; %)



Source: CSB.

Chart 27. ACCUMULATED FDI IN BREAKDOWN BY SECTOR (2000-2004; %)



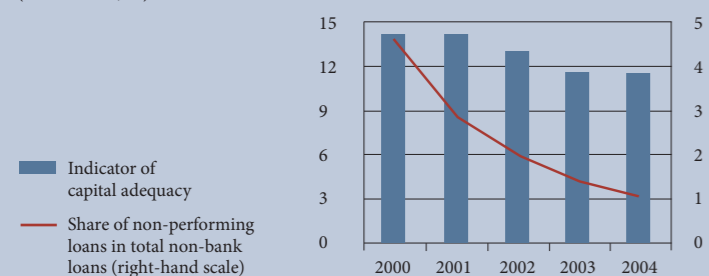
Source: Bank of Latvia.

Chart 28. JOBSEEKERS RATIO AND INFLATION DYNAMICS IN LATVIA (2000-2004; %)



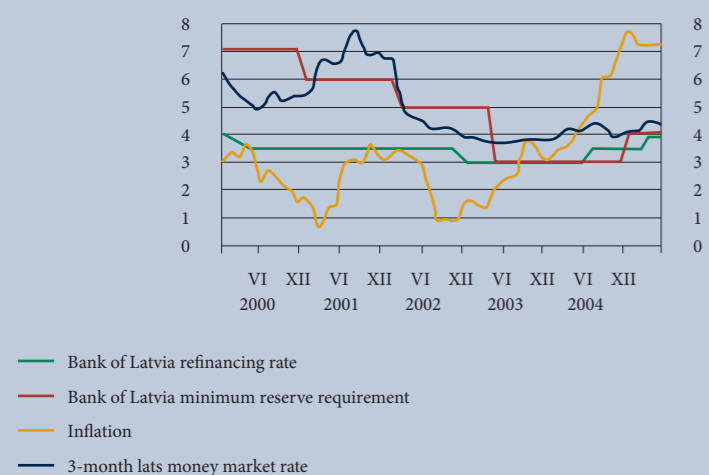
Sources: CSB and SEA.

Chart 29. PERFORMANCE INDICATORS OF LATVIAN BANKS (2000–2004; %)



Sources: Bank of Latvia and FCMC.

Chart 30. BANK OF LATVIA MONETARY POLICY INSTRUMENTS, MONEY MARKET INTEREST RATE AND INFLATION (2000–2004; %)



Source: Bank of Latvia.

fast economic development and heightened labour demand, risks substantially aggravated that such one-off price rises may couple with wage increases without a corresponding rise in labour productivity thus producing a price-wage spiral. Be it so, inflation would be difficult to control and would pose a threat to price stability in the country. In order to avoid the materialisation of such a scenario, public institutions had to interfere.

Solely from the point of view of risks threatening banking sector operation, there were no grounds for serious concern. In the IMF and World Bank Financial System Stability Assessment in 2001, Latvia's financial sector was positively evaluated, its competitiveness ascertained, and market supervision quality praised as being consistent with the best world practices in all major aspects.⁴⁸ The share of non-performing loans that might have been indicative of potential future losses contracted from year to year and in 2004 only slightly exceeded 1% of the total bank credit portfolio, which was one of the best indicators among EU countries. In addition, the bank capital adequacy, meant to provide a reserve "cushion" against losses in the event of a crisis, albeit slightly deteriorating, was still steadily lingering above the 10% margin set by the supervisory institution (which, in turn, was higher than the EU 8% threshold; see Chart 29).

Speaking about the monetary policy, a gradual policy paradigm shift was occurring. Since the mid-1990s when inflation started on a downward trend, the Bank of Latvia constantly lowered its interest rates and reserve ratios, thus pursuing expansionary monetary policy; when the inflationary risks and risks to maintaining price stability intensified, the Bank of Latvia turned to restrictive monetary policy stances. In March 2004, the refinancing rate was raised for the first time in 10 years; in July 2004, the reserve ratio was pushed up and bank liquidity thus reduced (see Chart 30). Unfortunately, these monetary policy decisions could only partly ensure tighter lending standards, because several major Latvian banks had access to their parent bank financing and their needs to resort to the Bank of Latvia monetary policy instruments had moderated. As a result, the money market interest rate increases were not particularly sharp even amid the more costly resources of the Bank of Latvia.

In an environment of robust economic growth and ascending risks to macroeconomic stability, the government of Latvia continued to pursue a rather expansionary fiscal policy by drawing up the state budget plan with a deficit. Instead of accumulating the annual extra budgetary tax revenue for building contingency provisions or a reserve for periods when the economic growth might fall behind the projections, a tradition was taking root to spend such above-the-plan tax revenue to

finance the increased expenditure emerging via mid-year amendments to the current budget. There were several reasons for such behaviour.

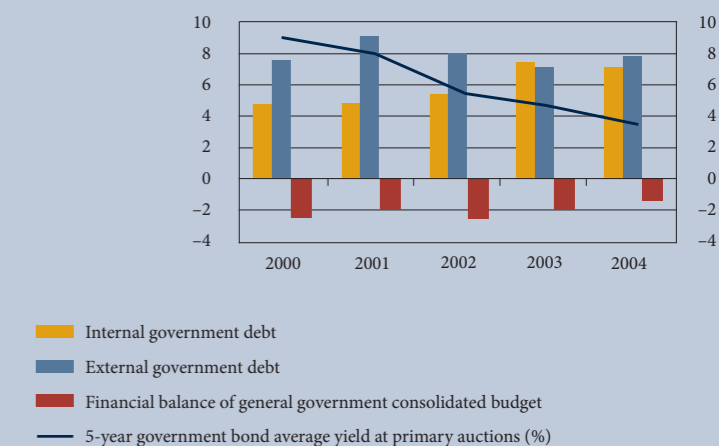
Several structural reforms that the government implemented exerted additional pressure on the budget. For instance, in July 2001, a pension reform was launched in Latvia, as a result of which a portion of social insurance contributions was assigned to the creation of pension accrual funds and, consequently, was not available for financing the current budget expenditure.

Besides, the economic policymakers faced a problem of dramatically falling public acceptance, and, in a short while, the popularity of both the government and the parliament had plunged down to one of the lowest levels in Europe (according to the data of a sociological survey of 2002, 40% of the population did not trust in the Saeima of the Republic of Latvia at all, and 36% had rather no trust in it; trust in the Cabinet of Ministers was only some percentage points higher⁴⁹). Measures to cut the budget deficit would only further reduce the popularity of government; hence the boosting of budget deficit and expenditure was an attempt to increase public support.

For all that, the most significant changes were related to shifts in policymakers' priorities and values. In the course of the following 10 years, the concern about macroeconomic stability, the first priority of economic policymakers after Latvia regained its independence, was gradually replaced by the need to attain an ever stronger economic growth, as Latvia's accession to the EU had clearly illuminated its position as the poorest EU economy.⁵⁰ The economic and financial policies were undergoing a cardinal shift in thinking and stances. The initially valid belief that a too excessive borrowing gave rise to additional costs, hence undermining the welfare of population, had gradually given place to policymakers' firm conviction that it was an increased budget deficit that promoted people's welfare.

The government financed the budget deficit that was building up as a result of this policy primarily with funds borrowed from the Latvian banks, yet the internal government debt remained at a rather low level, with its ratio to GDP among the smallest in the EU. Bank lending to the government also drove the expansion of market share. Supported by the strong domestic demand, the interest rates on government debt securities declined, and the budget deficit financing became easier. Apparently, the government took it for an assertion of rising financial market confidence in its fiscal policy, as substantial changes in the latter were not made, and budget continued to post a deficit (see Chart 31).

Chart 31. LATVIAN GOVERNMENT DEBT, BUDGET DEFICIT AND YIELDS ON GOVERNMENT BONDS (2000–2004; % of GDP)



Sources: Eurostat and Treasury.

CONCLUSIONS

Overall, Latvia's cessation from the USSR and the exit from the Russian ruble zone were effective, as was the change-over to the national currency, the lats; the price stabilisation goal set at the start of the reform process was achieved with no time to waste. Key measures supporting macroeconomic stability were the tight budget policy implemented by the government and the Bank of Latvia's relatively prompt disengagement from the inflation-boosting influence of the USSR and the Russian ruble, stabilisation of national currency's exchange rate and restricted lending to banks via raised interest rates on lending.

Improvements in the macroeconomic situation of Latvia did not bring about the anticipated rapid economic growth, and in 1995–2000, the economic development was rather unbalanced, with the banking crisis of 1995 and the Russian financial crisis of 1998 as the key drivers behind it.

Prior to Latvia's accession to the EU, its economic growth indicators had been good, yet, at the same time, first surfacing indications suggested that without preventive measures the country's macroeconomic situation could deteriorate over time and economic overheating (excessive economic growth followed by similarly sharp drop in economic activity) might occur. First differences in policymakers' views were also spreading: until the end of the 20th century, the policy focus had firmly been on macroeconomic stability in the country, whereas with the EU accession term approaching, the fiscal policy focused increasingly on attaining an ever faster economic growth, leaving macroeconomic stability concerns to monetary policy. However, with the arrival of foreign banks in Latvia, the need for resorting to the central bank's financing and, hence, also the efficiency of the Bank of Latvia monetary policy instruments dropped markedly.

The economic growth in Latvia became increasingly dependent on international financial capital flows and their continuity. Major risks to the economy were associated with eventual and substantial contraction or even termination of cross-border financial flows, which could markedly encumber further activities of the government and private sector. Such a possibility, however, seemed small enough in the light of experience acquired since the regaining of independence, as capital inflows in Latvia during all previous periods had rather been growing on a regular basis. The presence of Scandinavian banks in the region was an additional soothing factor, because these banks had faced an economic crisis in the 1990s, were likely to have learned lessons from it and thus in the position not to commit serious blunders in Latvia. Such hopes, alas, proved delusive and vain.

ENDNOTES

¹ BLA, BLF, descr. 11, f. 14, p. 2.

² Ibid., pp. 3 and 5.

³ Ibid., p. 14.

⁴ Ibid., f. 15, p. 8.

⁵ Ibid., p. 7.

⁶ *List of Members* [cited 27.05.2012]. Available: <http://www.imf.org/external/np/sec/memdir/memdate.htm>.

⁷ BLA, BLF, descr. 11, f. 15, p. 7.

⁸ Tarr, D. G. *How Moving to World Prices Affects the Terms of Trade in 15 Countries of the Former Soviet Union*. World Bank Policy Research Working Paper No. 1074, January 1993, p. 28.

⁹ Ibid., p. 17.

¹⁰ World Bank World Development Indicators Database. Available: <http://data.worldbank.org/data-catalog/world-development-indicators>.

¹¹ The development of military industrial complex played an important part as well, yet due to the lack of data quality analysis is impossible.

¹² *Latvijas Republikas Augstākās Padomes un Valdības Ziņotājs*. Nr. 3/4, 1991, 31. janv., 109.–112. lpp.

¹³ Ibid., Nr. 35/36, 1991, 12. sept., 1662. lpp.

¹⁴ Ibid., Nr. 42, 1991, 24. okt., 2048.–2054. lpp.

¹⁵ Ibid., Nr. 15/16, 1991, 25. apr., 571. lpp.

¹⁶ *Latvijas PSR Augstākās Padomes un Valdības Ziņotājs*. Nr. 12, 1990, 22. marts, 701. lpp.

¹⁷ Zelgalvis, E., Zelgalve, E. Nauda, bankas, finanses. *No: Sociālekonomiskā procesa trajektorija Latvijā no 1985. līdz 2002. gadam. Kur tā ved Latviju?* Zinātnisks pētījums. Ventspils: Ventspils Augstskola, 2002, 162. lpp.

¹⁸ *Latvijas PSR Augstākās Padomes un Valdības Ziņotājs*. Nr. 12, 1990, 22. marts, 700. lpp.

¹⁹ *Latvijas Republikas Augstākās Padomes un Valdības Ziņotājs*. Nr. 34, 1990, 23. aug., 1735. lpp.

²⁰ Ibid.

²¹ Ibid., 1736. lpp.

²² Ibid., Nr. 22/23, 1992, 4. jūn., 12. lpp.

²³ BLA, BLF, descr. 11, f. 4, p. 21.

²⁴ Ibid., f. 15, p. 9.

²⁵ *Latvijas Republikas Augstākās Padomes un Valdības Ziņotājs*. Nr. 22/23, 1992, 4. jūn., 1175. lpp.

²⁶ *Latvijas Vēstnesis*. Nr. 331/332, 1998, 4. nov., 2. lpp.

²⁷ Alesina, A., Summers, L. H. Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence. *Journal of Money, Credit and Banking*, vol. 25, No. 2, 1993, pp. 151–162.

²⁸ According to the intergovernmental agreement, Latvia had to pass over to Russia all Russian rubles it possessed in cash without any recompense (gratis). Hence in general, it was even convenient for the Bank of Latvia and the Latvian government that the population and enterprises in Latvia opted for Russian rubles when in the initial period of parallel circulation of the two currencies they were free to do so; as a result, the

Bank of Latvia worthless reserves of non-convertible currencies shrank. This fact is directly related to the so-called "case of carriages" when a Latvian enterprise chose to finance its import operations with Russia in cash in Russian rubles. The scope of operations and the fact that payment was made in cash, arouse strong public response and various speculations. Nevertheless, everything was legitimate, as taking cash out of the country had been approved by Latvia's Customs Administration. Furthermore, the reduction of Bank of Latvia non-convertible currency reserves was a better deal for Latvia than the alternative to provide the needed amount of cash in Latvian rubles to be afterwards converted into another convertible foreign currency. The amount of Latvian rubles corresponding to the amount of Russian rubles was already in circulation; hence the assertion about their material significance for Latvia is not true.

²⁹ BLA, BLF, descr. 1, f. 4, p. 22.

³⁰ *Bank of Latvia: Annual Report 1993*. Riga: Bank of Latvia, 1994, p. 54.

³¹ For instance, initially in 1990, the capital requirement in Latvia was set at only 5 million USSR rubles, which was a rather small amount; in addition, its value was constantly depreciating due to steeply rising inflation. Although capital requirements in Latvia increased over time, they were still quite liberal.

³² Osis, U., Šteinbuka, I. *Latvijas Republikas Finanšu tirgus un banku sistēmas attīstība*. Konceptija. Rīga, 1992, 26. okt., 3. lpp.

³³ *Latvijas Vēstnesis*. Nr. 163, 1995, 24. okt., 5. lpp.

³⁴ Osis, U., Šteinbuka, I. *Latvijas Republikas Finanšu tirgus un banku sistēmas attīstība*. Konceptija. Rīga, 1992, 26. okt., 20. lpp.

³⁵ www.fktk.lv/statistika/arhivs/banku_statistika_no_1994_gada/.

³⁶ *Credit Institutions Supervision Department: Annual Report 1999*. Riga: Bank of Latvia, 2000, p. 28.

³⁷ Speech of Bank of Latvia Governor E. Repše at the extraordinary session of the 5th Saeima of the Republic of Latvia on 19 May 1995. Available: http://www.saeima.lv/steno/st_955/st1905.html.

³⁸ *Latvijas Vēstnesis*. Nr. 163, 1995, 24. okt., 5. lpp.

³⁹ Bank of Latvia Annual Reports 1994, 1995 and 1996.

⁴⁰ To implement the restructuring of RKB, in August 1999, a Bank of Latvia's non-profit organisation *Rīgas Komerčbankas rehabilitācijas aģentūra*, Ltd. was set up and obtained 6.6% of RKB share capital at 15.5 million lats cost. In May 2000, this Bank of Latvia's daughter company disposed of its investment in RKB share capital, but in December 2000, taking into account that it had achieved its goal, *Rīgas Komerčbankas rehabilitācijas aģentūra*, Ltd. was liquidated. (Sources: *Bank of Latvia: Annual Report 1999*. Riga: Bank of Latvia, 2000, p. 53; *Bank of Latvia: Annual Report 2000*. Riga: Bank of Latvia, 2001, p. 50).

⁴¹ See, for example, Струт, Андрей. Экономические "страшилки". *Час*, № 236, 1998, 12 окт., с. 3.

⁴² *Latvijas Vēstnesis*. Nr. 162, 1998, 3. jūn., 2. lpp.

⁴³ *Bank of Latvia: Annual Report 1998*. Riga: Bank of Latvia, 1999, p. 29.

⁴⁴ *Credit Institutions Supervision Department: Annual Report 2000*. Riga: Bank of Latvia, 2001, p. 27.

⁴⁵ *SEB Annual Accounts 2004*. Press Release, Stockholm, 9 February 2005, 4. Available: <http://www.seb.ee/files/aruanded/SEB2004report.pdf>; *Swedish FöreningsSparbanken AB (Swedbank) Annual Report 2004*, p. 9. Available: http://www.swedbank.com/idc/groups/public/@i/@sbg/@gs/@ir/documents/financial/fa_100100.pdf.

⁴⁶ *Latvijas Vēstnesis*. Nr. 230/232, 2000, 20. jūn., 2. lpp.

⁴⁷ *Members and Observers. WTO Membership*. Available: http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm.

⁴⁸ *Financial System Stability Assessment. Republic of Latvia. December 28, 2001*. IMF Country Report No. 02/67. Available: <http://www.imf.org/external/pubs/ft/scr/2002/cr0267.pdf>.

⁴⁹ Bank of Latvia survey results.

⁵⁰ When joining the EU in 2004, Latvia's per capita GDP accounted only for 44% of the EU average in terms of purchasing power parity (i.e. based on relatively lower general price level in Latvia) or 21% of the EU average income in nominal terms. (Source: Eurostat. Available: http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_gdp_c&lang=en.)

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INTRODUCTION

With the Supreme Soviet of the Latvian SSR adopting the Declaration On the Restoration of Independence of the Republic of Latvia on 4 May 1990, a period of national rebirth set in, during which the country was transformed from a centrally planned economy to a market economy; this transition also entailed an exit from the economic space of the USSR and an ever deeper involvement in the economic and financial system of Western Europe.

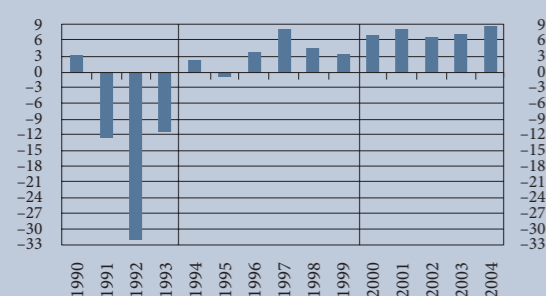
Similar to Latvia, the neighbouring Estonia and Lithuania departed from the planned economy rather fast and at an early stage; the majority of other former USSR republics followed the suit, albeit at a somewhat slower pace. The further 20-year-long history of economic development of some "dinosaurs" that were still kept captive in the planned economy proved that the transition to market economy had been the right option. Despite recent economic difficulties and remaining challenges and notwithstanding the depth of the latest economic crisis in Latvia, the way of economic transformation had been chosen correctly.

The phase of economic transformation concluded with Latvia's accession to the EU on 1 May 2004. This 15-year period can be conditionally divided into three stages characterised by quite different economic growth trends (see Chart 1).

The period between 1990 and 1993 was marked by inflation surging to the level of hyperinflation and the economic downturn reducing the economic activity by almost one third in 1992. In 1994–1999, macroeconomic stabilisation of the economy took place, thereby triggering a return to economic growth, with the reforms initiated and launched at that time laying the foundation for the economy for many years to come. However, the banking crisis of 1995 and the Russian financial crisis of 1998 hampered the implementation of country's economic potential.

In 2000–2004, when Latvia was getting ready for the EU accession, a gradual harmonisation of economic and legislative frameworks with the EU requirements was under way. With confidence in irreversibility of the reform process strengthening, the inflow of investment in the economy increased and enabled Latvia to fully manifest its economic potential. This period of economic growth has been the most important development phase in the history of renewed Latvia so far.

Chart 1. RATE OF CHANGES IN LATVIA'S REAL GDP (%)



Source: CSB.

TRANSITION FROM PLANNED TO MARKET ECONOMY (1990-1993)

Following the declaration of independent statehood, the task of comprehensive transformation of country's economic system, i.e. discarding the administratively centralised state management of national economy and introducing a market-mechanism-based economic system, was vested in the newly established Council of Ministers. The most important reforms envisaged price liberalisation, the establishment of a private sector, the reduction and eventual discontinuation of state budget subsidies to enterprises, relaxing restrictions on foreign trade and financial flows, the creation of a national currency system, including a two-tier banking system, and the operation of a viable central bank. Such reforms were to be launched in the circumstances when the legislative framework of the new country was practically non-existent or did not operate, the economic relations with former USSR republics loosened rapidly, and the formation of new economic ties took some time. The needed economic transformations were so comprehensive in scope and depth that their implementation, if attempted by the country on its own, would last unnecessarily long.

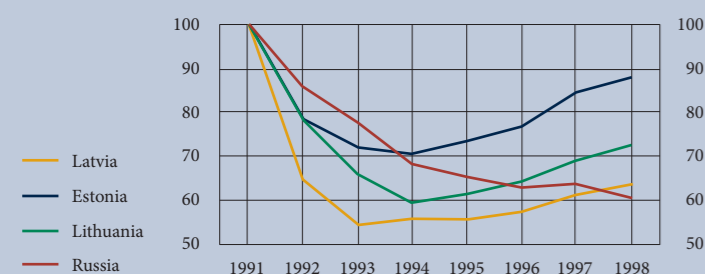
Therefore, on 19 September 1991, the government of Latvia applied for IMF membership, and, on 30 September 1991, the IMF informed Latvia about the commencement of entry negotiations with Latvia.¹ The first IMF mission under mission chief Leif Hansen arrived in Latvia on 10 November 1991.² The ability of a country's central bank to comply with the IMF rules and to implement best practices of central bank operation is an essential precondition for IMF membership; hence, on 25 November 1991, the first mission of the IMF Central Bank Department under Erik Niepoort began assessing the performance of the Bank of Latvia.³ The mission comprised staff members of Nordic central banks. Statistics and monetary analysis, foreign currency operations, accounting and payment systems were the priority areas of central bank's operation, which had to be improved by the Bank of Latvia to become a full-fledged central bank.⁴ The IMF entry process was a challenge for both the Bank of Latvia and the IMF staff: the former had to get an insight into the IMF requirements and operational framework, while the latter had to grasp statistics of the planned economy and its compatibility with the analysis of market economy processes. In general, the smooth procedure of the IMF accession process enabled to plan its accomplishment in the first half of 1992.⁵ On 19 May 1992, Latvia gained IMF membership⁶, which opened up fund borrowing opportunities for Latvia to pursue the needed reforms and to apply for IMF's technical assistance; it, likewise, demonstrated to the world the irreversibility of reform process and feasibility of investment in Latvia. Latvia accepted the proposal to join the Nordic-Baltic Constituency to represent Latvia's interests in the IMF administration.⁷

With a comprehensive shift in the system of ownership rights, the country's foreign trade system underwent the most profound changes. The republics of the former USSR had mainly traded with each other. According to the World Bank data, Latvia's exports to former USSR republics accounted for 95.7% of the total in 1990, while its imports from them constituted 83.5% of the total.⁸ The trade flows were, however, administratively regulated, and export and import prices largely differed from those of free market. This referred particularly to the prices of energy and other resources, which were notably lower than in the global market. This opened up industrial production opportunities in those USSR republics, including also Baltic States, where energy and other resources were scanty.

Meanwhile, when these countries regained their independence, the foreign trade regime also changed. The prices of imported resources and energy were in line with global market prices, thus rendering many small and formerly effective production units, which had depended on the low resources prices, non-competitive in export markets. Consequently, liberalisation of foreign trade flows brought about substantial price fluctuations adversely affecting the economic development. Thus, for instance, according to the World Bank estimates, the losses of the Baltic States due to transition from the former USSR trade and pricing system to market economy and prices were among the heaviest in the republics of the former USSR. Latvia's losses from the shift in terms of foreign trade accounted for more than 11% of GDP in 1990 (slightly below 10% in Lithuania and almost 13% in Estonia)⁹. By contrast, in Russia, which ranked among energy and resources exporters, the transition to market prices resulted in substantial gains (around 18% of GDP). Moreover, following the demise of the USSR, export and import relationships among enterprises had to be created practically from zero, because in the USSR a special institution had been responsible for foreign trade and the companies often were not aware of the purchasers of their output. Thus it is the liberalisation of foreign trade and the subsequent price changes that were responsible, to a large extent, for a more dramatic GDP decline in the Baltic States than elsewhere (see Chart 2).

Meanwhile, the differences in terms of decelerating economic activity among the Baltic States can be explained, to a large extent, by their contrasting economic structures inside the USSR. Unlike Lithuania, the Latvian economy was more focused on industrial production, including the performance of large all-union-scale factories (e.g. the State Electrotechnical Factory VEF, the Riga Semiconductor Factory Alfa, the Radiotehnika Factory, the Riga Carriage Building Plant, etc.). In 1990 overall, VAT from industrial output of Latvia contributed 34% to GDP, whereas the figures for Lithuania and Estonia were 21% and

Chart 2. REAL GDP INDEX (1990 = 100) IN THE BALTIC STATES AND RUSSIA



Sources: CSB and Havrylyshyn, O., Wolf, T., Berengaut, J. et al. Growth Experience in Transition Countries 1990–98. IMF Occasional Paper, No. 184, Washington DC, April 2000.

Table 1. ECONOMIC REFORM INDEX IN THE BALTIC STATES AND RUSSIA

	1990	1991	1992	1993	1994
Latvia	0.13	0.29	0.51	0.67	0.71
Lithuania	0.13	0.33	0.55	0.78	0.79
Estonia	0.20	0.32	0.64	0.81	0.83
Russia	0.04	0.10	0.49	0.59	0.67
Price liberalisation					
Latvia	0.25	0.42	0.67	0.75	0.75
Lithuania	0.25	0.42	0.67	0.75	0.75
Estonia	0.25	0.42	0.75	0.75	0.75
Russia	0.00	0.08	0.5	0.58	0.75
Emergence of private sector					
Latvia	0.10	0.20	0.30	0.40	0.63
Lithuania	0.10	0.30	0.40	0.60	0.75
Estonia	0.20	0.20	0.40	0.60	0.81
Russia	0.10	0.10	0.40	0.50	0.63
Trade liberalisation					
Latvia	0.0	0.2	0.5	0.8	1.0
Lithuania	0.0	0.2	0.5	0.9	1.0
Estonia	0.1	0.3	0.7	1.0	1.0
Russia	0.0	0.1	0.5	0.6	0.8

Source: Havrylyshyn, O., Wolf, T., Berengaut, J. et al. Growth Experience in Transition Countries 1990–98. IMF Occasional Paper, No. 184, Washington DC, April 2000.

42% respectively.¹⁰ Hence, in the years of soviet rule, Latvia managed to attain one of the highest welfare levels in the former USSR. However, in the context of liberalisation of the economy, the predominance of industrial production was a significant factor contributing to deceleration in Latvia's economic activity, particularly so because industrial production was hit by price liberalisation effects more than other sectors.¹¹

The pace of the economic reform process was also affecting the growth in the republics of the former USSR. According to an IMF research paper, Estonia excelled in the highest speed of economic reform process, while Latvia lagged behind Lithuania and Estonia in terms of privatisation and trade liberalisation (see Table 1). This may also underpin relatively poorer growth indicators of the Latvian economy.

In general, the Baltic countries ranked among the most active reformers of the former USSR. To some extent, it was determined by a rather limited set of alternative policies. With the transition to a market-mechanisms-based economic model, macroeconomic stability had to be achieved: without it, the economic decline could not be stopped and growth recovery commenced; in addition, a sooner return to the West European economic space was highly desirable for political reasons as well. Along with the strong fall in domestic activity, the sharply strengthening inflationary pressures that were a direct consequence of the extensive printing of money gave rise to the most serious macroeconomic problem. As such practically uncontrolled monetary expansion was triggered mainly by the need to finance government spending, one of the priority tasks of the renewed Latvia's government, along with the re-establishment of the lats, was the pursuit of fiscal discipline. Therefore, as early as January 1991, Latvia launched its own tax system and prepared its national budget independently of the USSR, notwithstanding the fact that the ruble of the USSR was still in circulation in the territory of Latvia.

The Law of 28 December 1990 "On Taxes and Fees in the Republic of Latvia"¹² established the basic principles of determining taxes and fees, among them types of taxes and fees, taxable objects, taxpayers, liability for tax law violations, dispute settlement procedure as well as basic principles of drafting specific tax laws. The law stipulated that, irrespective of the form of ownership, all legal entities and natural persons engaged in economic activities and doing business in the territory of Latvia should pay taxes and fees. However, not all enterprises operating in Latvia paid taxes to the state budget. Several companies of all-union significance, located in Latvia but directly subject to various USSR institutions, continued to transfer tax payments to Moscow. This problem was resolved on 24 August 1991 when the Supreme Council of the Republic of Latvia

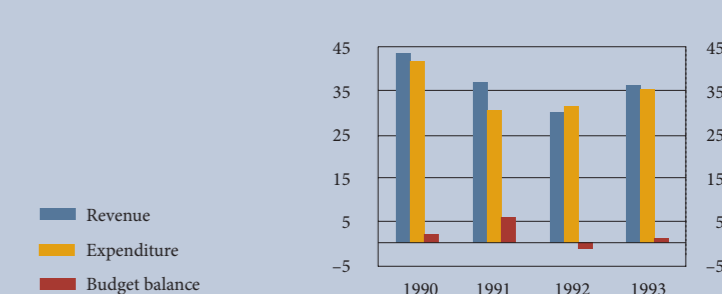
passed the decision "On the Economic Basis for the Sovereignty of Latvia"¹³ which according to the Constitutional Law "On the Statehood of the Republic of Latvia"¹⁴ stipulated that all enterprises and other civil objects located or registered in Latvia and formerly in all-union subordination should come under Latvia's jurisdiction as property of the State of Latvia, if not otherwise stipulated in intergovernmental agreements.

Like the other Baltic States, Latvia was net creditor to the USSR state budget, paying more money to the budget than drawing from it, therefore with the independent budget and discontinuation of payments to the USSR state budget, Latvia's state budget recorded a sizable surplus. Thus, for instance, in 1991, the budget surplus was more than 6% of GDP. It provided a very useful reserve cushion and helped avoid large budget deficits even amid the significant drop in the economic activity, thus alleviating economic stabilisation efforts of the government (see Chart 3).

Taking into account the need for expanding foreign currency circulation and creating a foreign exchange market, the Resolution passed on 29 November 1990 by the Supreme Council of the Republic of Latvia "On Measures for Creating Foreign Exchange Market of the Republic of Latvia"¹⁵ played a crucial role. It stipulated that all legal entities and natural persons in Latvia can possess foreign currency, and free circulation of foreign currency in Latvia became legal as of 1 January 1991. By this resolution, foreign exchange operations, i.e. buying and selling foreign currencies, were accepted as a type of business, and market exchange rates were used in these transactions. Meanwhile, the Bank of Latvia was vested with the task to set average exchange rates on the basis of foreign exchange buying (bid) and selling (ask) rates quoted for the previous day by institutions engaged in foreign exchange. At the same time, legal entities – parties in foreign economic relations – were allowed to pay a part of their staff salaries in foreign currencies earned via their foreign economic activities. The said resolution largely legalised the foreign currency circulation in Latvia, at the same time promoting external economic relations and the inflow of foreign currency into Latvia from less liberal neighbouring countries.

However, the introduction of the national currency remained the priority of macroeconomic stabilisation, for the USSR ruble emissions could not ensure immediate normalisation of the situation. A precondition for the attainment of this goal was a currency-issuing bank that would be independent of the USSR. The origins of the restoration of the Bank of Latvia operation go back to the initial days of awakening, and the passing of the Law "On Banks"¹⁶ by the Supreme Soviet of the Latvian SSR on 2 March 1990 was an important attainment towards an independent economic system of Latvia and the restoration of the Bank of Latvia operation.¹⁷

Chart 3. LATVIA'S STATE BUDGET REVENUE, EXPENDITURE AND BALANCE (1990–1993; % of GDP)



Source: Valdivieso, L. M. Macroeconomic Developments in the Baltics, Russia, and Other Countries of the Former Soviet Union, 1992–1997. IMF Occasional Paper, No. 175, Washington DC, January 1999.



By this law, the function of banking supervision and control was vested in the Bank of Latvia. Along with the currency issuing function, the Bank of Latvia continued to meet its obligations of financing the economy. Restricted money supply amid macroeconomic stabilisation contradicted the central bank's function of providing financing to the economy, which, in turn, required an increase in money supply. On 2 March 1990, the Supreme Soviet of the Latvian SSR passed also the Resolution "On the Bank of Latvia"¹⁸, which stipulated the establishing of a central bank of the Latvian SSR and giving it an official name of *Latvijas Banka*. As the USSR ruble was sole legal tender in circulation in Latvia, an independent policy of currency issuance was not feasible, and the Bank of Latvia did not actually commence operation as issuing bank.

As the legislation passed on the central bank of Latvia was perceived a temporary solution unsustainable to serve for longer-term economic needs of the country, its improvement went on. As early as 31 July 1990, the Supreme Council of the Republic of Latvia adopted the Law "On Amendments to the Law of the Latvian SSR "On Banks"¹⁹ and the Resolution "On the Establishment of the Bank of Latvia"²⁰, and also approved the Regulation "On the Bank of Latvia"²¹. The amendments to the Law "On Banks" specified that the Bank of Latvia was an independent state bank, with its operation regulated by the Law "On the Bank of Latvia" (prior to the enactment of this law, the said Regulation was in force).

The Supreme Council of the Republic of Latvia passed the Law "On the Bank of Latvia" on 19 May 1992²², and it differed substantially from the legislation regulating central bank operation in the USSR times or in the 1920s and 1930s of independent Latvia (see Box 1). In fact, this new legislative act, both in terms of style and content, followed the pattern of the respective regulatory framework of *Deutsche Bundesbank*, because the latter provided technical assistance to the Bank of Latvia in its efforts to improve the legislative framework.²³ In addition, the IMF experts also voiced their opinion about the draft of the Law "On the Bank of Latvia".²⁴ This enabled Latvia to follow the best world practices in central banking and implementation of monetary policy from the very outset of the reform process. By the Law "On the Bank of Latvia", a number of so far unprecedented practical elements were introduced in public administration which notably contributed to achieving macroeconomic stability in the country in the years to come.

First, the Law "On the Bank of Latvia" detached the function of issuing currency from that of commercial banking, defining the maintenance of price stability, attainable through an independent monetary policy, as the priority goal of the Bank of Latvia. In such a way, the responsibility areas were distinctly

separated, with the Bank of Latvia being vested with the responsibility for price stability, leaving the economic development to the government. Formerly the vesting of the two objectives in the central currency-issuing bank had resulted in an excessive issuance of currency; hence this strict distinction between the two functions was the most significant and most substantial effect of this law. Those structural units of the Bank of Latvia which were engaged in commercial banking had to be restructured into independent credit institutions by the end of 1992.²⁵

Second, for the Bank of Latvia to operate as an effective currency-issuing state bank, it had to be saved from the influence of politicians who focused on achieving short-term goals that could pose risks to sustainable development of the country over longer horizons. That is why the Law "On the Bank of Latvia" imposed substantial binding restrictions on the Bank of Latvia's direct financing to government operations (with a complete ban by 1998²⁶); it, likewise, ruled that the Bank of Latvia should neither seek nor take instructions from the government and should not be subject to government decisions. The law strengthened the financial, institutional and operational independence of the Bank of Latvia, with the new provisions differing cardinally from the previous practice in all these areas. It was supported by the fact that the Bank of Latvia could use the experience of *Deutsche Bundesbank*, which was ranked among the most independent central banks of the world.²⁷

Commencing its operation in the new status, the Bank of Latvia faced a major problem of dual circulation: along with the Latvian ruble put into circulation as an official currency a couple of weeks prior to the adoption of the Law "On the Bank of Latvia" (as of 7 May 1992), the banknotes of the USSR ruble, i.e. money notes of the USSR State Bank, were also in circulation. This dual circulation practically rendered invalid the pursuit of Latvia's law-stipulated monetary policy and the control over the amount of currency in circulation, as the USSR rubles were replaced in Latvia at a rate 1 : 1. As long as the conversion rate remained unchanged, the Bank of Latvia had no control over the money supply in Latvia.

With the pace of currency issuance in Russia and other republics of the former USSR accelerating in an uncontrolled manner, the massive money flows from the ruble zone countries also triggered a rise in the issued amounts of Latvian ruble, which brought about a steep escalation of inflation in Latvia (to almost 1 000% in 1992). With the aim to prevent the money supply from growing uncontrollably in Latvia, the Latvian ruble was declared sole legal tender as of 20 July 1992, special correspondent accounts were opened for all settlements with the republics of the former USSR as of 24 July, the fund transfer across

these accounts was banned on 4 August, but the exchange of the Latvian ruble against the Russian ruble at rate 1 : 1 was discontinued on 7 August 1992. In setting the exchange rate of the Latvian ruble against the currencies of republics of the former USSR, the Bank of Latvia used the exchange rates of these currencies against the US dollar. The rate of the Russian ruble as a foreign currency was first set by the Bank of Latvia for the period from 27 July to 2 August 1992. Initially, the rate was 1 : 1, yet, already on 17 August, the Russian ruble was equal to 0.9 Latvian rubles and rapidly continued to depreciate with every coming month afterwards, to stabilise at slightly below 0.4 Russian rubles per 1 Latvian ruble in November–December (see Chart 4).

However, these measures did not stop money inflows from the republics of the former USSR. In contrast to Latvia and the other Baltic countries where the national currencies were freely convertible against the US dollar and other "hard" currencies, free currency conversion was practically non-existent in the remaining part of republics of the former USSR. Consequently, the official exchange rate of these currencies against the US dollar used by the Bank of Latvia in setting the respective rates against the Latvian ruble, with the former rate starting to depreciate after the Latvian ruble was allowed to float, still did not mirror their real market value (which actually was much more below the officially set rate). On the other hand, the possibility to exchange such rapidly depreciating Russian rubles for Latvian rubles and afterwards to freely exchange these "soft" currencies for "hard" foreign currencies was in fact a legal way to get rid of the amassed worthless non-convertible rubles, easily transforming them into convertible foreign currency reserves. Taking into account the continuous depreciation of such soft (or non-convertible) currencies and the inconsistency between official and actual exchange rates, this strategy earned additional profit for businesses with access to credit resources in Russian rubles and other non-convertible currencies. Hence it is not surprising that even after the revoking of fixed rate of 1 : 1 in Latvia at the close of 1992, a substantial inflow of Russian rubles continued, and the Bank of Latvia kept on exchanging them for Latvian rubles (see Chart 5).

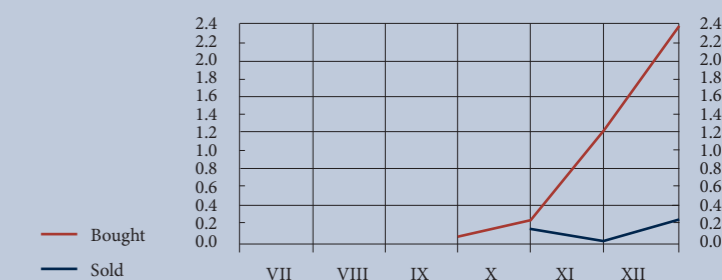
As a result, the Bank of Latvia incurred several problems. First, due to free exchange of non-convertible currencies, the amount of Latvian rubles in circulation continued to rise rapidly, while inflationary pressures did not ease notably enough. Second, because of the dual currency exchange (Russian rubles for Latvian rubles, Latvian rubles for convertible foreign currencies), the Bank of Latvia lost part of its convertible currency reserves, instead of which stocks of non-convertible Russian rubles, not

Chart 4. FOREIGN EXCHANGE RATES SET BY THE BANK OF LATVIA IN 1992 (Latvian rubles per foreign currency unit)



Source: Bank of Latvia.

Chart 5. PURCHASE AND SALE OF RUSSIAN RUBLES BY THE BANK OF LATVIA IN 1992 (millions of SUR)



Source: Bank of Latvia Annual Report 1992.

Box 1

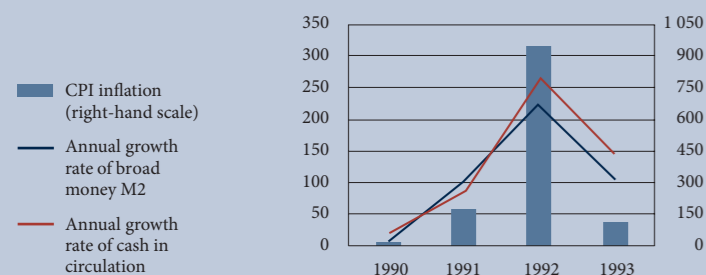
COMPARISON OF CENTRAL BANK STATUTES AND LEGISLATION

Indicators	Bank of Latvia Statutes (edition of 19 September 1922)	USSR State Bank Statutes (edition of 1 September 1988)	Law "On the Bank of Latvia" (edition of 19 May 1992)	Deutsche Bundesbank Law (edition of 22 October 1992)
Goals	Not specified	Ensure centrally planned management of the state currency and credit system.	Control over money supply to maintain price stability in the country.	Maintain price stability
Tasks	Control currency circulation in the country; promote trade, industry and agriculture by issuing short-term credits; alleviate domestic and foreign payment process; conduct state treasury operations.	Organise and control currency circulation in the country; increase purchasing power of ruble; boost lending and settlement efficiency; coordinate banking activities; accumulate budget funds and transfer them to banks to enhance lending; attract deposits.	Issue national currency; set official exchange rates for the national monetary unit against foreign currencies; act as advisory body of the Saeima and Cabinet of Ministers on monetary policy and banking operation policy; organise and ensure the operation of the clearing and payment systems; conduct foreign exchange operations; conduct supervision and audit of other credit institutions; issue licences for foreign currency purchase and sale as business activity; collect, process and publish statistical data.	Execute domestic and international payments; issue national currency; provide advice to the government on most important monetary policy issues.
Foreign exchange regime	Exchange money notes for gold at request, calculating 0.2903226 g pure gold for one lats.	The State Bank sets exchange rates binding on all banks in the territory of the USSR.	The Bank of Latvia sets the official exchange rate for the national monetary unit against foreign currencies.	Not specified.
Currency issuance	Money notes shall be issued in lats, the backing of their full nominal value shall be: 1) for the amount not exceeding 100 million lats – no less than 50% with gold or secure foreign currency, the rest – with secure short-term bills of exchange; 2) for the amount exceeding 100 million lats (to 150 million lats) – 75% with gold or secure currency, 25% – with secure short-term bills of exchange; 3) for the amount exceeding 150 million lats – 100% with gold or foreign currency.	The amount of money issued is determined by the USSR Council of Ministers.	The Bank of Latvia shall be the sole bearer of the right to issue the national currency, banknotes and coins, and these shall be sole legal tender in the country.	The sole issuer of banknotes as sole legal tender in the country. The banknotes of denomination below 10 German marks shall be issued only upon government's consent.
Operations	Discount of bills of exchange and other maturing liabilities; issue credits and short-term loans; accept money deposits and other valuables; buy and sell bills of exchange, foreign currencies and other valuables; execute money transfers; execute various transfers at the expense of state institutions.	Financing of the economy in cooperation with other specialised banks of the USSR. Credit interest rates are set by the USSR State Bank upon the approval of the USSR State Plan and Ministry of Finance. Profit as basic indicator of state bank's business activities.	Opening of accounts for the government of Latvia, foreign banks, international organisations, Latvian banks and other credit institutions; purchase and sale of foreign currencies and precious metals, acceptance of deposits, bank operations and transactions with foreign countries, their central banks, financial institutions and international organisations; issuance of short-term loans to credit institutions, pawn transactions; granting of short-term credit to the government in the amount not exceeding one twelfth of the current budget revenue; operations with securities.	Engage in transactions with banks, other market participants and the government.

Indicators	Bank of Latvia Statutes (edition of 19 September 1922)	USSR State Bank Statutes (edition of 1 September 1988)	Law "On the Bank of Latvia" (edition of 19 May 1992)	Deutsche Bundesbank Law (edition of 22 October 1992)
Bank administration	The Council consists of Chairman, Deputy and 11 members, including a representative of Ministry of Finance. Board consists of chief director, a deputy and 3 directors. Bank's Council and Board are appointed by the Cabinet of Ministers from candidates nominated by the Minister of Finance.	Council chairman (equal status with ministers determined by law), deputies and council members. Council Chairman appointed by the USSR Supreme Council, deputies and council members – by the Council of Ministers. Managers of the USSR State Bank Republican Offices appointed by the Council Chairman of USSR State Bank.	The Council consists of 8 persons: governor, deputy governor and 6 council members. To execute practical work and to ensure efficient management of the Bank of Latvia, the Council of the Bank of Latvia shall establish a permanent Board of the Bank of Latvia consisting of six members. The Governor of the Bank of Latvia is appointed by the Supreme Council of the Republic of Latvia upon the recommendation of the Chairman of the Supreme Council. The Deputy Governor and members of the Council are appointed by the Supreme Council of the Republic of Latvia upon the recommendation of the Governor of the Bank of Latvia. The Chairman of the Board is confirmed in the office by the Council of the Bank of Latvia upon the recommendation of the Governor of the Bank of Latvia. The members of the Board are approved by the Council of the Bank of Latvia upon the recommendation of the Chairman of the Board.	The Council of the Bank comprises the President and Vice-president, the other members of the Directorate and the Presidents of the Land Central Banks. The Directorate is composed of the President, Vice-president and no more than six members. valdība un apstiprina federālais The president of the Bank, Vice-president and the members of the Directorate are recommended by the government and they are approved by the Federal President.
Council members' term of office	3 years	Not specified.	6 years	8 years
Council independence	Bank's Council resolutions are to be submitted to the Minister of Finance who enjoys veto power. If Bank's Council sticks to its decision, the Minister of Finance submits the disputable issue to the Cabinet of Ministers for settling.	The USSR State Bank is subject to the USSR Council of Ministers. Where disputes arise between the Chairman and other Council Members, the Chairman is entitled to implement his own decisions upon giving notice to the Council of Ministers. Council Members can appeal to the Council of Ministers.	In its practical tasks and control activities the Bank of Latvia shall not be subject to the decisions and instructions of the government or its institutions. Meetings of the Bank's Council can be attended by the Minister of Finance of the Republic of Latvia without the right to vote. Where the Minister of Finance objects to the Bank of Latvia Council resolution, he/she is authorised to request a 10-day postponement for the enactment of the resolution; if the Council does not alter its resolution within this period, it shall be implemented. The Bank of Latvia is independent in the adoption of its decisions and their practical implementation.	In its execution of the task prescribed by law the Bank is independent of the government. Members of the government are entitled to attend Bank's Council meetings without the right to vote.

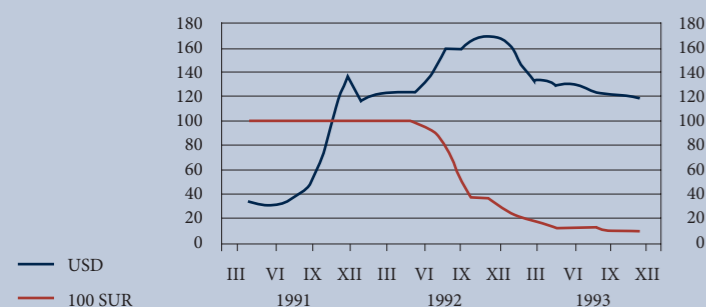
Sources: Valdības Vēstnesis. Nr. 213, 1922, 22. sept., 1. un 2. lpp.; Устав Государственного Банка Союза Советских Социалистических Республик. Утвержден Постановлением Совета Министров СССР от 1 сентября 1988 г., No. 1061; Latvijas Republikas Augstākās Padomes un Valdības Ziņotājs. Nr. 22/23, 1992, 4. jūn., 12. lpp.; Bekanntmachung der Neufassung des Gesetzes über die Deutsche Bundesbank vom 22. Oktober 1992. Available: http://www.bundesbank.de/download/aufgaben/mitteilungen/recht/92_1005.mitteilung.pdf.

Chart 6. CASH ISSUANCE RATE AND INFLATION IN LATVIA (1990-1993; %)



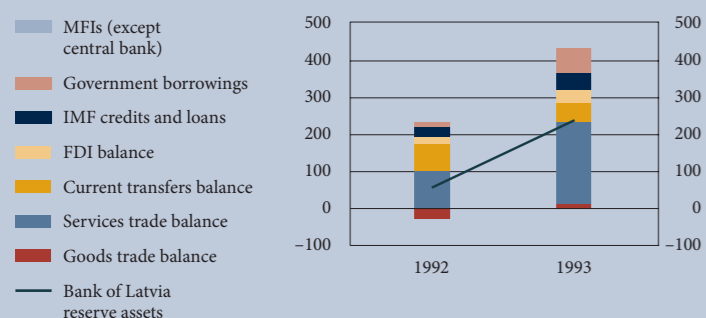
Sources: CSB and Bank of Latvia.

Chart 7. EXCHANGE RATE OF LATVIAN RUBLE AGAINST US DOLLAR AND RUSSIAN RUBLE



Source: Bank of Latvia.

Chart 8. MAIN COMPONENTS OF LATVIA'S BALANCE OF PAYMENTS IN 1992 AND 1993 (millions of lats)



Source: Bank of Latvia.

suitable for the backing of issued Latvian rubles, were piling up, increasing cash storing costs for the Bank of Latvia.²⁸

In order to stabilise the speed at which currency was issued, the Council of the Bank of Latvia made a decision to end the purchase of non-convertible currencies as of 22 January 1993.²⁹ At this juncture, the "umbilical cord" with the monetary system of the former USSR was cut completely, and Latvia could commence the pursuit of really independent monetary policy. With the uncontrollably issued Russian ruble inflows in Latvia and their exchange for Latvian rubles phased out, the excessive issuance of the Latvian rubles also ceased. Accordingly, within a year, the inflation level declined substantially (see Chart 6), thus creating a more benign environment for macroeconomic stabilisation in Latvia.

The strengthening of Latvian ruble against convertible foreign currencies also contributed to disinflation. It was essential for the new currency to gain credibility at an early stage, and the best way of consolidating it was to convince the population and businesses that in the foreseeable future the Latvian ruble would preserve its purchasing power both domestically and vis-à-vis foreign hard currencies. Attempting to consolidate the trust in the Latvian ruble, the Bank of Latvia commenced selling the US dollar to banks at a slightly lower rate than the market rate in September 1992. When the peg of the Latvian ruble to the Russian ruble was abandoned and the money growth decelerated accordingly, the exchange rate of the Latvian ruble against convertible currencies became stable and began to strengthen (see Chart 7).

This nominal appreciation was well-supported by positive dynamics of the balance of payments: the Bank of Latvia's foreign reserves grew substantially, thus enabling the central bank to use them for further strengthening of the national currency via interventions in the foreign exchange market. Due to rapid depreciation of the national currency in the previous years, the value of the Latvia ruble in 1992 and 1993 fell notably below the level that was economically justifiable. On the one hand, it had an upward pressure on inflation, while, on the other hand, the balance of foreign trade in goods and services improved notably (trade balance was also positively affected by the falling income levels). The positive foreign trade balance ensured that inflows of foreign currency in Latvia exceeded outflows. The foreign reserves of the Bank of Latvia were also boosted by Latvia's foreign borrowings (e.g. G24 and IMF loans). Foreign direct investment played a relatively minor role, and bank borrowing from abroad was practically non-existent at that time (see Chart 8).

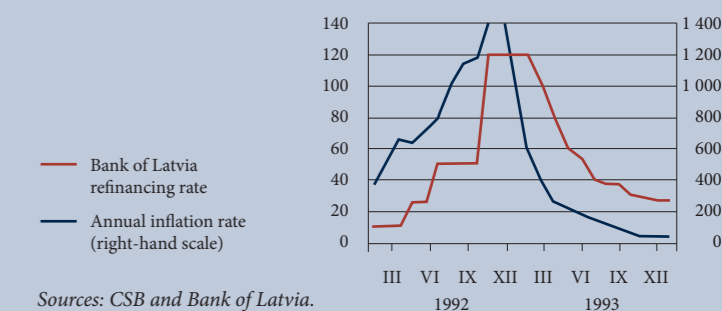
In its efforts to render monetary policy more effective and keep money supply under control, the Bank of Latvia also raised

interest rates on loans to banks. In early 1992, i.e. at the time when the central bank had not yet started real operation, the interest rates applied to bank loans were at a 10% level, although the inflation rate was approaching 400%. Thus the imposed interest rates were not consistent with the economic situation, and Latvia was spared from an even steeper inflation surge only by its weakly developed banking sector. It should be acknowledged, however, that the potential of bank borrowing at such rates was rather limited due to the lack of eligible collateral and other reasons. In order to minimise the possibility of extra amounts of money going into circulation via banks and, consequently, rising inflation, in 1992, the Bank of Latvia started to apply higher interest rates on credits as well, and by the close of the year, its refinancing rate had already amounted to 120% (see Chart 9). When inflation abated, interest rates set by the Bank of Latvia began to act as a brake on lending (see Chart 10). A further decline in inflation in 1993 enabled the Bank of Latvia to lower these rates without threatening price stability.

Overall, the stabilisation of the Latvian ruble vis-à-vis foreign currencies, the restricted money supply and the subsequent easing of inflationary pressures suggest that the inhabitants of Latvia and market participants abroad had begun to trust in the new Latvian money. Consequently, the Latvian ruble had fulfilled its mission of paving the way to the introduction of the lats, a full-fledged national currency unit. The first lats banknotes were put into circulation on 5 March 1993. The exchange rate at which Latvian rubles were exchanged for lats was not of essential macroeconomic importance. The assumption that the real income levels of people in Latvia declined just because of the exchange of Latvian rubles and lats at a rate 200:1 is delusive (see Chart 2).

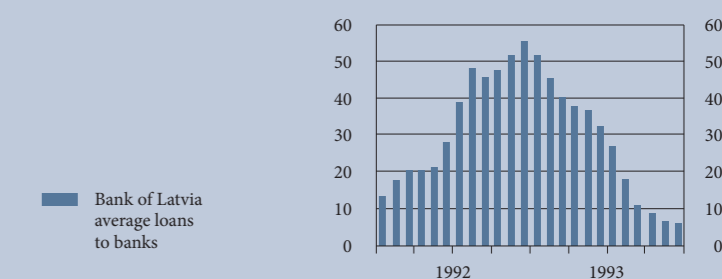
In general, Latvia's exit from the Russian ruble zone and the introduction of national currency unit proceeded successfully and contrary to sometimes gloomy predictions about the collapse of domestic monetary system and the entire economy before long. The goal of price stabilisation was attained in a comparatively short time. It was supported by the independence the central bank enjoyed, fully separating the functions of money issuance and lending to the economy and substantially curbing the possibilities of budget deficit financing with direct central bank loans, and by the effectively implemented monetary reform. Among major measures underpinning macroeconomic stability mention should be made of the tight budget policy of the government, leading to budgets with small deficits or even surpluses, and the actions taken by the Bank of Latvia, e.g. immediate disassociation from the Russian ruble, stabilisation of the national currency and restricted lending to banks via raising interest rates on credit.

Chart 9. ANNUAL INFLATION RATE AND BANK OF LATVIA REFINANCING RATE IN 1992 AND 1993 (%)



Sources: CSB and Bank of Latvia.

Chart 10. BANK OF LATVIA LENDING TO BANKS IN 1992 AND 1993 (millions of lats)



Source: Bank of Latvia.

Box 2

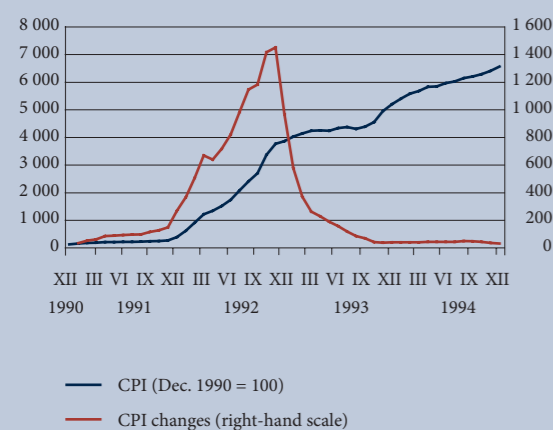
EXCHANGE RATE OF THE LATS (LVL 1 = LVR 200) AND CHANGES IN POPULATION'S PURCHASING POWER

For many people in Latvia, the introduction of the national currency, the lats, was associated with the assumption that, similar to many monetary reforms in soviet times, this one was again launched at the expense of forced reduction of population's purchasing power. This belief is as if reinforced by the fact that the amount of lats exchanged for Latvian rubles at the official rate 1:200 could buy considerably less goods than a similar amount of the USSR rubles some years ago. However, this assumption is deceptive and not true, and blaming the introduction of the lats for the reduced purchasing power of population is likewise wrong.

The actual exchange rate of the lats in no way affected the population's purchasing power, because along with the income denomination at the rate 1 : 200, goods and services prices changed automatically. For instance, if prior to the introduction of the lats a loaf of bread cost 20 Latvian rubles and 200 Latvian rubles could buy 10 such loafs, after the changeover to the lats the price of bread automatically dropped to 10 santims (20 LVR/200 = LVL 0.10) and the equivalent of 200 Latvian rubles or 1 lats could again buy 10 loafs of bread, i.e. exactly the same amount as before the money reform.

The significant loss of the purchasing power of the national currency and the subsequent, almost complete loss of people's cash savings in Latvia at the beginning of the 1990s is an undeniable fact. It was driven neither by the Bank of Latvia's monetary policy and the introduction of the lats nor by its exchange rate against the Latvian ruble, but rather by the unreasonable policy of excessive money printing conducted by the Bank of Russia, due to which money supply expanded rapidly, resulting in hyperinflation and dramatic depreciation of currency (see Chart 11).

Chart 11. INFLATION-BASED CURRENCY DEPRECIATION IN LATVIA (1990-1994; %)



Source: CSB.

The results presented in Table 2 show dramatic depreciation of currency due to hyperinflation. Until 20 July 1992, when the Latvian ruble became sole legal tender in Latvia, it was the Bank of Russia that actually implemented monetary policy in Latvia, and the Bank of Latvia did not have any monetary policy instruments to remedy the situation. In 1991, due to an upsurge in inflationary pressures, the currency started to depreciate sharply, and within a year, people's money savings lost 72.4% of their value. The process continued and even intensified in 1992. For instance, in June 1992, the population faced the fact that almost 90% of their previous year's money savings had been lost. This was before the Bank of Latvia commenced implementation of an independent monetary policy. In fact, when such policy was finally launched in July 1992, the monetary savings of the population had been almost completely destroyed by hyperinflation of the previous years: of each 100 USSR rubles saved by the end of 1990 only 4.89 Latvian rubles remained (in terms of real purchasing power). Thus over 95% of the population's cash savings were lost due to money issuances conducted by the Bank of

Russia. With the introduction of the lats in March 1993 and the exchange at the rate above, only 2.37 Latvian rubles remained (in terms of real purchasing power) of each 100 USSR rubles amassed in 1990.

Hence the population's sentiment of those days about their lost cash savings was absolutely reasonable and unbiased. It should be noted, however, that these losses were not caused by the rate at which the lats were exchanged for the Latvian rubles; they were rather a result of the worthlessness of the Latvian ruble due to massive money emissions conducted by the Bank of Russia.

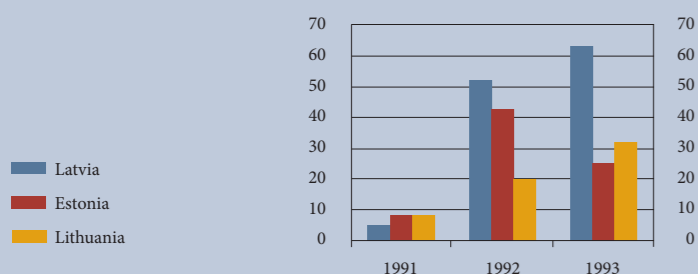
From an objective point of view, the introduction of the lats did not cause a loss of accrued cash but rather decelerated the decline in its value and, hence, helped preserve the value of money that had "survived" during 1991 and 1992. It is confirmed by the fact that in March 1994, i.e. one year after the introduction of the lats, the value of savings made one year earlier were eroded by inflation to a significantly lesser extent than before (by 25.5% against up to an 89.2% loss in previous periods).

Table 2. LOSS OF REAL PURCHASING POWER OF SAVINGS DUE TO PRICE RISES IN 1991-1994

	100 USSR rubles accrued in December 1990		100 currency units (rubles, lats) accrued 12 months ago	
	Purchasing power	Loss of purchasing power since accrual (%)	Purchasing power	Yearly loss of purchasing power (%)
December 1991	27.62	72.4	27.62	72.4
July 1992	4.89	95.1	10.83	89.2
March 1993	2.37	97.6	28.09	71.9
March 1994	1.77	98.2	74.54	25.5

Source: Authors' calculations.

Chart 12. NUMBER OF BANKS IN THE BALTIC STATES (1991-1993)



Source: Berengaut, J., Lopez-Claros, A., Le Gall, F. et al. The Baltic Countries: From Economic Stabilization to EU Accession. IMF Occasional Paper, No. 173, Washington DC, November 1998.

Following the separation from the Bank of Latvia of the commercial banking function and creation of the two-tier banking system, the banking sector began to evolve fast. With some exceptions, e.g. the state JSC *Latvijas Universālā banka* (the Universal Bank of Latvia, established in 1993 on the basis of 21 privatised former branches of the Bank of Latvia) and the specialised state JSC *Latvijas Hipotēku un zemes banka* (Mortgage and Land Bank of Latvia, established in the same year), this evolution was primarily driven by the private sector, (of 15 former Bank of Latvia branches, eight new banks were formed by attracting private capital, while 11 of its former branches were sold at auctions to already operating banks).³⁰ Even though the functions of supervising and auditing banks and other credit institutions were vested in the Bank of Latvia, the legal framework for bank operation was the responsibility of the government and parliament and was drafted in line with the political priorities of those days foreseeing quite liberal attitudes towards banks.³¹

On the one hand, it shortly ignited a buoyant growth of the financial sector but, on the other hand, increased the exposure to various such risks related to the sector's stability which could not be averted by only monitoring the compliance with the requirements of the bank regulatory framework. For instance, in 1992, the report to the government of the Ministry of Finance of the Republic of Latvia openly stated the opinion that "the majority of them [banks] are economically and professionally weak financial institutions"³² with low equity capital levels. To found a bank, the minimum amount of start-up capital was increased to 50 million Latvian rubles in March 1993, but already in May of the same year, this amount was set to 100 thousand

lats in accordance with the Law "On Stock Companies". The latter was amended in 1994, when the minimum start-up capital was increased to 2 million lats, but in 1995, consistently with the provisions under the Law "On Credit Institutions"³³, this amount was raised to ECU 5 million, with a transition period for reaching this level ending at the close of 1999.

Such liberal attitudes to the operation of the banking sector were driven by the government's objective to attain a fast economic growth, which according to all national development scenarios was unthinkable without a banking sector evolving similarly fast. The banking sector development plan prepared by the Ministry of Finance of the Republic of Latvia ranked financial industry groups, i.e. banks that extend credits primarily to the enterprises that simultaneously are their shareholders and large owners, as one of the most effective means of banking: "A new trend has already emerged in Latvia, where a number of commercial banks are closely linked with a certain group of industrial enterprises that often are the founders of these banks. It is particularly pronounced in the private sector, where commercial banks (...) provide financial servicing and investment to a limited circle of businesses (owners). This practice explicitly shows that when the banking capital and management are brought together with the business capital, a financial industry (trade) group, a very strong microeconomic structure, emerges."³⁴

The activities of banks and other financial intermediaries in Latvia intensified fast and buoyantly in a rather short time due to the relatively liberal legal framework and low capital requirements for banks. Moreover, Latvia started to grow as a significant financial centre for interstate settlements of the former USSR republics (spurred by a liberal foreign exchange market and free convertibility of currency). As a result, the number of banks in Latvia grew by leaps, and in 1993 there were over 60 banks, which was more than in Lithuania and Estonia taken together (see Chart 12). Although the pace of the process was consistent with the development of a country on its road to market economy, it amplified risks of a potential crisis at the same time.

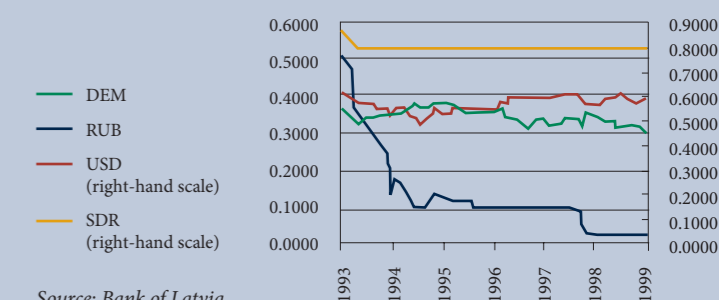
MACROECONOMIC STABILISATION AND CRISES (1994-1999)

As the Latvia's national currency was gaining ever larger confidence locally and among foreign market participants, and with foreign capital coming in the country at a robust rate, the exchange rate of the lats continued to strengthen. This helped the Bank of Latvia meet the price stability goal, as nominal appreciation was conducive to lower inflationary pressures. Furthermore, a stronger lats helped enhance the purchasing power of Latvian population abroad (also providing better opportunities for purchasing foreign-produced equipment and technologies). The rising purchasing power was a factor contributing to better confidence in the national currency, and was in contrast to constantly dropping purchasing power in the years of the soviet economic system. The positive effects apart, this strengthening in national currency made exports from Latvia more expensive and less competitive. That is why the Bank of Latvia resolved in February 1994 that a further strengthening of the lats exchange rate for the purpose of boosting confidence was no longer necessary and pegged the lats to the SDR, the currency unit used by the IMF. The SDR basket of currencies, comprising such important currencies as the US dollar (the main currency for foreign trade settlements with the republics of the former USSR), the German mark (a settlement currency for many trade transactions with countries in Western Europe) and the British pound sterling (the UK, Latvia's third largest export market, for example, received 9.7% of total exports in 1994), was the most suitable structure for Latvia's economic relations. Moreover, the peg to the SDR basket of currencies ensured maintaining and sustaining a stable exchange rate vis-à-vis all major world currencies, because, free fluctuations of these currencies against each other in the global financial market notwithstanding, they were mutually offsetting with respect to the lats: when the US dollar depreciated against the lats, the German mark appreciated, and vice versa (see Chart 13). In such a way, the lats peg to the SDR basket of currencies created favourable conditions for further expanding and bolstering foreign trade relations.

Subsequent developments confirm that the Bank of Latvia's conjecture about further easing of inflationary pressures without currency appreciation was right, as inflation indeed kept declining sharply. It enabled the Bank of Latvia to lower interest rates on loans to banks, which, in turn, had a positive impact on interest rates in the money market, and on loans to non-financial corporations and households (see Chart 14).

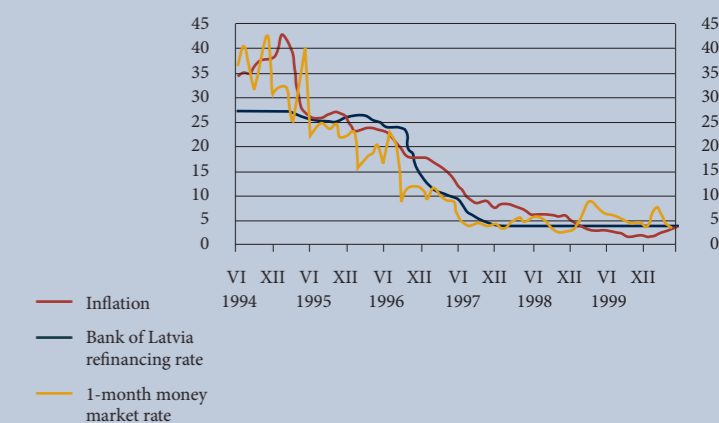
Macroeconomic stability is an important precondition for economic growth; therefore, with the macroeconomic situation in Latvia improving, a rapid economic expansion was anticipated. This did not materialise, however, and, till 2000 at least, the country's economic development was rather unbalanced. The bank-

Chart 13. DYNAMICS OF LATS EXCHANGE RATE (1993-1999)



Source: Bank of Latvia.

Chart 14. BANK OF LATVIA REFINANCING RATE, INFLATION AND MONEY MARKET INTEREST RATE (1994-1999; %)



Sources: CSB and Bank of Latvia.

ing crisis of 1995 and the Russian financial crisis of 1998 played a decisive role.

In 1991-1994, the amount of deposits attracted by banks and the bank assets increased 2-3 times. As alternative investment opportunities were absent, businesses and households placed increasing sums of money into banks (in the second half of 1994, the volume of domestic deposits was close to 500 million lats). Meanwhile, the possibilities for the banks to further invest this money profitably were limited, for the banking sector was growing faster than the real economy.

Latvia quickly and effectively coped with hyperinflation, liberalised the prices and foreign exchange regime, re-oriented foreign trade, restored private property rights and implemented privatisation of small enterprises. In the meantime, adjusting of

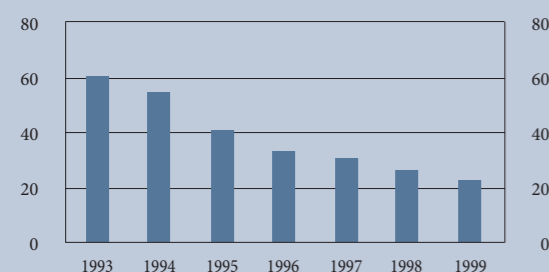
legal and tax frameworks and privatisation of large enterprises were delayed. For all that, the liberal bank licensing framework and foreign exchange policy promoted buoyant development of banks, while the economic reform process lagged substantially behind. It soon became evident that the growth of several banks stemmed from precarious foundations: their assets were unsafely invested and capital artificially boosted via circumvention. The overall loss incurred by banks in 1994 amounted to 7.8 million lats.³⁵

Dubious asset allocation was, in part, associated with the overall economic situation, because creditworthy borrowers with realistic business plans, able to secure a bank loan with collateral and provide guaranties to the bank as well as having a verifiable past credit history were in scanty numbers in Latvia.

Operating efficiency of banks was impaired by the absence of national development strategy, including a structural policy for economic development and a regional policy. The utilisation of most foreign funding also proved inefficient, for instead of industrial growth and investment it went to consumption and budget financing.

At that time, the Bank of Latvia was responsible for the supervision of the banking sector; since regaining independence, it had strived to align the requirements and regulations for Latvian banks with the legal framework existing in West European countries. As the regulatory framework in Latvia was the legacy of the former USSR, which cardinally differed from the banking principles in the market economy, such system had to be developed from scratch. The basic regulations for the operation of banking sector had been approved by the Bank of Latvia by the close of 1994.

Chart 15. NUMBER OF BANKS IN LATVIA (1993–1999)



Source: Bank of Latvia.

The banking crisis of 1995 and its implications

The financial problems of banks aggravated in early 1995. Several banks did not submit their financial statements for 1994 approved by international auditors by the established deadline. Even though insolvency of some banks did not cause a systemic crisis, it adversely affected the operation of other Latvian banks.

In 1995 overall, licenses of 14 banks were revoked.³⁶ JSC *Ban-ka Baltija* undeniably was the largest of them; yet some other banks with their licences cancelled also ranked among the ten top Latvian banks, e.g. JSC *Latvijas Depozītu banka* and JSC *Centra banka*. In general, the number of banks decreased 2.4 times in 1995–1999 (see Chart 15).

The Bank of Latvia's view on the 1995 banking crisis is well-characterised by the statement of E. Repše, the Governor of the Bank of Latvia, at the session of the Saeima (Parliament) of the Republic of Latvia on 19 May 1995: "If due to irresponsibility or by deliberate malicious conduct of bank officials the bank goes bankrupt, both the shareholders who had been urged and forced by the bank management, and the bank administration who have undersigned such transactions – in fact everybody somehow involved in it, shall be called to account. It is quite possible that the legislative framework is not perfect enough to have such proceedings go fast and smoothly. (...) Unfortunately, the Bank of Latvia is not entitled to perform acts in accordance with criminal proceedings, including detention, arrest and examination, under issued warning about liability for giving false testimony, of offenders or suspect persons. (...) The Bank of Latvia did ensure supervision, yet we did not ensure direct and absolute control over the conducted banking operations. Apparently (...), in Latvia's situation it was this absolute control and interference into banking operations that was needed, although, in fact it would not mean the supervision of this bank but rather the managing of it. For sure, it is not done in such a way anywhere in the world. (...) At the Bank of Latvia, there are 30 employees in the Department of Commercial Banking Supervision, and it is enough for normal supervision consistently with the world standards. Apparently, this proportion had to be different, and we had to employ 120 people to allocate 2 officials for permanent job per each of 60 banks who would literally keep a strict eye on bank managers. Of course, dear colleagues, even this would not ensure complete non-vulnerability of the banking sector, for two persons can also prove unable to supervise an operating bank, and there always is an opportunity to conduct financial operations in neighbouring premises, unnoticed, hiding them. We had a good instance with the *Latgales akciju komercbanka*. When upon the termination of this bank's operation the Bank of Latvia team arrived in it simultaneously with a special unit of Ministry of the Interior representatives coming from Riga, and the bank officials

were presented a ban on conducting any transactions, which had been in effect since the morning of that date, and all bank premises and means of communication were taken under control, the officials of this bank, to settle payments of a customer, managed to execute a payment order worth several million US dollars from another telex equipment all the same. Formally speaking, it was forbidden, yet, apparently, the fear of this client and of failing to carry out its order was intense enough for the bank management to violate these explicit prohibitions. You cannot insure against it hundred percent."³⁷

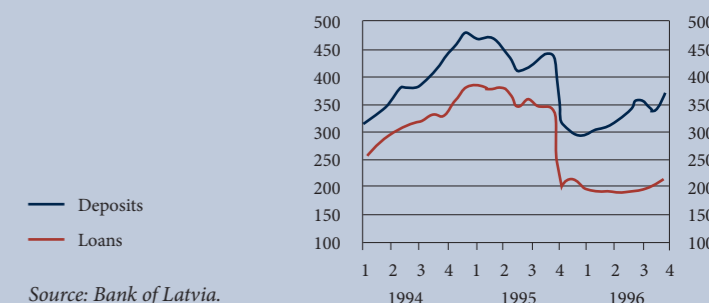
Consequently, the banking problems were not caused by objective factors; in most cases, these causes were subjective and bank-performance-related, among them inefficiency of management, inability to predict the course of developments and to adjust to the circumstances (e.g. long-standing expectations of the lats devaluation, retaining large open foreign exchange positions, wrong interest rate policy, with 90% interest on deposits in the situation of 30% annual inflation). Nevertheless, bank insolvency was most often caused by the activities of dishonest bank staff and deliberate fund squandering to serve personal business interests on behalf of shareholders. Despite such an attitude being typical for the so-called pocket banks, in the 1990s, it spread among large banks in Latvia as well.

The most characteristic negative feature of the 1995 banking crisis was the substantial loss of funds deposited with the failing banks. The amount of blocked assets in distressed banks exceeded 200 million lats or 40% of total attracted deposits. The respective share of households was even higher, because 53% of their bank deposits were affected. A drop in overall bank confidence determined also contractions in deposits with operating banks, yet the outflow of deposits was not disastrous, and in 2–3 months their volumes started to expand again, at first slowly and later gaining momentum, to reach the pre-crisis level in the middle of 1997 (see Chart 16).

The currency composition of deposits changed, too. Prior to the crisis, deposits in lats made up 60% of the total, while in the post-crisis period the respective share had contracted to 45%–50%. The so called dollarisation process was well-characterised by the share of deposits in foreign currencies in total money supply, which from 27% prior to the crisis amounted to 32% after it. Anxiety aroused by the banking crisis and worries how it would evolve further urged inhabitants to invest in short-term money instruments, reflected by shifts in deposit maturity profile. Of all non-bank deposits, the demand deposits, i.e. the most liquid ones, accounted for 61.5% at the end of June and 81.5% in December 1995.

Due to the factors above, in 1995, broad money shrank by 23%, back to the 1994 spring level. Deposits withdrawn from

Chart 16. DYNAMICS OF RESIDENT LOANS AND DEPOSITS (1994–1996; millions of lats)



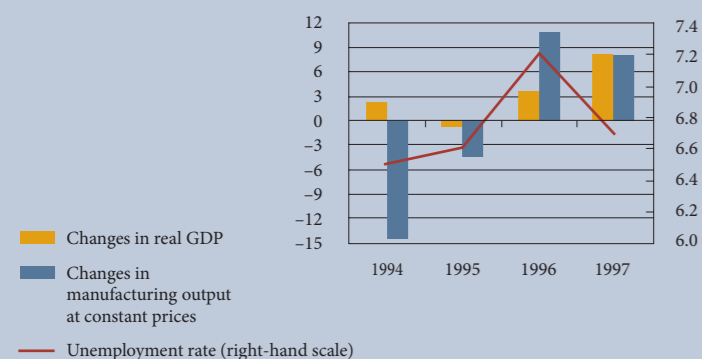
Source: Bank of Latvia.

banks were mostly held by the population in cash (primarily in foreign currencies). As a result, the cash foreign currency component of money supply grew, albeit it was practically impossible to assess its amount accurately. In total money supply, a sharp increase was also recorded for the lats share in currency in circulation (from 31% at the end of 1994 to 40% at the end of 1995). This pointed to the lack of confidence in banks, which, in turn, reduced the basis of available credit resources for the economy and confined its further growth.

When the banks that had survived the crisis started to assess lending-related risks more carefully, the number of financially viable lending projects contracted sharply. That is why, by the end of 1996, the credit portfolio of the Latvian banking sector had not increased overall, despite the observed declining trend in interest rates. Lending to trade fell particularly sharply (by more than 20%), giving also rise to shrinking in the domestic trade turnover. Lending to domestic enterprises and private borrowers went on falling also after the crisis, suggesting that banks were not willing to assume private sector risks but rather preferred to make use of investing in low-risk government securities.

Overall, the implications of the banking crisis for the financial sector were delayed and dispersed. The entire Latvian monetary system was undermined by the termination of operation of several banks. It was due to the weakening confidence in banks and the national currency, on-going dollarisation, outflows of foreign financing, the weakening bank role in financial intermediation, worsening monetary aggregates and strengthening currency in circulation to deposits ratio, contracting private sector deposits, blocked deposits, the narrowing domestic interbank market, shrinking lending, reduced government securities market and rising securities discount rates.

Chart 17. DYNAMICS OF LATVIA'S GDP, MANUFACTURING AND UNEMPLOYMENT INDICATORS (1994-1997; %)



Source: CSB.

The suspension of the operation of JSC *Banka Baltija*, the largest bank of Latvia, triggered rumours about financial problems in other banks and allegedly inevitable devaluation of the national currency. The Latvian currency market responded promptly: in May 1995, the Bank of Latvia sold 1.9 times more foreign currency than in the first quarter of 1995. The real economy was adversely affected by low liquidity associated with company accounts frozen in those banks whose operation was discontinued or suspended. As roughly one third of all company funds with banks were blocked, a significant part of businesses found their development prospects encumbered and were encouraged to resort to cash in their business activities more often.

Meanwhile, the economy was affected by several positive factors, which alleviated the effects of banking crisis. First, despite financial problems of several major banks, the rest operated effectively enough in Latvia; the total profit earned by the banking sector exceeded 5 million lats in 1995 and recorded a six-fold increase in 1996. Second, with inflation pressures abating and the national currency remaining stable, foreign direct investment inflows continued, enhancing the demand and employment. Third, the external environment was likewise supportive of the economic growth in Latvia: the expansion in Latvia's exports of goods exceeded 24% in 1995 and 15% in 1996.

Hence, somewhat contracting domestic demand resulting from the banking crisis notwithstanding, the overall decline in economic activity, albeit significant, was relatively short-lived. The volume of manufacturing output increased as early as 1996 for the first time after the restoration of Latvia's independence.

In 1997, unemployment hovered at about the same level as before the crisis (see Chart 17).

The relatively good economic performance enabled the government to restore fiscal discipline in a short time. The budget deficit, which in 1995 exceeded 3% of GDP (1.6% of GDP in accordance with the ESA 95 methodology), was cut down to 1.2% of GDP (0.6% of GDP in accordance with the ESA 95 methodology) in 1996, allowing for ending the year 1997 with a budget surplus (which was crucial in the context of the Russian financial crisis of 1998).

A major part of regulatory requirements for bank operation set by the Bank of Latvia were incorporated in the Law "On Credit Institutions" passed on 5 October 1995 (replacing the Law "On Banks")³⁸. The law stipulated that all banks of Latvia should abide by the International Accounting Standards and submit annual financial statements audited by internationally acknowledged auditors. The Bank of Latvia was one of the first central banks in Eastern and Central Europe to introduce this requirement. By passing this law, the regulatory framework of credit institution performance was substantially aligned with the requirements under EU directives.

Legal responsibility of credit institutions, their shareholders, managers, staff and customers for deliberately providing false or incomplete information and for a breach of binding rules was reinforced by the amendments to the Republic of Latvia Administrative Violations Code and Criminal Procedures Code. Consequently, the number of inspections at Latvia's financial institutions increased notably: the Bank of Latvia conducted 65 on-site examinations in 1994, 95 in 1995, and 123 in 1996.³⁹

The Russian financial crisis of 1998 and its consequences

Owing to the tightened supervisory measures, cases of intentional malevolence in the Latvian financial sector were practically ruled out in subsequent years. Nevertheless, it did not spare the country from impending crises. When in August 1998 the Russian government announced that it would be unable to make settlements for its securities in due time and in full amount, and these securities rapidly depreciated, the asset value of many Latvian banks also dropped markedly. For the financial system of Latvia, it triggered serious financial problems, which aggravated due to deposit outflows from a number of Latvian banks amid the environment of overall uncertainty (see Chart 18).

Although in most cases banks addressed these problems independently and efficiently, even managing to conclude the year with profit, serious problems were surfacing for two of them due to their assets blocked in Russia. On 27 August 1998, the Bank of Latvia suspended the operation of JSC *Latvijas kapitālbanka* on the basis of insolvency application filed by the bank. Still, this

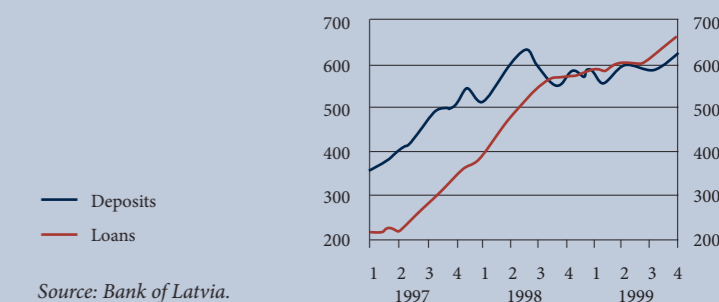
bank was relatively small and did not greatly affect the banking sector's stability overall. The second bank, which was rather deeply involved in the Russian securities market, was JSC *Rīgas Komercbanka* (RKB), the fifth largest Latvian bank. Its liquidity shortages were so critical that it had to stop operating and apply for assistance to the government and the Bank of Latvia.⁴⁰ This bank was pronounced insolvent as of 9 March 1999, yet, in contrast to the previous case of the systemically important JSC *Banka Baltija*, the RKB did not go bankrupt but was rehabilitated. In October 1999, the court ruled to stop the insolvency proceedings, and the RKB resumed operation under a new name of JSC *Pirmā Latvijas Komercbanka*. Meanwhile, the search for strategic investor was going on, and in summer of 2000, it was found in the person of *Norddeutsche Landesbank* (Germany).

However, the impact of the Russian financial crisis of 1998 on Latvia's economy was stronger than that of the 1995 crisis, because the former affected not only the financial sector but also most economic sectors due to quickly contracting market. The structure of foreign trade in Latvian goods changed substantially. Latvian exports to the EU countries expanded, while to Russia and other CIS countries exports had already been on a gradual descending trend since 1997 (see Chart 19). When in August 1998 the insolvency of the Russian government and devaluation of the Russian ruble were announced, exports from Latvia contracted particularly sharply: within a year, exports to Russia and other CIS countries shrank by around a half (see Chart 20). This was underpinned by the depreciation of Russian ruble, the subsequent decline in income levels and, hence, also the demand in Russia, and the financial sector problems that encumbered the smoothness of trade operations.

At that time, some market participants' and economists' calls for devaluation of the national currency rang out loud.⁴¹ Yet the Bank of Latvia managed to withstand the pressure. It considered that, first, devaluation of the lats would counteract the central bank's goal to maintain price stability, as at the end of 1998 inflation began to stabilise within 2%–3% range and devaluation would make it bounce in an unwelcome direction. Second, devaluation of the lats would strike a serious blow to the national economic policy, which was aimed at attaining and sustaining macroeconomic stability, and would weaken foreign investors' confidence in the country, thereby cutting off the inflow of investment. Third, devaluation of the lats would prevent diversification of export markets, thus retaining Latvia's excessive economic dependence on Russia.

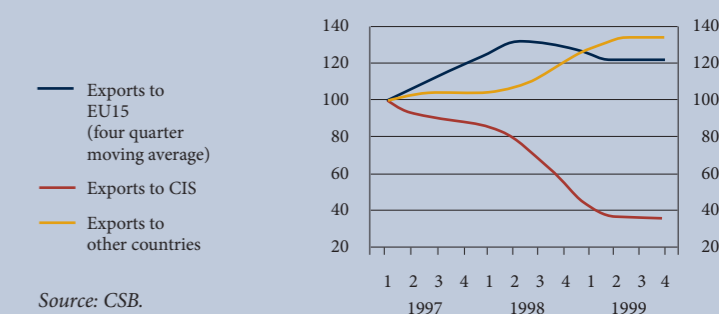
The subsequent events confirmed that the Bank of Latvia had been right and the decision not to devalue the lats amid implications from the Russian financial crisis had been made correctly. Despite Latvian exports to CIS countries contracting notably,

Chart 18. DYNAMICS OF RESIDENT LOANS AND DEPOSITS (1997-1999; millions of lats)



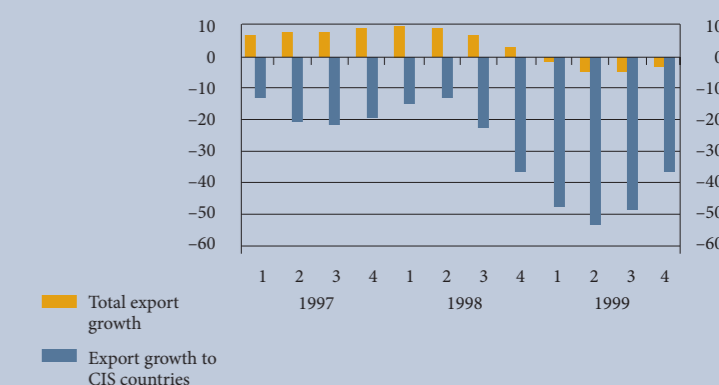
Source: Bank of Latvia.

Chart 19. VOLUME CHANGES OF LATVIAN GOODS EXPORTS (Q1 1997-Q4 1999; Q1 1997 = 100)



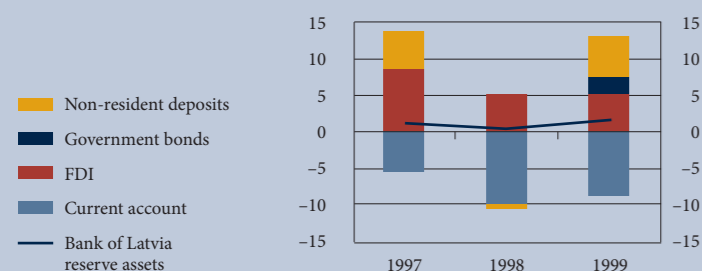
Source: CSB.

Chart 20. VOLUME GROWTH CHANGES OF LATVIAN GOODS EXPORTS (Q1 1997-Q4 1999; %)



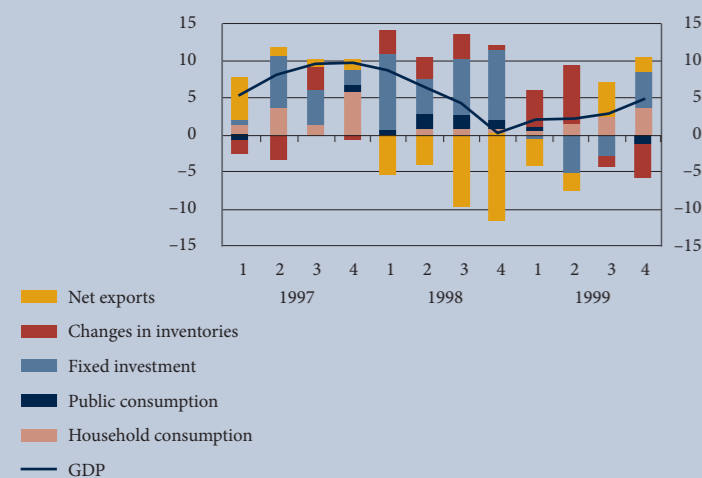
Source: CSB.

Chart 21. MAIN COMPONENTS OF LATVIA'S BALANCE OF PAYMENTS (1997-1999; % of GDP)



Source: Bank of Latvia.

Chart 22. CHANGES IN LATVIA'S GDP IN BREAKDOWN BY DEMAND COMPONENT (1997-1999; %)



Source: CSB.

exports to other economies declined to a lesser extent and to some, the other Baltic States in particular, even grew. Consequently, the overall volume of Latvian exports shrank only slightly, the substantially smaller export share to Russia notwithstanding, and the deceleration of export volume growth was short-lived. Invariable peg of the lats made Latvian exporters re-focus from the CIS market to the EU market, which they managed to do quite well: exports to the EU accounted for 49% of total Latvian exports in 1997 and for 63% in 1999 (the respective decline in exports to CIS countries was from 30% to 12%).

Likewise, the impact of Russian financial crisis of 1998 on the capital account of the balance of payments was temporary and transitory. In 1998, non-resident deposits flew out of Latvian banks, to renew again at previous levels in the following year. In addition, the sustained macroeconomic stability served as a good foundation for the attraction of foreign direct investment. Moreover, the country's stable macroeconomic situation encouraged the government to issue securities and borrow from international financial markets. As a result, the on-going inflow of foreign currency outpaced its outflows from the country despite a deficit in the current account of the balance of payments, and the Bank of Latvia foreign reserves continued to rise (see Chart 21).

Foreign capital inflows in Latvia were turned into new investment, and their growing volumes figured as the main reason why the economy could escape losing momentum even amid an adverse external environment (see Chart 22). Still, the economic development was not steady overall. Manufacturing and agriculture recorded an on-going downturn, while financial intermediation and real estate activities as well as commercial services, by contrast, were on a steep upward trend (see Chart 23).

On the fiscal side, a relatively sharp contraction in tax revenues and a rise in expenditure amid the Russian financial crisis of 1998 were observed, hence the budget balance worsened. In 1997, the budget surplus stood at 1.5% of GDP, while in 1999 the budget deficit amounted to almost 4% of GDP. Such deterioration of the budget balance is, as a rule, typical for periods of economic downturn and can be explained by the government attempts to alleviate the negative effects of external environment on the economy. A simultaneous balance between boosting the economy and maintaining macroeconomic stability is, likewise, important. As at the onset of the Russian financial crisis Latvia's fiscal indicators had been very good, the government could pursue an expansionary fiscal policy without any worries about the public debt growing too fast. This enabled the government to borrow from international financial markets to finance its budget deficit. On the other hand, the experience gained in 1998 and 1999, when softening of fiscal

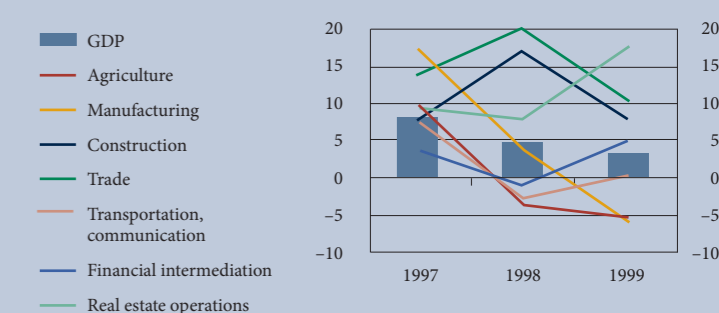
stances helped offset the effects of external factors on the Latvian economy, created an illusion that a budget deficit is a simple way to boost the economic activity in the country. Yet it turned out in the subsequent years when the economy advanced and the need for additional economic stimulus faded away that even a balanced budget, not to speak about a budget with a surplus, was politically too difficult a task to accomplish.

The Russian financial crisis of 1998 made it possible to assess the efficiency of financial sector's supervisory framework and specify the measures for minimising adverse effects of pending financial crises on the Latvian banking sector. In order to protect the interests of depositors and minimise the risk of unfounded outflows of finance, the Saeima of the Republic of Latvia adopted the Law "On Natural Person Deposit Guarantees" on 3 June 1998.⁴² This law stipulates that banks have to make payments to the Deposit Guarantee Fund, and, in the event of bankruptcy, bank depositors – natural persons – are entitled to receive a guaranteed compensation (which initially was prescribed in the amount of 500 lats, but over 10 years gradually increased to 13 thousand lats). Furthermore, the Russian financial crisis of 1998 forced the re-assessment of the existing assumption that investing in government securities was absolutely sound and did not require any provisions. The Bank of Latvia approved the bank capital requirement, ruling to apply a 50% risk weighting, in respective currencies, to claims against central banks and central governments in non-OECD countries (previously, 0%).⁴³

In general, the financial system of Latvia survived the Russian financial crisis of 1998 and its aftermath rather effectively, yet, for some Latvian banks, the asset value had depreciated and performance indicators decreased quite substantially due to the crisis. In these circumstances, further effective operation required both improving of bank management and investing of additional capital. In the meantime, the prospects for attracting domestic capital had deteriorated. The Scandinavian financial institutions acquired some of the largest Latvian banks, thus expanding their activities in a market with a good future outlook for growth, particularly considering Latvia's anticipated accession to the EU.

In 1998, *Skandinaviska Enskilda Banken AB* bought the shares of JSC *Latvijas Unibanka*, one of the largest Latvian banks, acquiring 23% of its capital. By end-2000, the SEB group had increased its stake in this bank to 98%. Likewise, in November 1998, *FöreningsSparbanken AB (Swedbank)* acquired JSC *Hansabank-Latvija*, the second largest Latvian bank, with its stake in bank's capital initially slightly below 50% and already at 52% in 1999. Foreign investors also obtained several small banks or their parts, so at the end of 1999 they possessed 66.2% of paid-up share capital in Latvian banks. In 2000, the Bank of Latvia

Chart 23. CHANGES IN LATVIA'S GDP IN BREAKDOWN BY SUPPLY COMPONENT (1997-1999; %)



Source: CSB.

issued a credit institution operating licence to the Riga Branch of *Merita Bank Plc.* (Finland), the German *Norddeutsche Landesbank Girozentrale* acquired shares of the restructured RKB, and the non-residents' share in paid-up capital of Latvian banks rose to 69.9%.⁴⁴

The predominating position of major Latvian banks gradually became more pronounced. The share of three largest Latvian banks in total bank assets amounted to 38.7% in 1997 and rose to 51.1% in 2000. According to the data of the Bank of Latvia, the shares in total bank assets of five largest Latvian banks were 51.2% and 62.8% respectively.

BUOYANT GROWTH AND FIRST SIGNS OF INSTABILITY (2000-2004)

The Latvian banks with foreign capital had access to financial resources of their parent banks, often available on more favourable terms than borrowing directly in the interbank market. Furthermore, the Swedish banks that held control over major Latvian banks resolved to expand operation in all Baltic States, and when the latter acceded to the EU these banks looked upon their markets as a part of their own domestic market.⁴⁵ In the meantime, with Latvia preparing for the EU accession, the aligning of its legislation with the EU requirements was taking place, strengthening ownership rights, bankruptcy proceedings and similar areas important for the operation of the banking

sector. Moreover, the low-level public and private sector debt enabled banks to anticipate a rapid market expansion and good profit opportunities in the near future.

All the above factors gradually spurred up lending which gained momentum particularly starting with 2002. The expansion of foreign bank activities in Latvia was accompanied by a robust acceleration in lending rate, as alongside with the growing demand spurred by falling interest rates, the Latvian banks with Swedish capital were void of the former supply restrictions, which had depended on the limited amount of domestic deposits. Empowered to borrow the lacking funds from parent banks, a number of Latvian banks now were able to extend loans in larger amounts than the attracted domestic deposits. Other banks, i.e. those without parent bank financing, had to either adjust to this new practice by seeking additional financing in foreign markets (via issuing bonds or borrowing from foreign banks or their syndicates) or take the risk of losing their market power.

In accordance with the Law "On the Financial and Capital Market Commission" adopted on 1 June 2000⁴⁶, the process of a uniform supervision of the financial and capital market initiated as early as 1997 was accomplished by merging, as from 1 July 2001, the Bank of Latvia Credit Institutions Supervision Department, the Securities Market Commission and the State Insurance Supervision Inspection. In such a way, the Bank of Latvia got void of the bank supervision and control function, which was now vested in the newly-formed Financial and Capital Market Commission (FCMC), which also supervised the operation of insurance and securities market and took over the responsibility for forming, managing and using the Deposit Guarantee Fund. The FCMC did not introduce substantially new restricting requirements for bank operation, because formally the whole supervisory framework for banks was already consistent with the EU standards. In line with the central objective of Latvia's foreign and economic policy, i.e. integration in the EU, in the first year of its existence the FCMC continued the aligning of legal acts regulating the activities of finance and capital market participants with the EC directives and recommendations.

In the period between 2000 and 2004, loans to residents increased from around 20% of GDP to 50% of GDP, with a simultaneous annual rise in the loan to deposit ratio from around 1.0 in 2000 to almost 1.7 in 2004 (see Chart 24). It suggests that as early as 2004 close to 40% of all bank-extended loans came from foreign financial sources. This acceleration in the pace of lending soon started to spill over to the other economic sectors, becoming more pronounced over time.

First, it negatively affected items on Latvia's balance of payments (see Chart 25). When capital inflows started to grow,

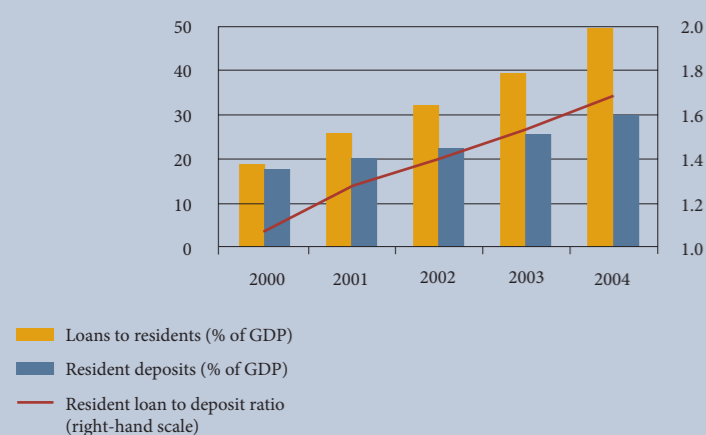
Latvia's current account balance deteriorated, and, in 2004, the current account deficit crossed the psychological margin of 10% of GDP. Moreover, if in some previous years foreign direct investment and government borrowing figured important in financing the current account, over time their place was more often taken by foreign borrowings of the banks. On the one hand, this type of financing was less stable than foreign direct investment due to its potentially easier outflow triggered by eventual changes in Latvia's economic situation or external environment. On the other hand, as most of these borrowings actually resulted from the redistribution of financial flows within one financial group (from parent bank to daughter bank), they did not pose so strong and obvious risks as did the traditional borrowings between non-affiliated enterprises.

Second, the increase in lending ensured substantial economic expansion, with GDP annually growing by 7.5% on average in 2000-2004. Following legal adjustments and the on-going liberalisation of trade (Latvia joined the World Trade Organisation on 10 February 1999⁴⁷), Latvia's exports expanded; however, as imports also increased, the overall contribution of foreign trade to changes in GDP had been negative since 2001. Consequently, the economy grew primarily on account of the robust expansion in private consumption and rapidly increasing investment (see Chart 26).

In the meantime, investment in domestic-consumption-oriented sectors became more substantial, while that in branches supporting Latvian export growth and external competitiveness diminished. In 2004, the sector of real estate activities and other commercial activities became the central and largest Latvian sector accumulating foreign direct investment (see Chart 27). For a small and open economy, such developments were unsustainable in the long run. In the short run, however, the results were good and convincingly testified to the resilience of economic progress. Amid intensifying economic activity, the unemployment rate slid down notably; yet, with spare and excess capacity gradually drying out and availability of high-quality workforce diminishing, rises in labour costs were impending. Initially, businesses could use various labour process improvements to offset the rises in labour compensation, and labour productivity increased. Over time, however, the buoyant economic growth and insufficient investment in productive sectors of the economy resulted in stronger inflationary pressures (see Chart 28).

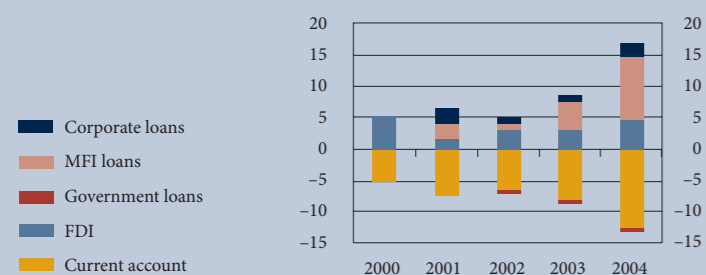
In addition, when Latvia acceded to the EU in 2004, inflation hiked due to several one-off factors (e.g. excise tax rate increases to the minimum level admissible under EU law, which in the case of Latvia implied a rather notable elevation in fuel prices). As a rule, such supply-side-ignited price hikes are transitory, because a price increase automatically exerts a downward pressure on demand and excludes further price rises. Still, amid the

Chart 24. DYNAMICS OF RESIDENT LOAN AND DEPOSIT CHANGES (2000-2004)



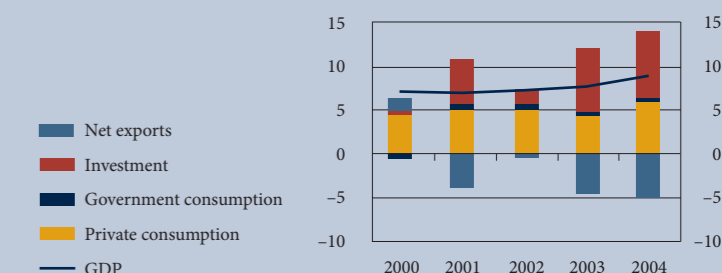
Sources: CSB and Bank of Latvia.

Chart 25. MAIN ITEMS OF LATVIA'S BALANCE OF PAYMENTS (2000-2004; % of GDP)



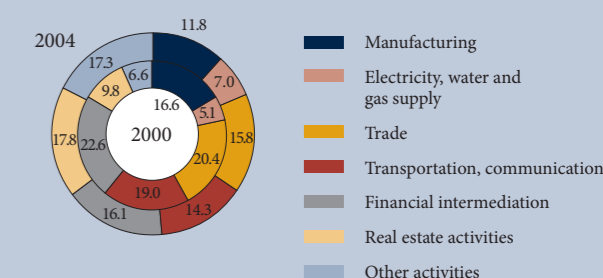
Source: Bank of Latvia.

Chart 26. LATVIA'S GDP AND CHANGES IN DEMAND-SIDE COMPONENTS AFFECTING IT (2000-2004; %)



Source: CSB.

Chart 27. ACCUMULATED FDI IN BREAKDOWN BY SECTOR (2000-2004; %)



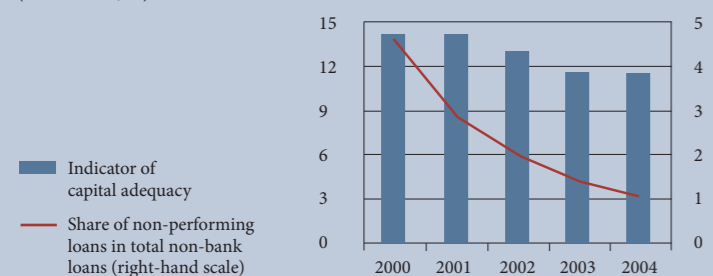
Source: Bank of Latvia.

Chart 28. JOBSITEKERS RATIO AND INFLATION DYNAMICS IN LATVIA (2000-2004; %)



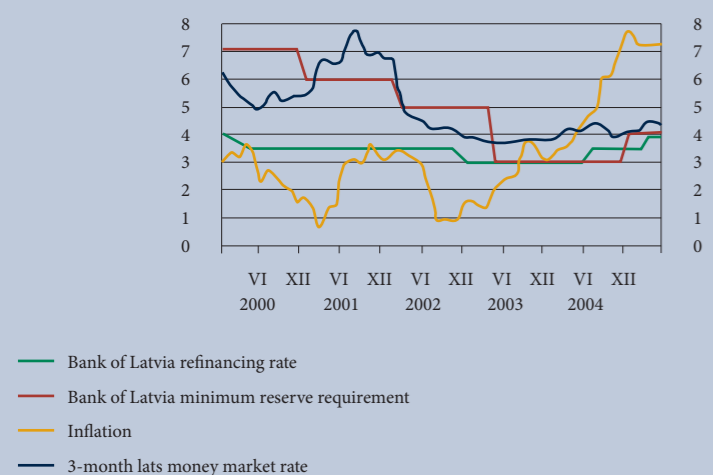
Sources: CSB and SEA.

Chart 29. PERFORMANCE INDICATORS OF LATVIAN BANKS (2000–2004; %)



Sources: Bank of Latvia and FCMC.

Chart 30. BANK OF LATVIA MONETARY POLICY INSTRUMENTS, MONEY MARKET INTEREST RATE AND INFLATION (2000–2004; %)



Source: Bank of Latvia.

fast economic development and heightened labour demand, risks substantially aggravated that such one-off price rises may couple with wage increases without a corresponding rise in labour productivity thus producing a price-wage spiral. Be it so, inflation would be difficult to control and would pose a threat to price stability in the country. In order to avoid the materialisation of such a scenario, public institutions had to interfere.

Solely from the point of view of risks threatening banking sector operation, there were no grounds for serious concern. In the IMF and World Bank Financial System Stability Assessment in 2001, Latvia's financial sector was positively evaluated, its competitiveness ascertained, and market supervision quality praised as being consistent with the best world practices in all major aspects.⁴⁸ The share of non-performing loans that might have been indicative of potential future losses contracted from year to year and in 2004 only slightly exceeded 1% of the total bank credit portfolio, which was one of the best indicators among EU countries. In addition, the bank capital adequacy, meant to provide a reserve "cushion" against losses in the event of a crisis, albeit slightly deteriorating, was still steadily lingering above the 10% margin set by the supervisory institution (which, in turn, was higher than the EU 8% threshold; see Chart 29).

Speaking about the monetary policy, a gradual policy paradigm shift was occurring. Since the mid-1990s when inflation started on a downward trend, the Bank of Latvia constantly lowered its interest rates and reserve ratios, thus pursuing expansionary monetary policy; when the inflationary risks and risks to maintaining price stability intensified, the Bank of Latvia turned to restrictive monetary policy stances. In March 2004, the refinancing rate was raised for the first time in 10 years; in July 2004, the reserve ratio was pushed up and bank liquidity thus reduced (see Chart 30). Unfortunately, these monetary policy decisions could only partly ensure tighter lending standards, because several major Latvian banks had access to their parent bank financing and their needs to resort to the Bank of Latvia monetary policy instruments had moderated. As a result, the money market interest rate increases were not particularly sharp even amid the more costly resources of the Bank of Latvia.

In an environment of robust economic growth and ascending risks to macroeconomic stability, the government of Latvia continued to pursue a rather expansionary fiscal policy by drawing up the state budget plan with a deficit. Instead of accumulating the annual extra budgetary tax revenue for building contingency provisions or a reserve for periods when the economic growth might fall behind the projections, a tradition was taking root to spend such above-the-plan tax revenue to

finance the increased expenditure emerging via mid-year amendments to the current budget. There were several reasons for such behaviour.

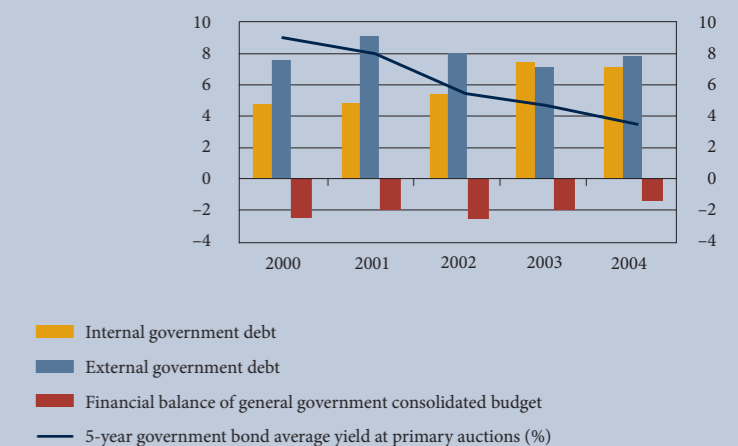
Several structural reforms that the government implemented exerted additional pressure on the budget. For instance, in July 2001, a pension reform was launched in Latvia, as a result of which a portion of social insurance contributions was assigned to the creation of pension accrual funds and, consequently, was not available for financing the current budget expenditure.

Besides, the economic policymakers faced a problem of dramatically falling public acceptance, and, in a short while, the popularity of both the government and the parliament had plunged down to one of the lowest levels in Europe (according to the data of a sociological survey of 2002, 40% of the population did not trust in the Saeima of the Republic of Latvia at all, and 36% had rather no trust in it; trust in the Cabinet of Ministers was only some percentage points higher⁴⁹). Measures to cut the budget deficit would only further reduce the popularity of government; hence the boosting of budget deficit and expenditure was an attempt to increase public support.

For all that, the most significant changes were related to shifts in policymakers' priorities and values. In the course of the following 10 years, the concern about macroeconomic stability, the first priority of economic policymakers after Latvia regained its independence, was gradually replaced by the need to attain an ever stronger economic growth, as Latvia's accession to the EU had clearly illuminated its position as the poorest EU economy.⁵⁰ The economic and financial policies were undergoing a cardinal shift in thinking and stances. The initially valid belief that a too excessive borrowing gave rise to additional costs, hence undermining the welfare of population, had gradually given place to policymakers' firm conviction that it was an increased budget deficit that promoted people's welfare.

The government financed the budget deficit that was building up as a result of this policy primarily with funds borrowed from the Latvian banks, yet the internal government debt remained at a rather low level, with its ratio to GDP among the smallest in the EU. Bank lending to the government also drove the expansion of market share. Supported by the strong domestic demand, the interest rates on government debt securities declined, and the budget deficit financing became easier. Apparently, the government took it for an assertion of rising financial market confidence in its fiscal policy, as substantial changes in the latter were not made, and budget continued to post a deficit (see Chart 31).

Chart 31. LATVIAN GOVERNMENT DEBT, BUDGET DEFICIT AND YIELDS ON GOVERNMENT BONDS (2000–2004; % of GDP)



Sources: Eurostat and Treasury.

CONCLUSIONS

Overall, Latvia's cessation from the USSR and the exit from the Russian ruble zone were effective, as was the change-over to the national currency, the lats; the price stabilisation goal set at the start of the reform process was achieved with no time to waste. Key measures supporting macroeconomic stability were the tight budget policy implemented by the government and the Bank of Latvia's relatively prompt disengagement from the inflation-boosting influence of the USSR and the Russian ruble, stabilisation of national currency's exchange rate and restricted lending to banks via raised interest rates on lending.

Improvements in the macroeconomic situation of Latvia did not bring about the anticipated rapid economic growth, and in 1995–2000, the economic development was rather unbalanced, with the banking crisis of 1995 and the Russian financial crisis of 1998 as the key drivers behind it.

Prior to Latvia's accession to the EU, its economic growth indicators had been good, yet, at the same time, first surfacing indications suggested that without preventive measures the country's macroeconomic situation could deteriorate over time and economic overheating (excessive economic growth followed by similarly sharp drop in economic activity) might occur. First differences in policymakers' views were also spreading: until the end of the 20th century, the policy focus had firmly been on macroeconomic stability in the country, whereas with the EU accession term approaching, the fiscal policy focused increasingly on attaining an ever faster economic growth, leaving macroeconomic stability concerns to monetary policy. However, with the arrival of foreign banks in Latvia, the need for resorting to the central bank's financing and, hence, also the efficiency of the Bank of Latvia monetary policy instruments dropped markedly.

The economic growth in Latvia became increasingly dependent on international financial capital flows and their continuity. Major risks to the economy were associated with eventual and substantial contraction or even termination of cross-border financial flows, which could markedly encumber further activities of the government and private sector. Such a possibility, however, seemed small enough in the light of experience acquired since the regaining of independence, as capital inflows in Latvia during all previous periods had rather been growing on a regular basis. The presence of Scandinavian banks in the region was an additional soothing factor, because these banks had faced an economic crisis in the 1990s, were likely to have learned lessons from it and thus in the position not to commit serious blunders in Latvia. Such hopes, alas, proved delusive and vain.

ENDNOTES

¹ BLA, BLF, descr. 11, f. 14, p. 2.

² Ibid., pp. 3 and 5.

³ Ibid., p. 14.

⁴ Ibid., f. 15, p. 8.

⁵ Ibid., p. 7.

⁶ *List of Members* [cited 27.05.2012]. Available: <http://www.imf.org/external/np/sec/memdir/memdate.htm>.

⁷ BLA, BLF, descr. 11, f. 15, p. 7.

⁸ Tarr, D. G. *How Moving to World Prices Affects the Terms of Trade in 15 Countries of the Former Soviet Union*. World Bank Policy Research Working Paper No. 1074, January 1993, p. 28.

⁹ Ibid., p. 17.

¹⁰ World Bank World Development Indicators Database. Available: <http://data.worldbank.org/data-catalog/world-development-indicators>.

¹¹ The development of military industrial complex played an important part as well, yet due to the lack of data quality analysis is impossible.

¹² *Latvijas Republikas Augstākās Padomes un Valdības Ziņotājs*. Nr. 3/4, 1991, 31. janv., 109.–112. lpp.

¹³ Ibid., Nr. 35/36, 1991, 12. sept., 1662. lpp.

¹⁴ Ibid., Nr. 42, 1991, 24. okt., 2048.–2054. lpp.

¹⁵ Ibid., Nr. 15/16, 1991, 25. apr., 571. lpp.

¹⁶ *Latvijas PSR Augstākās Padomes un Valdības Ziņotājs*. Nr. 12, 1990, 22. marts, 701. lpp.

¹⁷ Zelgalvis, E., Zelgalve, E. Nauda, bankas, finanses. *No: Sociālekonomiskā procesa trajektorija Latvijā no 1985. līdz 2002. gadam. Kur tā ved Latviju?* Zinātnisks pētījums. Ventspils: Ventspils Augstskola, 2002, 162. lpp.

¹⁸ *Latvijas PSR Augstākās Padomes un Valdības Ziņotājs*. Nr. 12, 1990, 22. marts, 700. lpp.

¹⁹ *Latvijas Republikas Augstākās Padomes un Valdības Ziņotājs*. Nr. 34, 1990, 23. aug., 1735. lpp.

²⁰ Ibid.

²¹ Ibid., 1736. lpp.

²² Ibid., Nr. 22/23, 1992, 4. jūn., 12. lpp.

²³ BLA, BLF, descr. 11, f. 4, p. 21.

²⁴ Ibid., f. 15, p. 9.

²⁵ *Latvijas Republikas Augstākās Padomes un Valdības Ziņotājs*. Nr. 22/23, 1992, 4. jūn., 1175. lpp.

²⁶ *Latvijas Vēstnesis*. Nr. 331/332, 1998, 4. nov., 2. lpp.

²⁷ Alesina, A., Summers, L. H. Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence. *Journal of Money, Credit and Banking*, vol. 25, No. 2, 1993, pp. 151–162.

²⁸ According to the intergovernmental agreement, Latvia had to pass over to Russia all Russian rubles it possessed in cash without any recompense (gratis). Hence in general, it was even convenient for the Bank of Latvia and the Latvian government that the population and enterprises in Latvia opted for Russian rubles when in the initial period of parallel circulation of the two currencies they were free to do so; as a result, the

Bank of Latvia worthless reserves of non-convertible currencies shrank. This fact is directly related to the so-called "case of carriages" when a Latvian enterprise chose to finance its import operations with Russia in cash in Russian rubles. The scope of operations and the fact that payment was made in cash, arouse strong public response and various speculations. Nevertheless, everything was legitimate, as taking cash out of the country had been approved by Latvia's Customs Administration. Furthermore, the reduction of Bank of Latvia non-convertible currency reserves was a better deal for Latvia than the alternative to provide the needed amount of cash in Latvian rubles to be afterwards converted into another convertible foreign currency. The amount of Latvian rubles corresponding to the amount of Russian rubles was already in circulation; hence the assertion about their material significance for Latvia is not true.

²⁹ BLA, BLF, descr. 1, f. 4, p. 22.

³⁰ *Bank of Latvia: Annual Report 1993*. Riga: Bank of Latvia, 1994, p. 54.

³¹ For instance, initially in 1990, the capital requirement in Latvia was set at only 5 million USSR rubles, which was a rather small amount; in addition, its value was constantly depreciating due to steeply rising inflation. Although capital requirements in Latvia increased over time, they were still quite liberal.

³² Osis, U., Šteinbuka, I. *Latvijas Republikas Finanšu tirgus un banku sistēmas attīstība*. Konceptija. Rīga, 1992, 26. okt., 3. lpp.

³³ *Latvijas Vēstnesis*. Nr. 163, 1995, 24. okt., 5. lpp.

³⁴ Osis, U., Šteinbuka, I. *Latvijas Republikas Finanšu tirgus un banku sistēmas attīstība*. Konceptija. Rīga, 1992, 26. okt., 20. lpp.

³⁵ www.fktk.lv/statistika/arhivs/banku_statistika_no_1994_gada/.

³⁶ *Credit Institutions Supervision Department: Annual Report 1999*. Riga: Bank of Latvia, 2000, p. 28.

³⁷ Speech of Bank of Latvia Governor E. Repše at the extraordinary session of the 5th Saeima of the Republic of Latvia on 19 May 1995. Available: http://www.saeima.lv/steno/st_955/st1905.html.

³⁸ *Latvijas Vēstnesis*. Nr. 163, 1995, 24. okt., 5. lpp.

³⁹ Bank of Latvia Annual Reports 1994, 1995 and 1996.

⁴⁰ To implement the restructuring of RKB, in August 1999, a Bank of Latvia's non-profit organisation *Rīgas Komerčbankas rehabilitācijas aģentūra*, Ltd. was set up and obtained 6.6% of RKB share capital at 15.5 million lats cost. In May 2000, this Bank of Latvia's daughter company disposed of its investment in RKB share capital, but in December 2000, taking into account that it had achieved its goal, *Rīgas Komerčbankas rehabilitācijas aģentūra*, Ltd. was liquidated. (Sources: *Bank of Latvia: Annual Report 1999*. Riga: Bank of Latvia, 2000, p. 53; *Bank of Latvia: Annual Report 2000*. Riga: Bank of Latvia, 2001, p. 50).

⁴¹ See, for example, Струт, Андрей. Экономические "страшилки". *Час*, № 236, 1998, 12 окт., с. 3.

⁴² *Latvijas Vēstnesis*. Nr. 162, 1998, 3. jūn., 2. lpp.

⁴³ *Bank of Latvia: Annual Report 1998*. Riga: Bank of Latvia, 1999, p. 29.

⁴⁴ *Credit Institutions Supervision Department: Annual Report 2000*. Riga: Bank of Latvia, 2001, p. 27.

⁴⁵ *SEB Annual Accounts 2004*. Press Release, Stockholm, 9 February 2005, 4. Available: <http://www.seb.ee/files/aruanded/SEB2004report.pdf>; *Swedish FöreningsSparbanken AB (Swedbank) Annual Report 2004*, p. 9. Available: http://www.swedbank.com/idc/groups/public/@i/@sbg/@gs/@ir/documents/financial/fa_100100.pdf.

⁴⁶ *Latvijas Vēstnesis*. Nr. 230/232, 2000, 20. jūn., 2. lpp.

⁴⁷ *Members and Observers. WTO Membership*. Available: http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm.

⁴⁸ *Financial System Stability Assessment. Republic of Latvia. December 28, 2001*. IMF Country Report No. 02/67. Available: <http://www.imf.org/external/pubs/ft/scr/2002/cr0267.pdf>.

⁴⁹ Bank of Latvia survey results.

⁵⁰ When joining the EU in 2004, Latvia's per capita GDP accounted only for 44% of the EU average in terms of purchasing power parity (i.e. based on relatively lower general price level in Latvia) or 21% of the EU average income in nominal terms. (Source: Eurostat. Available: http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_gdp_c&lang=en.)

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