EXHIBIT 11

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UNITED STATES DEPARTMENT OF COMMERCE
International Trade Administration
Washington, D.C. 20230

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Investigation
Public Document
DAS II/Office 5/CMS

MEMORANDUM FOR: Troy Cribb
Assistant Secretary
Import Administration

THROUGH: Holly Kuga ST
for Deputy Assistant Secretary
AD/CVD Enforcement Group II

FROM: Christopher Smith
Keir Whitson
Case Analysts
AD/CVD Enforcement II, Office 5

DATE: January 10, 2001.

SUBJECT: Antidumping Duty Investigation of Certain Steel Concrete Reinforcing Bars From Latvia - Request for Market Economy Status

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SUMMARY

The independent, democratic state of Latvia has successfully made the transition to a market-economy country. As a result of economic and institutional reforms undertaken since the breakup of the former Soviet Union in 1991, the Latvian currency is now fully convertible on current account transactions, wages in the private sector are determined by free bargaining between labor and management, and the Latvian government (through the Latvian Development Agency) actively promotes foreign direct investment. Privatization in Latvia has encompassed all but a handful of large firms, and pricing and production decisions now rest with the private sector. Commercial banks are solvent, set their own interest rates, and invest their assets seeking the greatest risk-adjusted return. The central bank sets monetary and exchange rate policies independent of government influence or control, and full trade liberalization has reintegrated Latvia into the multilateral trading system, linking prices, producers and consumers in Latvia to world markets.

Despite these achievements, some problems and obstacles remain. State-owned enterprises in the energy, transport and telecommunication sectors, enterprises which the government has been slow to privatize, still account for a significant share of GDP. Uncollected taxes, particularly in the energy sector, are a relatively large share of GDP, and land registration

is proceeding slowly, frustrating the development of a fully functioning land market and the badly needed fixed-asset investment on which that depends. Judicial capacity constraints are undermining government efforts to enforce bankruptcy laws, combat corruption, and promote the rule of law. And small- and medium-sized enterprises, which account for 95 percent of all enterprises in Latvia and are an important driver of the economy, are having difficulty modernizing and moving into higher value-added production.

On the whole, however, based on the preponderance of evidence related to economic reforms in Latvia, analyzed under section 771(18)(B) of the Tariff Act of 1930, as amended (the Act), we recommend that the Department find that Latvia has operated as market-economy country since January 1, 1999, and that this finding be effective for all current and future administrative proceedings.

BACKGROUND

On July 25, 2000, the Department published a notice of initiation of an antidumping investigation on steel concrete reinforcing bars from twelve countries, including Latvia. On August 24, 2000, the Department received a letter from the Latvian Minister of Foreign Affairs requesting that the Department revoke the nonmarket economy (NME) country-status of Latvia under section 771(18)(A) of the Act. On September 5, 2000, counsel for the sole Latvian respondent, Liepajas Metalurgs JSC, also requested that Latvia's NME status be revoked in the context of this proceeding.

The Government of Latvia presented the following four documents to support its contention that Latvia's NME status should be revoked:[1]

- The EU's Regular Report from the Commission on Latvia's Ascension.
- FITCH IBCA, Duff, & Phelps Sovereign Debt Analysis for Latvia.
- OECD Economic Surveys: The Baltic States, A Regional Assessment.
- International Monetary Fund: Staff Report for the 2000 Article IV Consultation and First Review Under the Standby Arrangement – Latvia.

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[1] The Latvian Embassy submitted the background materials on the status of Latvia's economy, attached to its August 24, 2000, letter to then Acting Assistant Secretary for Import Administration Troy Cribb.

On September 7, 2000 and October 10, 2000, the petitioners[2] responded to Latvia's request for market economy status. The petitioners argue:[3]

- Under U.S. law, countries which were once part of the Soviet Union retain the NME status of that former nation.
- Past cases have shown that WTO membership is not determinate of the Department's decisions on NME status.
- The Latvian embassy did not submit specific arguments for the revocation of Latvia's NME status.
- It would be inappropriate for the Department to make a judgement on Latvia's NME status without conducting a thorough review.
- The structure of the "Liepaja Special Economy Zone" in which the sole Latvian respondent, Liepajas Metalurgs, is situated creates the type of governmental control which the Act addresses.
- Major sectors of Latvia's economy have not been fully privatized.
- Significant restrictions exist on foreign investors.
- Weak trade unions reflect the lack of a free labor market.
- Government instability threatens the future of the reform process.

APPLICABLE STATUTE

In making an NME-country determination under section 771(18)(A) of the Act, Section 771(18)(B) requires that the department take into account:

1. the extent to which the currency of the foreign country is convertible into the currency of other countries;
2. the extent to which wage rates in the foreign country are determined by free bargaining between labor and management;
3. the extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country;
4. the extent of government ownership or control of the means of production;
5. the extent of government control over the allocation of resources and over the price and output decisions of enterprises; and
6. such other factors as the administering authority considers appropriate.

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[2] The petitioner in this case is the Rebar Trade Action Coalition, represented by Wiley, Rein and Fielding.

[3] See letter to the Department from Wiley, Rein, and Fielding dated September 7, 2000.

OVERVIEW OF ECONOMIC REFORMS

Latvia has a long history of economic liberalism and reform, interrupted by invasion and attempted subjugation by various foreign powers. Historically rooted in the trading traditions of the Hanseatic league,[4] Latvia long served as a transit hub for east-west trade between Europe, Scandinavia, and Russia. After being seized by Sweden in the early seventeenth century, then captured by czarist Russia in the early eighteenth century, Latvia attained its independence by expelling both German and Soviet Red Army forces in the aftermath of the First World War. Prime Minister Ulmanis, though regarded as authoritarian, led Latvia through large-scale privatization, currency reform, and land reform, generating relative economic success and living standards comparable to those of Western Europe.[5]

The Soviet Union annexed Latvia in 1940. In rebuilding Latvia's economy after the war, Soviet economic planners instituted a strict command system, collectivizing agricultural and nationalizing all urban land and business enterprises. The Russian rouble became Latvia's currency. Latvia did not have a central bank of its own, and economic activity in Latvia was dictated by Soviet five-year plans drawn up in Moscow. Consistent with Soviet industrial policy objectives, economic activity until 1991 was concentrated in industry and the production of military goods, while services and consumer goods were under-supplied. Production in Latvia, as in other republics, was highly specialized.[6] By the late Soviet period, Latvia produced every electric and diesel train in the Soviet Union, as well as more than half of all telephones and twenty percent of all telephone exchanges, refrigeration systems, and buses.[7] The high degree of vertical integration across the Soviet republics meant that Latvia was almost completely dependent on other republics for energy and raw material supplies (at arbitrarily low prices that did not reflect their true resource costs) and to serve as "export" markets.[8] The high degree of

[4] The Hanseatic League was a medieval commercial federation of German cities which, at its height in 1370, stretched from London to the city-state of Novgorod (present day north-west Russia). Governed by federated trade guilds, the League protected commerce from banditry and secured markets for producers within the guilds. The Hanseatic League rapidly expanded and was the highest authority in the Baltics until the Dutch invasion of 1441. The last Diet of the League was held in 1669, but the League has never formally been dissolved.

[5] Aigars Dabolins and Scott Shipman, *"Latvia - History,"* available at URL: http://www.latnet.lv/info_Latvia/history.html, under heading, "First Independence."

[6] International Monetary Fund *et al.*, A Study of the Soviet Economy (Paris: OECD Press, 1991), volume I, pp. 8-11.

[7] [illegible] section heading "Economic Sectors, Industry."

[8] International Monetary Fund, "Economic Review: Latvia" (Washington D.C.: IMF Press, 1992), p. 10.

centralized planning and control exercised under the Soviet command system eliminated virtually all direct contact between Latvian enterprises and the rest of the non-Soviet world.[9]

After the breakup of the Soviet Union and the re-establishment of Latvia's independence in 1991, Latvia undertook comprehensive and systematic reforms designed to radically transform Latvia into a democratic state with a fully functioning, western-style market economy. Latvia intended to go far beyond tinkering or modifying the existing (Soviet) command system to improve economic performance. Instead, the government wanted to rebuild the system from the ground up. [10]

The initial conditions facing the government and the country were harsh. Gone were captive export markets and cheap energy and raw material supplies from the Soviet Union, on both of which Latvia was critically dependent. Annual industrial and agricultural output together fell by 50 percent in 1992, over 50 percent in 1993 and 30 percent in 1994. At the same time, annual consumer price inflation exceeded 150 percent in 1991, 900 percent in 1992, and 100 percent in 1993.[11]

In the face of these tremendous difficulties, the government managed to focus on a small set of policy variables that, in hindsight, proved critical in helping to ensure the all-important rebound in industrial output and sustain the economic transformation process. The government liberalized trade, and Latvia's currency, the lat, became fully convertible on all current account and capital account transactions. Perhaps, most importantly, the government created an independent central bank that quickly brought inflation under control and established a strong, stable currency, which allowed Latvians to concentrate on money, production and trade, not hoarding, speculation and barter. Services now account for nearly 70 percent of the economy, and industrial production has shifted toward products like wood, food processing, and textiles in which Latvia has a comparative advantage.[12]

The following section presents a discussion of each of the six statutory factors that the Department considered in determining whether Latvia's NME-country status under the U.S. antidumping ("AD") law should be revoked at this time.

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[9] International Monetary Fund *et al.*, A Study of the Soviet Economy (Paris: OECD Press, 1991), volume I, pp. 8-11.

[10] Nissinen, Marja, Latvia's Transition to a Market Economy (New York, N.Y.: St. Martin's Press, 1999), pp. 61-2.

[11] European Bank for Reconstruction and Development, Transition Report 1999 (London: EBRD, 1999), p. 241.

[12] Economist Intelligence Unit, EIU Country Profiles, Latvia (London: EIU, May 5, 2000), see sections entitled "Economy" and "Economic sectors."

ANALYSIS OF SECTION 771(18)(B) FACTORS

1. *The extent to which the currency of the foreign country is convertible into the currency of other countries.*

After re-establishing independence from the former Soviet Union in 1991, Latvia found itself with no national currency, still doing transactions in Russian roubles. The government wanted to leave the rouble zone[13] as quickly as possible, to establish Latvia's own monetary and exchange rate policies and eliminate direct exposure to inflationary pressures and destabilizing forces emanating from Russia. Therefore, beginning in 1992 and ending in 1993, the government phased out the Russian rouble and phased in the Latvian lat (lat), using an interim currency, the Latvian rouble, as a bridge between the two.[14]

Over its short life, the Latvian rouble was allowed to float, as Latvia's central bank, the Bank of Latvia (BOL), worked to implement a tight monetary policy and bring inflation under control. Once that was achieved, the central bank's policy focus shifted to the exchange rate. In 1994, the lat was pegged to the IMF's Special Drawing Rights (a basket of major trading country currencies) to serve as a nominal anchor for the economy.[15] Since 1994, the *lat* has been fully convertible on all current account transactions. Resident and non-resident persons and enterprises can hold foreign currencies in domestic or foreign bank accounts, and there are no restrictions on the transfer or use of foreign exchange (FOREX) for domestic business transaction and international trade purposes. There are no FOREX surrender requirements and no restrictions on the repatriation of profits, after payment of taxes.[16] Until very recently, the government imposed few, if any, controls on capital account transactions. However, in the aftermath of the Russian financial crisis in 1998, Latvian residents are now subject to some controls on their portfolio and direct investments abroad, but are generally free to make such investments.[17]

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[13] By virtue of their use of a common currency, the rouble, the collection of newly independent states that were directly affected by Russian monetary, fiscal and exchange rate policies.

[14] *Ibid.*

[15] Biswajit Banerjee *et al.*, <u>Road Maps of the Transition. the Baltics, the Czech Republic, Hungary, and Russia</u> (Occasional Paper 127) (Washington, D.C.: International Monetary Fund, 1995), p. 3.

[16] International Monetary Fund, <u>Annual Report on Exchange Arrangements and Exchange Restrictions, 1996, 1997, 1998 and 1999</u> (Washington, D.C.: IMF Press, 1996-99), see Latvia chapters.

[17] Economist Intelligence Unit, <u>EIU Country Profiles, Latvia</u> (London: EIU, May 5, 2000), see section entitled "External sector."

The combination of the peg and the full convertibility of the *lat* requires that the central bank intervene in FOREX markets from time to time to eliminate temporary excess demand or supply conditions that ordinarily would be eliminated by movements of a floating exchange rate. Were these excess supply and demand conditions to become severe in terms of frequency or magnitude, tremendous market pressure would be brought to bear on the central bank to re-peg the lat. However, such market pressures have not materialized, as the peg has remained virtually unchanged since 1994.[18] The stability of the *lat* is due in part to the relatively stable macroeconomic conditions in Latvia and the fact that the *lat* is fully backed by reserves.[19] The government stands ready to buy and sell foreign exchange on demand.[20]

2. *The extent to which wage rates in the foreign country are determined by free bargaining between labor and management.*

Like many other countries in Eastern Europe, Latvia relies on a tripartite arrangement between trade unions, employer organizations and the government (referred to as the National Trilateral Co-operation Council, since 1999, and the Trilateral Consultative Council before then) to negotiate changes to the minimum monthly wage.[21] Under this arrangement, trade unions bring to the table their concerns about living standards and job protection, employer organizations bring concerns related to their costs and competitiveness, and the government brings concerns about its budget and various expenditure items tied directly and indirectly to the minimum wage. The minimum monthly wage in Latvia is reviewed on a regular basis and was increased annually between 1995 and 1999. Although still substantially below the subsistence wage, the minimum monthly wage has increased substantially as a percentage of the subsistence wage.

Although trade unions play a role in setting the minimum monthly wage, the labor movement is relatively new in Latvia, and unions therefore play only a minor role in setting wages above the minimum in the private sector. In 1999, 1699 collective agreements (which are concluded at the enterprise level between the trade union and management) covered 208,366 of Latvia's 1.2 million workers.[22] Thus, most Latvian workers negotiate their own wages. Under

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[18] International Monetary Fund, International Financial Statistics (Washington, D.C.: IMF Press, October 2000), p. 488.

[19] Economist Intelligence Unit, EIU Country Profiles, Latvia (London: EIU, May 5, 2000), see section entitled "Economy."

[20] Nissinen, Marja, Latvia's Transition to a Market Economy (New York, N.Y.: St. Martin's Press, 1999), p. 65.

[21] Ministry of Welfare, Government of Latvia, Social Report 2000 (Riga: MOW/GOL, 2000), pp. 16, 19.

[22] *Ibid.*, p.19.

[redacted] these contracts, employers may fire the worker and the worker may resign without notice. After this probationary period, the contract may be terminated without notice by mutual consent; the worker may resign for any reason, after giving one month's notice, regardless of the terms and conditions of the contract; and the employer may dismiss a worker with one month's notice for cause.[23] Latvia's labor code protects workers' right to strike, although some workers reportedly are reluctant to strike for fear of losing their job.[24]

These employee and employer freedoms, together with unrestricted labor mobility and an unemployment insurance program comparable to those of OECD countries, make it possible for both workers and employers to bargain effectively over wages. This can be seen in a shifting national wage structure that varies by profession, sector, and geographic region, reflecting the differences in the relative bargaining position of the respective workers and employers. A similar pattern can be seen in regional unemployment rates.[25] For example, while there is unrestricted labor mobility in Latvia, regional labor mobility is actually very low, as it is in many Eastern European countries in transition. As a result, wages are significantly lower and unemployment rates significantly higher in the eastern part of the country than in Riga and in the central part, reflecting, in part, the relatively weak bargaining position of workers in the East. Likewise, wages in the finance sector in 1998 are over 200 percent of the national average, reflecting, in part, the relative scarcity (and therefore stronger bargaining position) of qualified finance people.

3. *The extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country.*

Since 1991, the government has vigorously pursued policies designed to encourage foreign direct investment (FDI) in Latvia. The government sees FDI as a source of much needed advanced technology and managerial skill and as a way to finance and promote industrial restructuring and growth of the private sector. The Latvian Development Agency, a semi-autonomous governmental organization, helps facilitate foreign investment and provides information to foreign persons and enterprises seeking to comply with Latvian laws. The three largest foreign direct investments have been a $305 million British-Finnish investment in Latvia's telecommunications industry, a $77 million Singaporean investment in textiles, and a

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[23] U.S. Department of Commerce, "Latvia 1999 Investment Climate Statement" (Riga: USDOC, 1999), see section entitled "Labor."

[24] Freedom House, "Nations in Transit 1998: Latvia," available at URL: http://freedomhouse.org/nit98/latvia.htm, under heading, "Civil Society, 5) Are There free Trade Unions."

[25] Organization for Economic Co-Operation and Development , Economic Surveys: Baltic States (Paris: OECD, 2000), pp. 241, 244.

$61.8 million Russian investment in Latvia's oil transit infrastructure. Large foreign investments in privatized companies have also been made, including a Finnish purchase of *SC Komunalceltnieks*, the Singaporean purchase on the State Riga Technological Tools Plant, and the EBRD purchase of a share block of *Unibank*.[26]

Latvia's liberal FDI policies, combined with a relatively stable macroeconomic and generally favorable business environment have resulted in cumulative FDI per capita that is among the highest in the region, exceeded only by FDI in the Czech Republic, Estonia, and Hungary.[27] All sectors of Latvia's economy are open to foreign investment, and within the framework of the foreign investment law, foreign invested and domestic firms receive equal treatment under domestic law with respect to their business operations. One hundred percent foreign ownership of a company is permitted.[28] However, foreign persons or enterprises cannot [redacted] and gambling, and radio and television.[29] Foreign persons or enterprises must obtain a business license to operate in certain sensitive sectors including banking and financial services, weapons production, medicine and pharmaceuticals, insurance, tobacco and liquor, and trade in precious metals. The business licensing requirement in these sectors applies to domestic firms as well, and the number of sectors for which a license is required is decreasing over time. The number fell from 188 in 1997 to 66 in 1998.[30]

Foreign invested enterprises are not subject to technology transfer, trade or FOREX balancing, or domestic content requirements, or any other investment-related performance requirements.[31] Moreover, they are free to repatriate any or all of any investment made in Latvia

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[26] European Bank for Reconstruction and Development, "Latvia: 1999 Country Profile," available at URL: http://www.ebrd.com/english/opera/COUNTRY/country%20profiles.pdf/3996Latvia.pdf, p.13.

[27] European Bank for Reconstruction and Development, Transition Report 1999 (London: EBRD, 1999), p. 79.

[28] Nissinen, Marja, Latvia's Transition to a Market Economy (New York, N.Y.: St. Martin's Press, 1999), pp. 65-6.

[29] International Monetary Fund, Exchange Arrangements and Exchange Restrictions (Washington, D.C.: IMF Press, 1999), p. 492.

[30] Organization for Economic Co-Operation and Development, Investment Guide for Latvia (Paris: OECD Press, 1998), p. 108.

[31] Performance requirements can be imposed in privatization cases and free-trade zone and free port applicants, but they are imposed on foreign and domestic firms alike. See U.S. Department of Commerce, Latvia 1999 Investment Climate Statement (Riga: USDOC, 1999), section entitled "Performance Requirements and Incentives."

and can freely convert their *lat* earnings into foreign exchange for such purposes.[32] They are somewhat limited in their ability to purchase land. They can do so only if they are majority Latvian owned or if they are majority owned by individuals or legal persons from countries with which Latvia has a mutual investment protection agreement.[33]

Latvia has established Riga and Ventspils as free ports and Liepaja and Rezekne as special economic zones (SEZs), all of which offer various tax and duty benefits to firms operating in them. In the case of the Liepaja SEZ, the exemption from income and real estate taxes appears to be conditioned on export performance.[34]

While Latvia is open to foreign investment, the climate for foreign investors in Latvia is not without its problems. Effective enforcement of the foreign investment law and associated rules and regulations is hampered by the unavailability of official translations of laws, rules and regulations, an inefficient judicial system that effectively precludes timely resolution of disputes, and an inadequate number of officials knowledgeable about market concepts and business practices and experienced in resolving complex legal and commercial disputes.[35] Corruption is also undermining business confidence and the rule of law. The government has taken steps to address corruption with the 1996 Law on Corruption Prevention, which requires that certain government officials and their relatives report their income to the State Revenue Service. However, enforcement of this law is somewhat lax.[36]

4. *The extent of government ownership or control of the means of production.*

When privatization began in Latvia in 1990, the state essentially owned and controlled all land, property, and enterprises. There was no formally recognized private sector to speak of, although a number of individuals and state-owned enterprises had already set up co-operatives

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[32] Organization for Economic Co-Operation and Development, Investment Guide for Latvia (Paris: OECD Press, 1998), p. 63.

[33] Organization for Economic Co-Operation and Development, Investment Guide for Latvia (Paris: OECD Press, 1998), p. 142

[34] "Tax Alleviations in the Liepaja Special Economic Zone," Chapter IV, Article 27, which can be found on the Liepaja Special Economic Zone webpage at: www.liepaja-sez.lv/law_iv.html, in chapter 4, under Article 27.

[35] Organization for Economic Co-Operation and Development, Investment Guide for Latvia (Paris: OECD Press, 1998), pp. 14-15.

[36] *Ibid.* at pp. 206-7.

that were engaged in "side-line" business activities for private profit, using either leased or expropriated state-owned assets.[37]

Through privatization, the government aimed to undo what had been done during the Soviet era and, at the same time, lay down what was recognized as an important piece of the foundation of a market economy. Thus, privatization proceeded along two fronts. First, what could be returned to its rightful owner (or heirs) was returned, or compensation was granted. Whatever was not restituted in this manner was then sold (privatized). Sketchy figures on restitutions make it difficult to say how many land parcels, buildings, and enterprises actually have been returned, but the government placed the highest priority on restitution first, even if it meant generating commercial disputes between previous owners and current users of the property.

With regard to enterprise privatization, the government delegated to municipal governments the responsibility of selling off small businesses, *e.g.*, shops, restaurants. Selling began in 1991, and by 1994-5, virtually all small businesses were in private hands.[38] Lease buy-outs were the primary mode of transfer, as most buyers, typically the incumbent managers, had limited financial resources.[39]

Medium- and large-scale privatization in Latvia also commenced in 1991 and got off to a slow start, as officials debated over and experimented with a decentralized process in which various Ministries were given administrative responsibility for developing and implementing privatization plans for the enterprises under their respective jurisdictions. The process was cumbersome and overly bureaucratic and placed control in the hands of unqualified officials that did not necessarily share common goals and objectives. Contributing to these problems was the fact that Latvia did not have an updated citizenship law or its own currency at the time.[40]

After realizing in 1994 that the decentralized approach to medium- and large-scale privatization would not work, and that a centralized approach based on a comprehensive strategy was needed, Latvia established the Latvian Privatization Agency (L.A.) and the State Property Fund (SPF). The SPF was given the task of managing the assets of ongoing state enterprise concerns on a commercial basis, and the L.A. was responsible for privatizing enterprises not

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[37] Mygind, Niels, "Privatization, Governance and Restructuring of Enterprises in the Baltics," (OECD doc. # CCNM/BALT(2000)6)(Paris: OECD Press, 2000), pp.13-14.

[38] Nissinen, Marja, Latvia's Transition to a Market Economy (New York, N.Y.: St. Martin's Press, 1999), p. 80.

[39] Mygind, Niels, "Privatization, Governance and Restructuring of enterprises in the Baltics," (OECD doc. # CCNM/BALT(2000)6)(Paris: OECD Press, 2000), p. 14.

[40] Nissinen, Marja, Latvia's Transition to a Market Economy (New York, N.Y.: St. Martin's Press, 1999), pp. 81-3, 92-3.

managed by the SPF. The reorganization of the privatization process paid immediate dividends, as the pace and scope of privatization increased rapidly. In 1996, the government folded the SPF into the L.A., as enterprises previously managed by the SPF were slated for privatization.[41]

The L.A. uses three methods to privatize companies: public auctions, international tenders, and the sale of shares to employees and pensioners in exchange for vouchers. Public auctions were the preferred method for promoting broad ownership in profitable companies that were of little interest to international investors. Initial public auctions used a multi-round system to exchange privatization vouchers for shares in companies. Later, cash auctions were also used, for example, in the sale of the financial institutions *Latvijias Unibanka* and *Latvian Savings Bank*.[42] International tenders were arranged for the sale of 79 companies, drawing $40 million in investments, and will be used for at least two of Latvia's remaining large, state-owned companies, *Lattelekom* and *Latvian Shipping Company*.[43]

By the end of 1998, virtually all enterprises were in private hands, and the private sector accounted for 65 percent of GDP.[44] Latvia's private sector share of GDP is relatively low, given the large percentage of enterprises that have been privatized. However, the low share is somewhat misleading because it reflects, in part, the fact that the government, education, and health and social work sectors in GDP have little private-sector participation.[45] Looking outside the "public service and social service" sectors, we see that in agriculture and fishing, the private sector accounts for over 90 percent of output. In mining, manufacturing, construction and wholesale and retail trade, it is 95 percent or more.[46] Ports, airports, the postal and railway systems, cultural organizations such as the national ballet, and regional road maintenance and agricultural research units will not be privatized.[47]

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[41] *Ibid.*, p. 83.

[42] International Monetary Fund, "Republic of Latvia: Selected Issues and Statistical Appendix" (Washington, D.C.: IMF, 2000) August 2000, p. 37-8.

[43] *Ibid.*, p. 38.

[44] European Bank for Reconstruction and Development, Transition Report 1999 (London: EBRD, 1999), p. 240.

[45] International Monetary Fund, "Republic of Latvia: Selected issues and Statistical Appendix," (Washington, D.C.: IMF, 2000), pp. 42, 48.

[46] *Ibid*, at p. 42

[47] Nissinen, Marja, Latvia's Transition to a Market Economy (New York, N.Y.: St. Martin's Press, 1999), p. 82.

The remaining large enterprise privatizations have been problematic for several reasons. In some cases, *e.g.*, electricity and telecommunications, the government is both owner and regulator and is struggling with the problem of how best to divest and deregulate, given the importance of economic efficiency in these sectors[48] and concerns about privatization revenues. In other cases, *e.g.*, transport, the government is not willing to give up a controlling interest.[49] Perhaps, more significantly, powerful business groups, working through political proxies, continue to vie for ownership and control of some of Latvia's remaining prized industrial assets.[50] The stakes are high, as the enterprises in question are quite large and collectively account for a significant share–maybe as much as 10 percent–of Latvia's GDP.[51]

Land reform has been a high priority of the government since the beginning of reforms. In the case of land, in particular, many officials felt the moral and legal imperative to undo the expropriation and collectivization that occurred during the Soviet era (referred to as the "50-year occupation")[52] and restore, wherever possible, the pre-war, private property structure. Where restitution was not possible, the government intended to privatize the land in two stages. In the first stage, rural and urban land would be distributed to individuals and enterprises wanting it for private farm and non-farm use. In the second stage, the land would be sold to the user, formally converting land-use rights into land-ownership rights.[53] Built into the government's land use allocation policy was a strong preference for individual use over collective use. Any legal individual use was given priority over collective use.[54]

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[48] European Bank for Reconstruction and Development, <u>Transition Report 1999</u> (London: EBRD, 1999), p. 239.

[49] European Bank for Reconstruction and Development, <u>Transition Report Update</u> (London: EBRD, 2000), p. 64.

[50] Economist Intelligence Unit (EIU), <u>Country Reports Latvia</u> (London: EIU, July 17, 2000), see sections entitled "Political scene" and "Economic policy".

[51] International Monetary Fund, "Republic of Latvia: Selected issues and Statistical Appendix," (Washington, D.C.: IMF, 2000), p. 42, 58.

[52] Nissinen, Marja, <u>Latvia's Transition to a Market Economy</u> (New York, N.Y.: St. Martin's Press, 1999), p. 106.

[53] Presentation by Mr Z. Veitners, Deputy Director of the State Land Service of Latvia, at AGROBALT99 Conference on Land Reform Conditions and Problems in the Baltic States, May 1999 in Lithuania.

[54] Organization for Economic Co-Operation and Development, <u>Review of Agricultural Policies: Latvia</u> (Paris: OECD, 1996), pp. 19-20.

The plan was simple enough, but delays and problems with restitution, (mandatory) state-funded land surveys, and Land Book registration bottlenecks[55] have slowed the establishment of private land ownership rights. This, in turn, has slowed the development of a national land market, since only land registered in the Land Book can be bought or sold.[56] Thus, although virtually all non-forested land (urban and rural) now is in private use, a much smaller share of such land legally is privately owned, *e.g.*, 95 percent of agricultural land was in private hands at the end of 1999,[57] either restituted land or land allocated for private use, but only about 30 percent was privately owned.[58]

5. *The extent of government control over the allocation of resources and over the price and output decisions of enterprises.*

Under the Soviet command system, economic and industrial planning and policy implementation was highly centralized, with directives emanating out of either all-union ministries in Moscow (in the case of heavy industry) or regional ministries (in the case of light industry).[59] The communist party in power in Latvia at the time had no real role in policy design or planning, and in the economic sphere did little more than ensure Latvia's contribution to the Soviet Union's five year plan. Consequently, the dissolution of the Soviet Union and the end of the Latvian Communist Party's monopoly on power eliminated what had been the single most important motivation for government control of enterprise affairs and the allocation of resources in Latvia. Thus, although various Latvian government ministries individually may have been trying to preserve whatever residual control they had over the economy, when the new democratic government of Latvia assumed power, there was no concerted, system-wide attempt to preserve or otherwise reconstitute the central economic planning apparatus that existed in the Soviet era.

Price liberalization began in Latvia in 1991, as the government wanted to avoid shortages in the domestic market and stop, or at least limit, the drain of Latvian goods to less well-supplied

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55 Organization for Economic Co-Operation and Development, Economic Surveys: Baltic States (Paris: OECD Press, 2000), p. 192.

56 Organization for Economic Co-Operation and Development, Investment Guide for Latvia (Paris: OECD Press, 1998), p. 143.

57 Zvi Lerman, "Agriculture in ECE and CIS: From Common Heritage to Divergence," The Hebrew University and The World Bank, January 1999, table 1, p. 4.

58 Presentation by Z. Veitners, Deputy Director of the State Land Service of Latvia, at AGROBALT 1999, available at www.zum.lt/departinf/department/informacija/02.htm., under heading "Land Reform in Latvia."

59 Organization for Economic Co-Operation and Development, Economic Surveys: Baltic States (Paris: OECD Press, 2000), p. 26.

areas of the USSR.[60] By the end of 1992, goods and services still subject to price controls accounted for less than eight percent of the CPI (on the basis of share of total expenditure). However, since then, the share has increased to over twenty percent.[61] Evidently, this increase in the share of administered prices in the CPI is not due to an increase in the *number* of administered prices, as that number remains small. Only public transportation, utilities (water, sewage), residential and industrial energy (electricity, gas, steam) and housing remain subject to government price regulation, in many cases at the municipal government level.[62] The demand for most of these goods is relatively inelastic, and it is therefore very likely that repeated increases in the administered prices of these goods--which still are below full cost-recovery levels to reduce the possibility of social tensions[63]--have increased relative expenditures on these items, boosting their share in the CPI.

The issue of government control over production decisions and the allocation of resources is, perhaps, most critical as it concerns the allocation of capital, specifically bank credit, where, as in Latvia, stock and corporate bond markets are underdeveloped. Banking sector reform in Latvia started in 1992 with the break-up of the Soviet-era monobank into a central bank, the Bank of Latvia (BOL), and several commercial banks that first were transformed into joint-stock companies and then privatized.[64] The highly unregulated nature of the industry at the beginning of reforms meant that there were few, if any, barriers to entry, and, as a result, the number of new (private) banks increased dramatically, from 14 in 1991 to 62 in 1993.[65] Imprudent lending practices and unsupervised activities quickly resulted in a banking crisis in 1995 that forced the industry to consolidate and led to increased government supervision and regulation along western, market-economy lines, *e.g.*, higher minimum (start-up) capital requirements and reserve ratios, stringent loan-loss reserve requirements, and mandatory audits.[66]

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[60] Nissinen, Marja, Latvia's Transition to a Market Economy (New York, N.Y.: St. Martin's Press, 1999), p. 63.

[61] European Bank for Reconstruction and Development, Transition Report 1999 (London: EBRD, 1999), p. 240.

[62] Organization for Economic Co-Operation and Development, Economic Surveys: Baltic States (Paris: OECD Press, 2000), p. 33.

[63] Government of Latvia, Report on the Economic Reform Process in Latvia (submitted to the World Trade organization, doc. # WT/L/362, 2000), September 2000. See section entitled "Prices."

[64] Nissinen, Marja, Latvia's Transition to a Market Economy (New York, N.Y.: St. Martin's Press, 1999), p. 72.

[65] European Bank for Reconstruction and Development, Transition Report 1999 (London: EBRD, 1999), p. 240.

[66] Economist Intelligence Unit, EIU Country Profiles, Latvia (London: EIU, May 5, 2000), see section entitled "Economic sectors." Economist Intelligence Unit, "Country Alert, Latvia Finance: Banking Sector

Despite these growing pains, Latvia is seeing significant dividends from banking sector reforms. The BOL operates independently of the government and political influence in formulating Latvia's monetary and exchange rate policies.[67] Full interest rate liberalization in 1992,[68] rapid bank privatization, the entry of new banks, and the large share of foreign capital in the industry collectively have cut the ties that formerly bound state-owned banks to enterprises under the Soviet-era, credit-allocation system. Latvian banks now direct credit to its most profitable use, and more often than not, that has meant lending more to domestic and foreign governments and non-residents (individuals, firms and institutions) and less to Latvian residents. The split of bank claims (as a percentage of all bank assets) between those on government and foreign residents and those on domestic residents was 58/24, 65/20, 65/23, and 51/33 for end-of-year 1995, 1996, 1997, and 1998, respectively.[69] Latvian banks do not, as a general rule, aggressively seek out domestic firms as loan customers, particularly small-and medium-sized enterprises (which account for 95 percent of firms in Latvia), because of the real and perceived risk associated with the inadequacy of financial and accounting statements, business plans, and managerial talent of most Latvian firms. When banks lend to domestic residents, it tends to be to large enterprises, where the above problems are not so much of a concern.[70] Lending to state-owned enterprises accounts for a declining share of total loans to all enterprises, a share in 1997 that was about eight percent.[71] Financial intermediation in Latvia is relatively low, with the ratio of total credit to GDP standing at 23 percent at the end of 1999. Bank loans as a percentage of all assets remained fairly stable at roughly 40 percent, and banks keep a large share of their assets in liquid form.[72]

The banking sector today stands on its own. The government and central bank engaged in little, if any, recapitalization of the sector in the aftermath of financial crises of 1995 and, more recently, 1998, preferring, instead, to let the banks deal with the crises the old-fashioned way:

Recovers After 1995 Fraud Scandals," November 26, 1997.

[67] Organization for Economic Co-Operation and Development, Economic Surveys: Baltic States (Paris: OECD Press, 2000), p. 58.

[68] *Ibid.*, p. 238.

[69] Organization for Economic Co-Operation and Development, Economic Surveys: Baltic States (Paris: OECD Press, 2000), p. 261.

[70] European Commission, An Evaluation of PHARE SME Programs: Latvia, Final Report, December 1999, see section entitled "Credits."

[71] *Ibid.*

[72] Economist Intelligence Unit, EIU Country Reports, Latvia (London: EIU, July 17, 2000), see section entitled "Financial indicators."

suffer, struggle, and survive or perish.[73] Although the Russian rouble devaluation and government debt default put a real dent in bank profits in 1998 (through direct exposure from investments in Russian government securities and indirect exposure from loans to firms heavily dependent on Russian markets), Latvian banks remained solvent as a whole[74] and rebounded quickly, returning to profitability the next year.[75]

The market-based nature of bank lending in Latvia imposes hard budget constraints on enterprises by ensuring that bank credit is not used as a financial "life support system" for [illegible] not break.[76] Between 1991 and 2000, 2,458 companies filed or registered for bankruptcy, and by December 2000, bankruptcy procedures had been completed in 1,001 cases.[77] In the cases of major bankruptcies of banks and large firms, such as the March 1999 bankruptcy of *Pirma Latvijas Komercbanka* (The First Commercial Bank of Latvia), restructuring is the preferred option, but always in ways consistent with internationally accepted practices.[78]

Like the banks, workers and firms are also reallocating labor services and material resources to better use, in response to increased competition at home and in export markets. An examination of market entry and exit data and employment across sectors reveals that firms in agriculture and manufacturing, particularly large firms in the electrical machinery and equipment, radio, television, automobile and trailer industries, are shedding labor as they struggle to adjust to the loss of Soviet-era export markets and cope with their lack of international competitiveness. Some of this labor is being taken up by the expanding wood processing and furniture-making, textile, food, and metal processing industries, as firms and workers in increasing numbers take advantage of Latvia's relative abundance of timber and respond to export opportunities and

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[73] Economist Intelligence Unit, "Country Briefing, Latvia Finance: Banking Sector under Strain,"April 22, 1999).

[74] International Monetary Fund, "Republic of Latvia: Selected issues and Statistical Appendix," (Washington, D.C.: IMF, 2000), p. 83.

[75] Economist Intelligence Unit, <u>EIU Country Reports, Latvia</u> (London: EIU, July 17, 2000), see section entitled "Financial indicators."

[76] Anita Ramasastry, "EBRD Legal Indicator Survey: Assessing Insolvency Laws After Ten Years of Transition," Law in Transition, Spring 2000.

[77] LURSOFT, a private data compilation company in Latvia.

[78] Adrian Cohen, "Case Study: the Out-of-Court Restructuring of a Latvian Bank," Law in Transition, Spring 2000.

increased consumer demand. Workers and new firms are also jumping into the services sector to meet demand that was underdeveloped during the Soviet era.[79]

The highly decentralized, market-based nature of the ongoing reallocation of resources can be seen in the large increase in the number of small-and medium-sized enterprises (SMEs) in Latvia (firms with less than 250 employees). Between 1995 and 1998, the number of all [illegible] 95 percent of active enterprises in Latvia.[80] In the industrial sector, the number of SMEs increased almost 50 percent, going from 3,030 to 4,431, and the vast majority of these enterprises were small enterprises with less than ten employees.[81]

6. *Such other factors as the administering authority considers appropriate.*

The current open, decentralized trading system reflects Latvia's intention to maximize its potential as a primary transit hub for East-West trade. Latvia's simple average tariff rate is approximately four percent, although tariffs on agricultural products average 14 percent. Latvia does not make systematic use of non-tariff measures and is phasing out the few that are in effect.[82] The government requires import licenses in the case of products that are subject to an excise tax (spirits and alcoholic beverages, tobacco products, fuel, precious metals, and jewelry) to limit tax evasion. Because the Ministry of Finance apparently can reject a license application, licensing is not fully automatic.[83] Grain and grain products are subject to licensing requirements and tariff-rate quotas, which are administered by a state trading enterprise, the Cereal Trade Agency (CTA). The CTA acts as buyer and seller of last resort on Latvia's grain markets to keep prices above their references levels and maintain price stability.[84]

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[79] Organization for Economic Co-Operation and Development, Economic Surveys: Baltic States (Paris: OECD Press, 2000), pp. 182, 236-7.

[80] European Commission, An Evaluation of PAHRE SME Programs: Latvia, Final Report, December 1999, see section entitled "Growth and Development of SMEs."

[81] Organization for Economic Co-Operation and Development, Economic Surveys: Baltic States (Paris: OECD Press, 2000), p. 182.

[82] Economist Intelligence Unit, EIU Country Profiles, Latvia (London: EIU, May 5, 2000), see section entitled "External sector."

[83] Government of Latvia, Replies to Questions on Import Licensing Procedures, submitted to WTO, September 1999, WTO doc. # G/LIC/N/3LVA/1, see sections entitled "Purpose and coverage of licensing" and "Procedures."

[84] Government of Latvia, New and Full Updating Notifications Pursuant to Article XVII:4(a) of the GATT 1994 and Paragraph 1 of the Understanding on the Interpretation of Article XVII, submitted to the WTO, July 1999, WTO doc. # G/STR/N/4/LVA and G/STR/N/5/NVA.

Latvia's recent accession to the WTO (February 1999), and all the rights and obligations that that membership implies, will help to consolidate and give permanence to the broad range of trade reforms Latvia has undertaken to date. Latvia's ongoing efforts to secure membership in the EU,
particularly those designed to conform Latvian social and legal institutions with EU norms, will necessarily deepen and strengthen the overall reform results.

In 1991, Latvia was the first of the states of the former Soviet Union to enact a national competition law, similar to the European Union's, under which a five-member Competition Council, and a Competition Bureau working under it, can investigate abuse of a dominant market position, restrictive agreements, mergers, governmental bodies engaged in anti-competitive activities, and "unfair competition" (such as the use or distribution of another firm's business secrets or disseminating false or misleading information about a competitor).[85] The competition authorities initiated 76 investigations in 1998, mostly abuse of dominant position and unfair competition cases. A large number of these investigations were terminated when no violation was found or the conduct in question had been terminated, roughly 10 cases were either settled or resulted in an enforcement order, and the remainder are ongoing.[86]

The judicial system remains underdeveloped, as low court funding levels and inadequate training of many judges reduces the efficiency and credibility of the legal system. However, there are signs that the situation is improving. In the last two years, Latvia's two legal bar associations (the Latvian Lawyer's Association and the Latvian College of Sworn Advocates) have increased their membership, and a system of state-provided public defenders has taken root in Latvia.[87] A recent initiative by the American Bar Association's Central and Eastern European Law Initiative (CEELI) to bring computers into Latvian courts and train the courts on the use of juridical databases has increased the level of efficiency in Latvia's courts. CEELI reported that the Latvian courts are incrementally bringing their facilities up to higher standards.[88]

The development of an efficient, equitable and transparent tax-collection system is critically important in helping to ensure that the government remains sufficiently divorced from enterprise management, enterprise budget constraints remain sufficiently hard, investment returns can be reasonably anticipated, and social welfare programs that help to ease the pain of economic

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[85] Organization for Economic Co-Operation and Development, Competition Law and Policy in the Baltic Countries, OECD Press, Paris: 1999.

[86] *Ibid.*

[87] Freedom House, Nations in Transit 1998: Latvia, available at URL: http://www.freedomhouse.org/nit98/latvia.pdf, under heading, "Rule of Law, 7) Does the State Provide Public Defenders?"

[88] American Bar Association Central and Eastern European Law Initiative, "CEELI in Latvia," available at URL: http://www.abanet.org/ceeli/countries/latviainfo.html#judicialreform, under heading, "Judicial reform."

transitions can be funded. Where taxes are not collected or deferred, or where taxes are imposed on an arbitrary, *ad hoc* basis and in an opaque manner, compromising government-enterprise relationships, corporate governance and budget constraints can become weak and the rule of law suffers, generating economic lassitude and instability. Latvia has done much work to simplify its tax system, relying on a 18 percent VAT and standard 25 percent income and profit taxes. However, tax evasion and tax arrears remain substantial, together about six percent of GDP, mostly related to the energy sector.[89]

ANALYSIS AND ASSESSMENT

Section 771(18)(B) of the Act enumerates six factors that the Department must consider in determining whether a country operates on market principles of cost or pricing structures, within the meaning of section 771(18)(A). However, the statute provides no direction or guidance with respect to the relative weight that should be placed on each factor in assessing the overall state of the economy, which implies that the Department may use discretion in its evaluation, based upon unique facts in each case. We note at the outset that each of the six statutory factors discussed is framed in terms of the *extent* of government intervention, and not in terms of absolutes, suggesting that complete *laissez faire* or a perfectly competitive market economy is not the applicable standard.

Latvia achieved remarkable results early on in the transition process, given the initial shock to its economy from price liberalization and the collapse of critical markets in the former Soviet Union. The Central Bank's independence from political influences and its strong commitment first to price stability and then to exchange rate stability, combined with the government's commitment to fiscal restraint, have fostered macroeconomic conditions that have greatly facilitated the market reform process in Latvia. Price stability, a currency pegged to the SDR, markets that are open both to import and export trade, and operational autonomy for firms resulting from privatization collectively have reduced business and market uncertainties and greatly increased opportunities for Latvian firms. This has made it easier for them to reorient production and trade away from markets in the former Soviet Union to western markets. Perhaps most importantly, the relatively stable macroeconomic environment has enabled individuals and firms to engage in commercially oriented, money-based transactions focused on production and trade and develop networks of long-term horizontal and vertical business relationships with customers and institutions inside and outside of Latvia that deepen and strengthen markets.

Keeping the process on track has been a government often divided over how to resolve the everyday problems of governing, but in all cases united on the goal of building a market economy in Latvia. There has been little internal disagreement on fundamental or core issues

[89] Organization for Economic Co-Operation and Development, Economic Surveys: Baltic States (Paris: OECD Press, 2000), p. 88.

such as the need for macroeconomic stability, comprehensive privatization, liberalization, and market-supporting laws and institutions. The important issue of land reform is a good example of Latvia's collective will on resolving "core" issues and problems. At the outset of reforms, the government made land restitution and privatization a priority, one that carried through successive governments without modification, although the extent to which foreigners would be able to purchase land was vigorously debated.[90] Perhaps the best example of this policy consensus on core issues was the establishment, at the beginning of reforms, of a strong, independent central bank and a private banking sector.

Despite the consensus on approach, the results to date in some important reform areas have fallen short of expectations. Large-scale privatizations in the energy and telecommunications sectors are not yet complete, and while they are small in number, they loom large in their importance to the economy. Land privatization should be accelerated, given the importance of a fully functioning land market to investment (from both foreign and domestic sources), and the importance of investment in modernizing industry and moving Latvia to higher value-added production and exports.[91] Of equal importance is the need to strengthen the rule of law by reducing corruption and tax arrears and to improve and increase the quality and capacity of the judicial system. And to the extent that special tax and duty rules apply to firms operating in free ports and special economic zones, like in many countries of the world, such rules should be consistent with Latvia's obligations under the WTO Agreement on Subsidies and Countervailing Measures.

On balance, though, taking account of the successes and the problems and obstacles that remain reforms have progressed to the point where revocation of Latvia's non-market economy country status is warranted. Latvia has proceeded unerringly and without hesitation in the direction of comprehensive reform and has not looked back. Most of the economic, legal and institutional parts and assemblies of the old system have been changed or are being changed, and the question is the extent to which the system of new parts and assemblies works. While macroeconomic performance itself is not dispositive of the microeconomic and institutional aspects of an economy, Latvia's economic performance since the re-establishment of independence suggests that the new system is working. Over the first five years of reforms, industrial output in Latvia fell, cumulatively by over 60 percent, but each year by a progressively smaller rate. In 1995, the fall in industrial output bottomed out. Industrial output began to grow in 1996 and has grown every year since, with the exception of 1999, which followed the Russian financial crisis of 1998.[92] Most significantly, this growth has been self-sustaining, not requiring

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[90] Nissinen, Marja, Latvia's Transition to a Market Economy (New York, N.Y.: St. Martin's Press, 1999), p. 141.

[91] Economist Intelligence Unit, EIU Country Reports, Latvia (London: EIU, July 17, 2000), see section entitled "

[92] European Bank for Reconstruction and Development, Transition Report 1999 (London: EBRD, 1999), p. 240. Economist Intelligence Unit, EIU Country Profiles, Latvia (London: EIU, May 5, 2000), see table entitled

large-scale government support or intermediation. Labor productivity, industrial wages, and gross fixed investment have all been increasing, consumer price inflation has been brought down to single digits, the exchange rate is stable, interest rates have come down and stabilized, and capital flight is not a problem.[93]

RECOMMENDATION

Based on the preponderance of evidence on economic reforms in Latvia to date, analyzed as required under section 771(18)(B) of the Act, the Department should determine that (1) revocation of Latvia's non-market economy status under section 771(18)(A) is warranted, (2) Latvia has operated as market-economy country since January 1, 1999, and (3) this finding is effective for all current and future administrative proceedings.

Agree ✓ Disagree ________

Troy H. Cribb

Troy Cribb
Assistant Secretary
for Import Administration

1/12/01

Date

"Indices of industrial production."

[93] *Ibid*., see tables in the back of EIU report.