
# Macroeconomic Review of Latvia

March 2011

## In Focus

- The Ministry of Finance reports that the budget deficit in 2010 according to the ESA95 methodology was 8.2%. Precise data will be available in April
- The recovery of the Latvian economy is gaining strength. The flash estimate shows that GDP in the 4th quarter of 2010 rose by 3.7%
- Current account deficit last year was 4% of GDP. The surplus will keep shrinking
- In 2010, compared with 2009, industrial output grew by 13.9%, of which manufacturing – by 14%. This year industry will keep a good pace of development yet the tempo will be slower than in 2010
- In 2010 the value of foreign trade turnover reached 10507.3 million lats exceeding the result of 2009 by 26.4%. Exports rose to 4666.5 million lats (+29.5%), while imports went up to 5840.8 million lats (+24.0%). Despite the robust export growth, deficit of the foreign trade balance is expected to increase further. Export volume in constant prices in 2010 rose by 19.6%; imports climbed up by 15.6%
- Registered unemployment rate at the end of February reached 14.5 percent. With the arrival of spring the icy mountain of unemployment will keep to melt further
- Hotels and other hospitality establishments in 2010 welcomed 1312 thousand guests or 17.7% more than in 2009

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# Latvia's key economic data and forecasts

| | 2008 | 2009 | 2010 | Period | 2011 | 2011f | 2012f |
|---|---|---|---|---|---|---|---|
| GDP growth (%) | -4.2 | -18.0 | -0.2* | - | - | 4.0 | 5.0 |
| GDP at current prices (mln LVL) | 16190 | 13080 | 9282 I-IX | - | - | 13300 | 14100 |
| Consumer prices index (% annual average) | 15.4 | 3.5 | -1.1 | I | -0.5 | 3.4 | 2.4 |
| Fiscal deficit, surplus of the Government consolidated budget (ESA 95, % of GDP) | -4.2 | -10.2 | -8.2* | - | - | -5.8 | -2.8 |
| Current account balance (% of GDP) | -12.6 | 9.4 | 4.0* | - | - | -0.5 | -2.5 |
| Foreign direct investment flow (mln LVL) | 607 | 36 | 284 | - | - | 350 | 350 |
| Cumulative foreign direct investment (mln LVL) | 5711 | 5734 | 6116 IX | - | - | 6280 | 6650 |
| Foreign trade balance (% of GDP) | -19.0 | -8.0 | -8.0 I-IX | - | - | -10.0 | -12.0 |
| Government foreign debt (mln LVL) | 1260 | 3253 | 4135 | - | - | 4700 | 5200 |
| Manufacturing output (% yoy) | -8.3 | -17.7 | 14.0 | - | - | 8.0 | 7.5 |
| Retail trade turnover (% yoy) | -7.3 | -27.3 | -2.0 | I | 0.1 | 5.0 | 5.0 |
| Unemployment rate (%, end of period) | 7.0 | 16.0 | 14.3 | II | 14.5 | 12.6 | 9.3 |
| Job seekers rate (%, end of period) | 9.9 | 19.7 | 16.9 | - | - | 15.2 | 14.0 |
| Average gross salary growth (% yoy) | 20.4 | -3.9 | -3.5 | - | - | 4.0 | 6.5 |
| Real wage and salary index (% yoy) | 6.2 | -5.6 | -6.5 | - | - | 1.5 | 3.0 |
| Standard & Poor's long-term credit rating | BBB- | BB | BB+ | - | - | - | - |

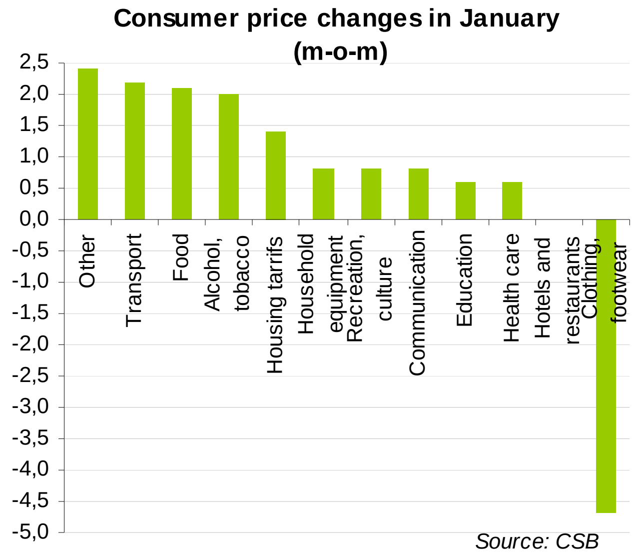
** Provisional data. Sources: Central Statistical Bureau of Latvia, the Bank of Latvia. SEB banka's forecasts.*

## Prices in January driven by taxes

Currently we observe the rise of consumer prices that is dictated by external factors and is heating up the prices in the domestic market of Latvia. In addition, with the current raising of taxes, the oil into the fire is poured by the government. Due to the soaring fuel and food prices in the global markets and the tax changes the expenses of the Latvian population have increased. In January monthly inflation reached 1.3%, which is the highest monthly inflation figure since January 2009. More than half of the overall increase of inflation is attributed to inflation of electricity (0.33 percentage points due to the rise of VAT from 10% to 22%) and to fuel prices (the result of a 0.3 percentage point rise in the global fuel exchanges and the rise of taxes). Compared with January 2010, consumer prices are 3.7% higher. Besides, over the year, the essential goods, including food products, have become on average 8.5% more expensive, housing 9.6% and transport 6.8% more expensive. In the household expenses in 2010 the share of the essential goods, e.g., food, is likely to have grown, hence, the upward correction and update of the food basket price index have affected January's inflation figure.

In the months to come inflation may grow to new heights, exceeding 4%, considering that in January in all groups of goods (particularly in those that in January are discounted and offered on sales) the tax increase effect was not fully perceivable yet. Tax changes in separate cases have been an excuse for rising of prices and sometimes disproportionately to the actual tax increase.

In the coming months the relatively high inflation rate will be further pushed up by the envisaged rise of electricity tariffs. On 1 June excise tax for natural gas, alcoholic drinks and tobacco will go up too.



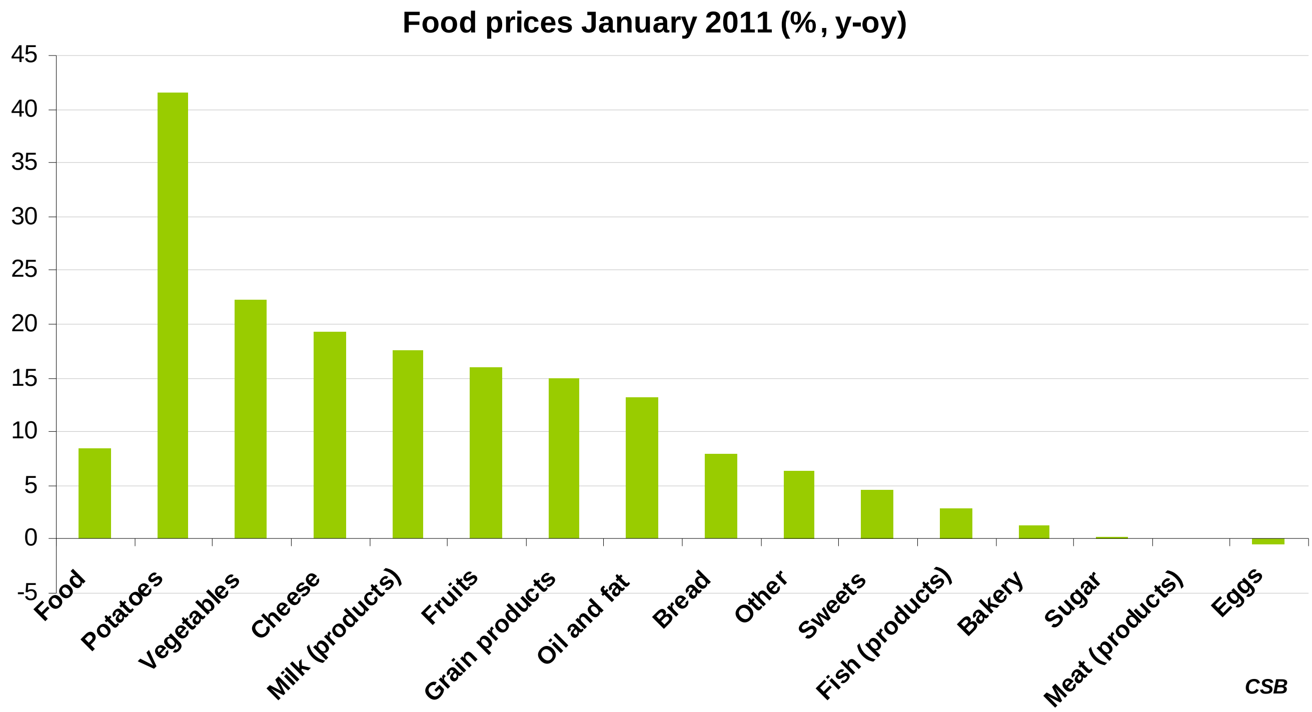

The reduced VAT rate for natural gas will be cancelled. We should also note that the inflation expectancy has raised – the majority of the population and business community predicts rising of inflation in the next 12 months, which can be a factor sustaining inflation.

Although trade is not falling any more and some groups of goods have even rebounded, the purchasing power of the population still remains low. Therefore, the sharp rise of prices can be detrimental for the trade volumes as part of the population may be forced to revise their consumer product basket. The people's purchasing capacity does not allow to recklessly manipulating with prices and calls for more responsible work of manufacturers and traders who should assume their share of expenses or should not exaggerate them.

In January monthly inflation was 1.3%. Assuming that the traders put all the rise of taxes into the prices without deferring it until the following months and without absorbing this increase, the average rise of prices in January was tax-driven, meaning, that if the taxes were not raised, average prices in January would have remained unchanged. It should be noted that the impact of taxes in different groups of goods differs and this is the result of calculations that should not be interpreted literally.

## Weather dictating food prices

One of the current forces pushing up inflation is food prices not only in Latvia but in many places worldwide. For example, in 2010 due to bad weather conditions in Korea prices for meat, vegetables and fish rose to the highest level in 16 years. Emerging economies raise the demand for food thus, together with the climatic conditions worldwide, reducing the food product resources and increasing tensions in the society. This has already caused popular unrest in a number of countries and now is causing the anxiety that the wave of the food protests of 2008 may be repeated. While the heads of international institutions and states are placating the public and seeking solutions, it becomes clear that the global challenge of food sufficiency and availability this year and afterwards will get only more serious. So, **what are the factors and trends driving the food prices up?** It should be noted also, that the current price rise is a serious threat to the economic recovery that we experience now.




After the turmoil triggered by food prices in 2008 good harvests and the recession sent the prices down until the year 2010 saw another sharp rise of food prices. Its causes were natural: floods in Canada and Australia and drought and fires in Russia. Last year the Food Price Index[1] of the UN Food and Agriculture Organization kept rising throughout the year and in December reached new record heights. At present the prices of agricultural products are approximately 10 percent higher than at the time of the food crisis of 2008. At the basis of the sharp rise are the growing prices of sugar, maize, oil and meat.

In December 2010 the price of sugar broke another record increasing more than twice. The cause was bad weather conditions in the leading countries – sugar exporters – India and Mexico. Raising the tension even further, India restricted its sugar exports. Australia suffered from floods of unprecedented scale. Most likely it also will lead to sugar and corn export restrictions. Indonesia, too, has experienced the impact of prolonged rains on this year's harvest. In Central America drought has ruined the bean harvest and their price in some countries has even tripled. In India due to heavy rains the price of onions – an important product in the Indian cuisine – has grown alarmingly and already has caused popular discontent. The price of cocoa beans has climbed to the peak in the last 30 years and is likely to go further up. According to the US government estimates, this year's wheat harvest will be the poorest in the last two years. Even if it is among record highs, it will still be insufficient to satisfy the growing demand.

Nevertheless, the picture is not so bleak everywhere. Asia and the world's poorest countries are more dependant on the rice harvest, which is their staple food, and its price. Since 2008 the rice price has dropped approximately by half and has not risen too fast. Besides, the record rice harvest is being anticipated this year. However, in two last years the demand for rice in China, Brazil, India and Russia has grown on average by five percent annually. In east Africa the price of maize that is one of the basic food products there has plummeted due to a very good harvest. At the same time, some countries that do not depend on food imports from the weather-troubled countries have not experienced major price rises.

According to FAO, the food price hikes are not caused by financial markets and yet they clearly make situation more difficult. The temptation to earn a profit on the price rise only aggravates the situation.

[1] Food and Agriculture Organization of the United Nations (FAO)

Therefore, in the coming years the instruments will be sought to curb the impact of speculative deals on the food prices. The task is very difficult, if not unfeasible. The current system that is enhancing growth was created to provide predictability and minimise risks in food supply.

**What are the conclusions?** Despite the international institutions' assurances that the events of 2008 and the emergency situation will not return, these look like the first signs of what can happen to us in the future. The relentless rise of food prices will greatly reduce access to food for many millions of people worldwide. As estimated by international institutions billion of the global population is suffering from chronic malnutrition. Hence the popular unrest and political excesses caused by food prices and famines and repeating with unpredictable frequency in many regions of the world are likely risks in the future. Some countries, such as China, are aware of this. In exchange for investments, China is gaining access to Africa's fertile lands in order to feed the huge nation in the future.

**The demand will keep growing due to the rising global population and the improving living conditions in Asia as well as the use of crops as a source of energy.** Increase in productivity that for many years could satisfy the growing demand will not be able to cope with it any more.

If we now speak of protectionism in terms of currency wars, the future tensions will arise from the export restrictions imposed by the countries. Therefore, the price trends will depend on the ability of the countries exporting food to avoid export restrictions or bans.

The price rise dictated mostly by external factors will negatively affect the purchasing power of the Latvian population. Latvia will have to face this issue. Therefore it is worthwhile to contemplate the possibility of such shocks in Latvia and ways of their mitigation. Although the public is quite numb and hardly react to the processes going on in Latvia, it may not always be so. One of the ways is to promote market development and supervision, healthy competition and to minimise the influence of oligopolies in pricing of goods.

In the current situation, despite the price hikes of many products, their dynamics greatly differ. Therefore, in order to minimize the negative impact of the price rise, we should switch to the use of the products whose prices rise slower. We should not so easily succumb to various commotions and try to create food reserves. It is playing into the hands of various speculators, agents and traders.

Fast and unexpected calamities do not happen often, yet their link with the anticipated climate change and its influence on harvests show that their frequency may increase. In the era of globalization any shock of this type may hit the domestic market faster and harder than we would like to see. Therefore, as we continue to integrate in the global economy, we must be aware of these risks. Finally, it should be added that although the price fluctuations and shocks undermine the purchasing power of people, particularly the less wealthy, they still create the circumstances for development of agriculture and related industries.

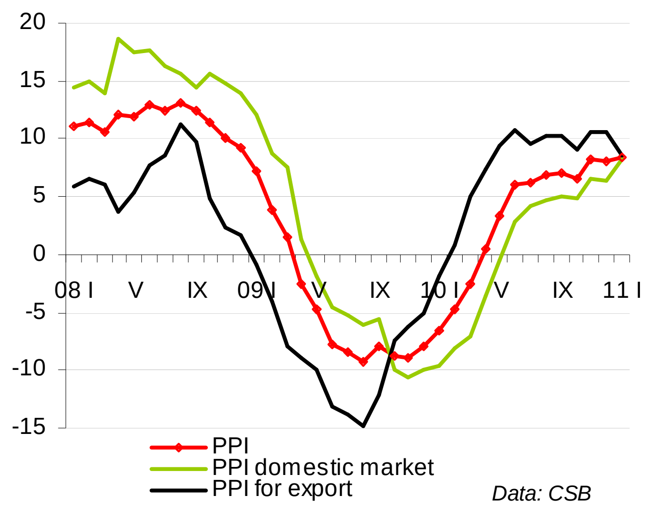
## Producer prices rise faster

Last year saw rapid changes happening to the producer prices. Their average level in 2010 rose by 3.1%. Although in Q1 deflation was still at large, the sturdy growth of export product prices already in April pulled the overall price level upwards. At some distance in time and a slower rate, the prices of domestic goods followed the rise of export prices. The different dynamics can be explained by various situations in markets and purchasing power and by the fact that foreign markets rebounded from the crisis faster.

The rise of prices has become one of the central economic issues. Hence the interest in the trends of producer prices as the indicator of possible change of the consumer price index has grown too. Thus in January, compared with December 2010, producer prices in industry rose by 1.3%. A bigger rise of prices was observed for the goods sold in the domestic market (+1.6%), while the prices of exported goods were 0.9% up.

In January producer prices in annual terms had grown by 8.4%. Statistics show the annual rise of the products sold in the domestic market by 8.3%. At the same time, the price rise for exported products has dropped to 8.5%. The greatest impact on the changes of producer prices has been made by the rise of electricity tariffs, the prices of metals, food products and wood products. Generally the prices are going up due to external factors - the growing global demand and speculation processes that the producers are compelled to follow. As foreign economies expand, particularly the emerging economies in Asia and Latin America, and the shortage of certain products and commodities is growing, the pressure on Latvia's consumer prices will persist. The struggle for distribution of profits among the participants of the entire production chain up to the consumer will escalate due to the consumers' low purchasing capacity and the rising tax burden.

**Producer price index (%, Y-o-Y)**



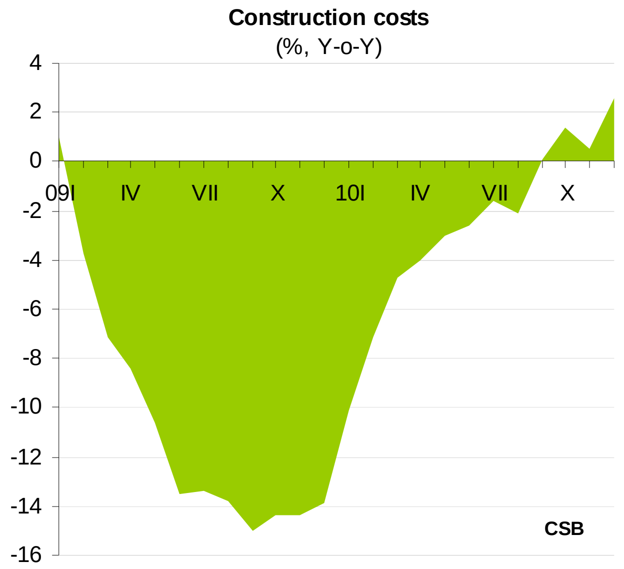

In January the rise of producer prices for the local and export goods levelled out. Considering the base effect, in the coming months the price rise for export products might slow down while the prices of domestically sold goods might grow faster. The future developments will greatly depend on the results of implementation of anti-inflation measures in the emerging countries that may curb their rapid development and cool down the commodity prices. The price trends of raw food products will be determined by weather and the new harvest. However, the global population growth trends and the increasing welfare of the densely populated Asia warn that the demand for commodities will keep growing and the prices will follow suit.

The persistent declarations that the prices must be raised further makes one wonder, how true they are. The competition in the market must be closely monitored so that prices grow adequately and by laying the blame on the global processes the prices are not raised for the products that are not affected. It should be noted that the price rise in an industry does not mean that it should be reflected in all the segments of goods. For example, the costs will grow for the products containing sugar, cereals, milk. Yet the manufacturers often substitute the expensive ingredients for cheaper ones, but the prices still go up. The producers will keep trying to control the rise of costs by achieving a more moderate rise of end product prices. A sharper rise of prices is expected in food industry as well as such narrow and administratively controlled segments as waste disposal, water and electric energy supply. The pressure of growing prices this year will be felt by energy-intensive industries. In some industries the rising price of resources will be offset by the recent drop of wages. In 2011 the overall level of producer prices may rise by 4-5%.

## Construction will cost more

In 2010, compared with 2009, average construction costs shrunk by 2.7%. However, already the last months of 2010 showed that it would be increasingly expensive to build new objects. The huge unemployment and comparatively slack activity in the industry is not the argument for keeping the builders' wages down. As last year, this year too it will be one of the biggest boosters of costs. With the growing economic activity the interest in construction will return, which means that the increasing need for qualified staff will make its impact on the level of wages and salaries.

The recession time brought corrections in the number of employees and equipment that was cut back according to the demand. The falling demand and prices allowed decreasing costs. However, inflation is back, taxes go up and will be reflected in the expenses. Vigorous work on new objects can hardly be expected; mostly the ongoing construction works will be finished. This means that the requirements for equipment will be modest and the costs of maintenance and exploitation of machinery and equipment will not rise significantly.

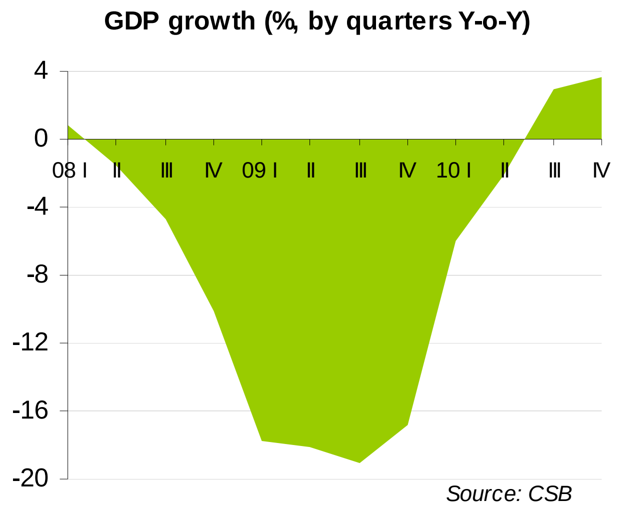



The prices of building materials can go only up under the influence of external, regional factors and markets. The rising costs of commodities and energy resources are but few factors. On the other hand, the sufficient manufacturing capacity and the real estate markets that need to cope with the surpluses created in the boom time, the unemployment and debts will keep the costs down.

Until the present time the industry has been supported by the government procurements, yet the rise of costs may be influenced by the orders from industry. The faster the demand for new buildings grows, the higher the costs will climb. This year the costs may grow on average by 3-5%.

## Growth is gaining strength

The flash estimate of GDP shows that the economic recovery is getting stronger. In Q4 of 2010 the growth had reached 1.1% whereas in annual terms GDP had risen to 3.7%.




We do not see the full picture of the factors ensuring growth yet. At the end of 2010 retail trade became very lively, especially car sales that could partly be explained with the consumers' prudent decision to make the purchase before the taxes go up. This year, too, the car market is expected to be active as the financial situation stabilises and financing becomes more available. The private sector will gain strength and the domestic spending will grow at a modest pace. Purchasing capacity will improve slowly as the wage and salary increase will be erased by inflation. The debt burden will decrease. The main growth force will be the development of the corporate sector. Industry will continue to boost the economic activity, yet its tempo will decrease compared with 2010. The focus on attraction of tourists has brought its results to the hospitality businesses and this trend should continue in 2011 too. Things are not so bright in the construction and finance. Therefore the biggest and most important role is going to be played by exports and exploration of new foreign markets that will determine the situation in employment.

Currently the global economy is continuing to grow and Latvia has the opportunity to join the general trend. The IMF outlook for this year is more optimistic too. The average growth of Central and east-European countries' economies is estimated at 3.6% that is, upgraded by 0.5 percentage points. Nevertheless, Latvia will have to increase its growth rate in order to address the issues of employment, emigration and other acute problems. Maintenance of growth rate at even 4% will mean that unemployment will decrease too slowly and the economy will return to the pre-crisis level only in 5 - 6 years. The biggest stumbling blocks are the rising costs of commodities and taxes that may curb the economic growth both in Latvia and worldwide. The budget consolidation is not going to disappear from the government's agenda. Budget deficit must be brought to a more sustainable level. However, further continuation of the current practice to consolidate the budget by raising revenues will have a negative effect on economic recovery and will only increase the share of gray economy. It is vital to make an effective use of the EU funds in order to create a long-term effect on the economy and to attract the investors who would create jobs in Latvia.

## Never-ending consolidation

The year 2011 for the government began with the task to consolidate the budget by 50 million lats. January was spent with no solutions and February brought the first outlines of the plan. The coalition parties' cooperation council agreed upon the consolidation measures. They include the combat against the shadow economy, levying of tax on the non-bank credit institutions, cutting of salaries in the public administration by approximately 5%, and raising of the gambling tax. The possibility of increasing the excise tax for fuel (petrol), cigarettes and alcoholic drinks will also be considered. The biggest stress is laid on the increase of revenues (by 34 m lats) while 16 million lats will be gained by cutting costs.

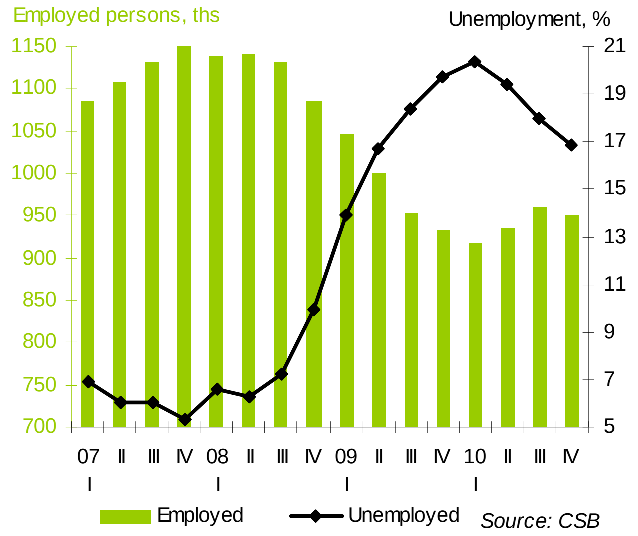
Many questions arise about the planned activities. First, the public administration will be reduced thus adding to the ranks of jobseekers. How will the quotas of cutting the staff be distributed among the ministries, which most likely will have drawn the red lines as in the earlier case with their budgets? These reforms without a clear purpose mean that the existing functions will have to be maintained by smaller human resources. Hence the next question whether raising of taxes and playing into the hands of the gray economy will not tear new holes in the budget as the weakened public administration will be unable either to collect the existing taxes or to combat the tax evasion. Rising of fuel prices will negatively affect the economic processes and increase inflation. As fuel grows more expensive, the demand for black market fuel will grow. The same is true of alcoholic drinks and tobacco.

The international creditors will have to be persuaded about the rationality of the consolidation plan. Most probably, they will scrap some parts of it. They already hinted that there should be more done to curb expenditure. As long as the coalition has no common understanding and vision of the necessity of consolidation, there is no reason to expect sustainable solutions. The question, where to find the millions for budget consolidation in 2012, is still to be answered. If various risks come true, the troubles will start again. Most probably, sooner or later, the social costs will have to be revised. Meanwhile, the decisions will be achieved by political compromise instead of sound reasoning. Of course, possible next taxes increase round next year raises question about euro introduction in 2014 as this will boost inflation above necessary criteria.

## Unemployment shrinks; hopelessness rises

The question, when the positive trend of macroeconomic data will be reflected in employment and wages, is becoming more and more acute. Yet there is no quick answer to it. The opportunities to find a job will increase gradually and only when government will be actively involved in this process. Although the latest data show that unemployment in Q4 of 2010 continued to shrink and reached 16.9%, there were 193.8 thousand jobseekers. The number and the share of jobseekers have decreased both year on year and in comparison with Q3 of 2010.

**Employment and unemployment**




Under the influence of seasonal and other factors in Q4 of 2010, year on year, the number of economically active population shrank by 1.5%. At the end of the summer season some categories of the population, such as students and pupils, have returned to classes and become economically passive. It can be explained by the limited jobs and the situation in the labour market when the employer can be more demanding. Besides, over the year, the number and share of the employed has increased. Albeit it is still below the levels reached in 2007 and 2008. In comparison with the previous quarter of the year, under the influence of seasonal factors, employment has slightly decreased. It will rebound with the arrival of the warm season.

The bad consequence of the crisis is the growing number of the long-term unemployed that over the year has risen by 37.3 thousand to almost 60 thousand. According to statistics, 89.4% of jobseekers were previously employed people. The labour market development trend shows that they will gradually lose their qualifications as the existing economic growth will not be sufficient to create enough jobs in the relevant professions to decrease the ranks of jobseekers. The solution of this problem depends only on the efficiency of the government's employment policy instruments. The structure of the economy during the recession will have changed and the work force will require new skills and knowledge. So far, the training of the unemployed has been justly criticised. The employers should receive more support by providing tax relief to raise their motivation to train their own work force. The number of the unemployed who have lost hope to find jobs will keep growing. In Q4 of 2010 there were 55.6 thousands of such people. Their number over the year has grown by 11.4 thousand.

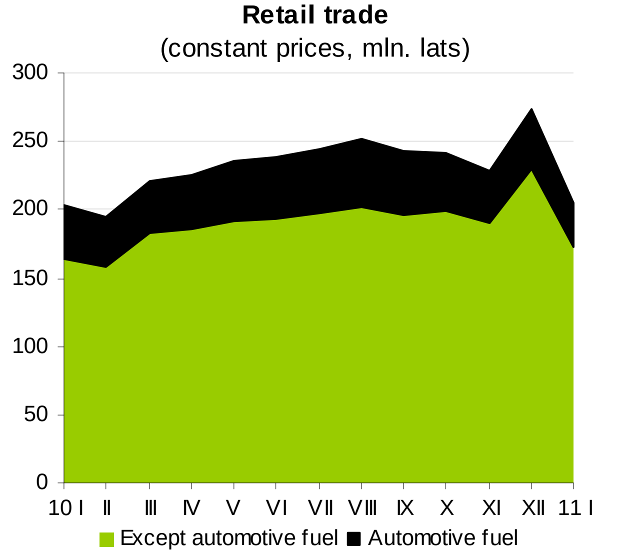
## Activity curbed by high fuel prices

In January, after the tumult of retail sales at the end of the year, a certain respite in the consumers' activities was bound to follow. In the first month of the year the turnover of the retail companies shrank by 1.7%. However, it happened mostly due to the drop in the car fuel sales. Excluding fuel, the non-food product sales achieved a tiny growth (+0.6%). The turnover of food product sales over the month grew by 1%.

At the same time, in annual terms that more objectively show the trend, the retail turnover index has managed to grow by 0.1%. Small as this achievement may seem, excluding the drop in fuel sales (-18.7%), overall trade volume has increased by 4.8%. It has happened mostly due to the rising sales (+10.2%) of non-food products (except fuel). The retail sales of food products at the same time have dropped by -2.1%.

Over the period from 2007 to 2010 the total trade volume shrunk by 34% and bottomed out. Slowly, as the economy is gaining strength, consumption, too, is becoming livelier.

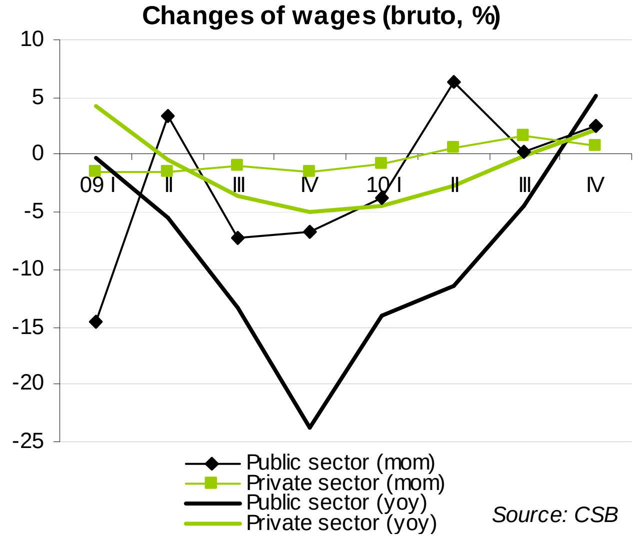
This year will see increasing trade activity. Nevertheless, it will be corrected by the rising inflation and taxes that will take a large bite out of the potential increase of income, and the consumption structure will continue to change. Fuel sales will keep falling for several reasons: daily travel and maintenance of a personal vehicle are becoming increasingly expensive. It makes many owners of vehicles revise their habits; therefore compact cars will become more and more popular.




The question should be asked to what extent the drop of fuel sales is the result of the shrinking consumption and how much of it is absorbed by the shadow economy. The government should repeatedly assess the impact of the excise tax rise and come to grips with the shadow economy that is booming under the increase of taxes. The high prices will most likely contribute to the growth of the black fuel market. It will happen both under the influence of the rising oil prices and taxes. The big fuel costs will inevitably be reflected in consumption of other segments and the overall rise of activity. The impact of the climbing food prices will have a similar effect making people revise their consumer goods basket looking for the items to be economised on or replaced by cheaper ones. Direct sales of products are becoming very popular due to their more attractive prices and the opportunity to avoid taxes and statistics. However, as the positive trend in the economy persists, those consumers who have retained jobs and incomes will resume their interest in purchase of long-needed or desired goods at the same time looking for friendlier prices. The activity will rise mostly in non-food segments. Consequently the shadow economy, too, will boost its supply, yet the combat against it is not likely to bring any visible results soon.

## Wages start climbing up again

The wage and salary data for Q4 of 2010 may be puzzling, yet they show that the average salary over the year has grown by 3.4% and reached 455 lats.




The biggest rise was observed in the public sector (+5.1%); while in the private sector it reached only 2.1%. The growing prices and demand for the produce have made their impact on the agricultural and forestry sector where wages rose by 11.7%. The remuneration of the public utility providers grew by 8.1% while the staff of education institutions earned 10.7%. On the other hand, in the construction, finance and insurance industries salaries still decreased.

Despite the growth in Q4, the rising taxes and inflation are pulling down the positive trend. Hence, the average remuneration in Q4 under the influence of taxes shrunk by 0.2%, whereas, considering the rise of prices, the average salary was 2% lower. This year we will see remuneration rising at a different rate in various industries. The potential increase will be absorbed by the rising prices therefore the purchasing power will recover at a slower rate. Despite the severe consolidation measures, wages and salaries may rise also in the public sector due to the pressure of various branches where the remuneration level deserves serious criticism and the high self-esteem of many employees of public institutions.

However, for the pay rise to be legitimate we need a clear and well-defined reform plan. The rise of salaries as the result of improved efficiency, reshuffling and downsizing of the public administration is more than welcome.

However, there is a great possibility that the practice of „bubble years" may return when the remuneration in the public sector rises faster than in the private sector creating unhealthy competition for the latter. In the private sector this year remuneration will be modest due to the rather unstable economic situation and huge unemployment.

Generally, in 2010, compared with 2009, average gross wage dropped from 461 to 445 lats (-3.5%). Under the impact of tax changes it fell further by 7.5%, was mitigated by deflation and the real wages and salaries dropped by 6.5%.