
# Macroeconomic Review of Latvia

April 2010

## In Focus

- During the April unemployment rate fell by 0.6 percentage points and stood at 16.7% at the end of the month. Approximately half of decrease is due to methodological changes
- In March industrial production jumped by 11.4% (YoY), manufacturing showed augmentation of 11.4%. Growth mainly was secured by growth in wood and chemical product production. Export will stay as the main industrial production's driving force
- In April after six year intermission were offered three year domestic government T-bills. Auction participants' demand exceeded supply 3.2 times. It was sold all the securities offered at value of 10 million lati with an average yield rate of 5.933%
- Noting that Latvia's economy has stabilized and that financial stress has been reduced, the ratings agency Moody's on March 31 revised its rating of Baa3 from negative to stable
- In the first three months of this year the cargo turnover handled at Latvian ports decreased by 5.9% (YoY). Trends in industry suggest that in future periods last year's volumes may fail to hold
- In the first three months of 2010 the central government consolidated budget expenditure exceeded revenues and the financial deficit amounted 180.8 million. lati. Shortage developed in connection with the Constitutional Court decision to repay detained pensions. Overall revenue receipts are according to the planned level
- The central government debt at end-March accounted 4.8 billions lati, increase of 443 million lati from previous month, and 650.4 mln lati increase over the end-December 2009

**Dainis Gašpuitis**
Macroeconomics Expert

Telephone: 67779994
dainis.gaspuitis@seb.lv

**Edmunds Rudzītis**
Socioeconomics Expert

Telephone: 67215933
edmunds.rudzitis@seb.lv

A/S SEB banka
Meistaru iela 1, Valdlauči
Ķekavas pagasts
Ķekavas novads
LV 1076
http://www.seb.lv

# Latvia's key economic data and forecasts

| | 2007 | 2008 | 2009 | 2010 | Period | 2010P |
|---|---|---|---|---|---|---|
| GDP growth (%) | 10.0 | -4.6 | -18.0 | - | - | -2.8 |
| GDP at current prices (mln LVL) | 14780 | 16240 | 13244 | - | - | 12550 |
| Consumer prices index (% annual average) | 10.1 | 15.4 | 3.5 | 0.3 | III | -2.4 |
| Fiscal deficit, surplus of the Government consolidated budget (ESA 95, % of GDP) | -0.4 | -4.1 | -9.0 | - | - | -8.5 |
| Current account balance (% of GDP) | -22.5 | -12.6 | 9.4 | - | - | 7.0 |
| Foreign direct investment flow (mln LVL) | 1193 | 607 | 36.3 | 18.3 | II | 50-100 |
| Cumulative foreign direct investment (mln LVL) | 5247 | 5711 | 5734 | - | - | 5900 |
| Foreign trade balance (% of GDP) | -25.3 | -19.0 | -8.0 | - | - | -5.0 |
| Government foreign debt (mln LVL) | 635 | 1260 | 3253 | 3832 | III | 5100 |
| Manufacturing output (% yoy) | -1.0 | -8.3 | -17.7 | 4.7 | I-III | 8.0 |
| Retail trade turnover (% yoy) | 18.8 | -8.2 | -28.0 | -12.5 | I-III | -7.0 |
| Unemployment rate (%, end of period) | 4.9 | 7.0 | 16.0 | 16.7 | IV | 17.0 |
| Job seekers rate (%, end of period) | 5.3 | 9.9 | 19.7 | - | - | 19.0 |
| Average gross salary growth (% yoy) | 32.0 | 20.4 | -3.9 | - | - | -6.0 |
| Real wage and salary index (% yoy) | 19.9 | 6.2 | -5.6 | - | - | -7.0 |
| Standard & Poor's long-term credit rating | BBB+ | BBB- | BB | - | - | - |

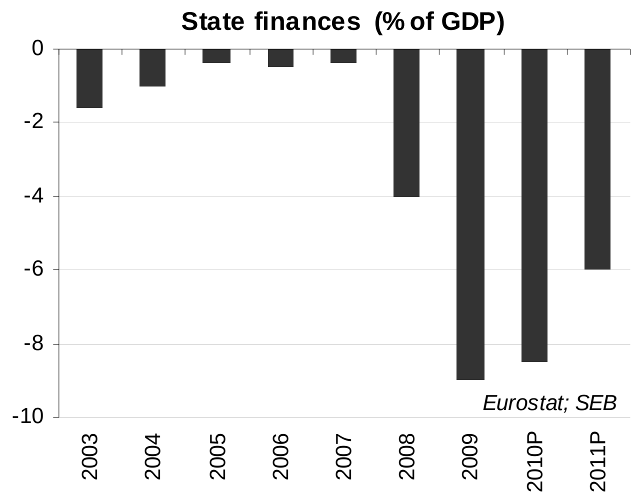
** Provisional data. Sources: Central Statistical Bureau of Latvia, the Bank of Latvia. SEB banka's forecasts.*

## Budget deficit 9%: better than expected

The long-awaited summary of Latvia's financial status in 2009 showed that the government had managed to close the year with a deficit of 9% or one percentage point below the level approved in the agreement with the international creditors.

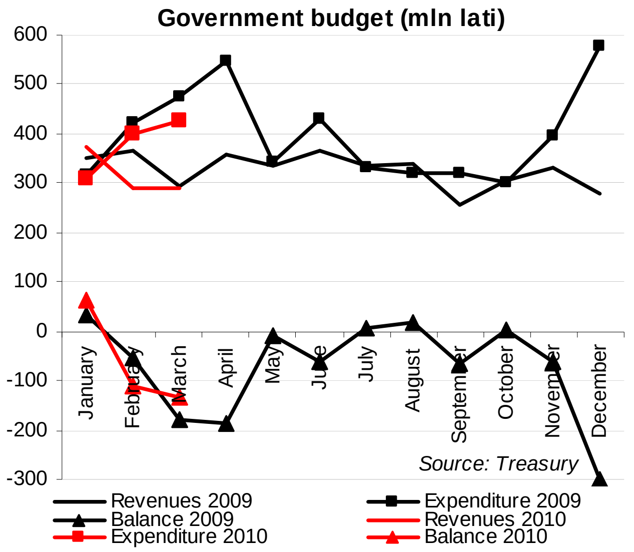
It was achieved mostly due to the consolidation process with slashing of costs and raising of taxes. Despite the grim situation in the economy, the darkest scenario has not come true. The sharp fall of the budgetary revenues was caused by the rapid cooling of the imbalanced economy. In this aspect Latvia is different from many other countries that in the previous years had pursued a more prudent fiscal policy and now can afford to increase the deficit for the purposes of economic stimulation.

Irrespective of the austerity measures, in relation to GDP the share of the central and local governments' expenditure has grown much faster than their revenues which means that the optimisation processes cannot overtake the falling economy.




In the result, the actual deficit in millions has remained at the level of 2008. The most drastic changes have affected the social insurance fund where the surplus of 253 million lati in 2008 was followed by a deficit of 304 million lati in 2009.

The target for this year is a budget deficit of 8.5% of GDP, which is not likely to be improved as in 2009. Repeating such an achievement will not be possible in the situation of approaching election period and the necessity to consolidate approximately 900 million lati over the next two years. The optimisation processes already performed last year exhausted the easy solutions. The government, too, will hardly continue to initiate further cost cutting measures. Therefore, the most burning issues are minimisation of the shadow economy and introduction of structural reforms as well as the possible tax changes or increases.




Without an entirely new concept of the state management and budgetary expenditure the coming changes will further degrade the image of the state in the eyes of the nation. Most probably the actual scope of the measures to be implemented will become clear to the people only after the approval of the cabinet by the newly elected Saeima. The amount of work to be done is already being assessed. It is essential to start discussions in order to come up with the best possible solutions. The sooner the discussions are started the less „surprises" will come out.

## In March prices go up

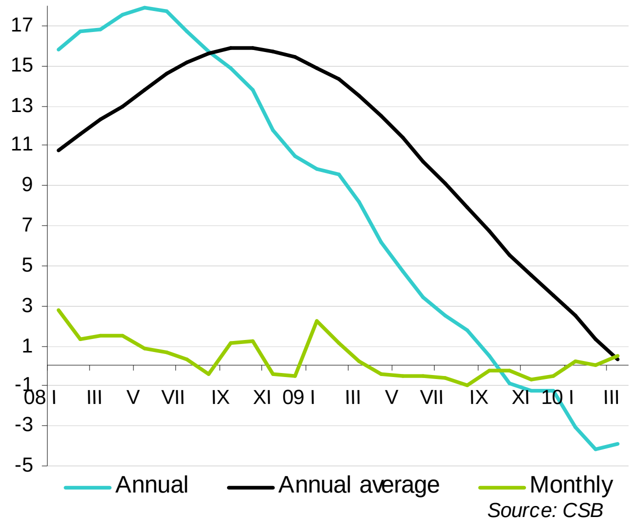
Consumer prices in March rose significantly by 0.5% over the month. They were affected by external factors, particularly the rise of oil and food prices in the world pushing the prices up in the domestic market. The biggest increase was observed in garments and footwear (+3.9%). The reasons are the arrival of the new season's goods and the end of sales campaigns. Nevertheless, compared with March 2009, clothes and footwear can be bought 8.2% cheaper. The growth of the fuel prices could be predicted. The global rise of oil price was stimulated by the fast growing economies and news of economic stabilisation in the developed countries as well as relatively limited supply of oil at the time of the crisis. The interaction of the euro and the US dollar (economic maladies of Greece), as well as the rise of taxes, too, made their impact. The prices of food products also have been stabilising for some time and now are starting to climb up.

Many food products had become very cheap; therefore they most likely will get only more expensive. The fall of the local purchasing power keeps correcting the prices of services although they decrease very reluctantly. It is good to see that the previously soaring prices of medical services and medications are being corrected under the direct impact of the falling consumption of the population.

In annual terms the prices still show a drop of 3.9%, yet there are signals that manufacturers and service providers intend to revise them upwards under the pressure of rising costs of materials and other expenses as well as the influence of global trends.

The inflation forecasts will most probably have to be revised. The deflation period could be shorter than previously estimated and we should discard the possibility of an extended or significant deflation period in Latvia's economy.

Consumer Price Index (%)

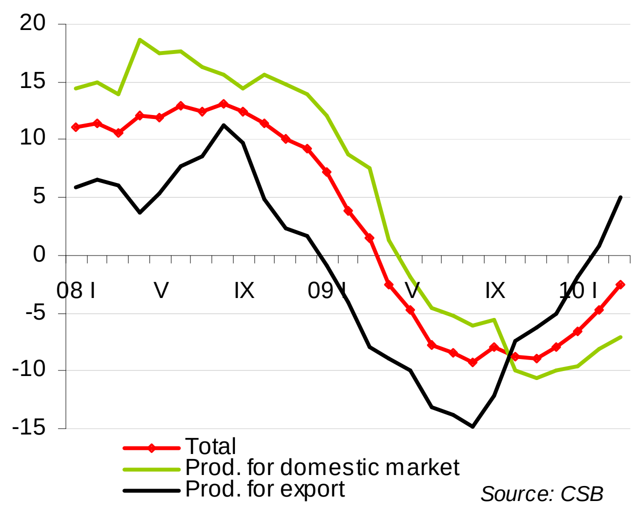



Deflation is decreasing and already toward the end of this year in annual terms we may see even some inflation. It will be brought by the global price trends of energy resources and raw materials and development of inflation in the neighbouring countries. If their prices stand still or even climb up, it will be reflected in tariffs and consequently in the rising consumer prices. Producer prices are sending warning signals. Deflation this year could remain as an average annual indicator.

## Signal of producer prices to the consumers

Global trends cannot pass unnoticed in respect of producer prices that are gradually moving toward inflation. Besides this growth rate is rising. As expected, in March 2010, compared with February, producer prices rose by 0.8%.

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




The main factors determining this increase in March were a significant jump of costs in manufacturing, particularly for raw materials and energy resources, and the rise in water supply and waste disposal prices. At the same time, in March, year on year, deflation rate was 2.5%. It is a declining trend. In February deflation was still at 4.7%. The producer price index is determined by the different dynamics of the prices of export and local market products. Thus, the rise of export product prices in March reached annualized growth rate of 5% already, while the local market product price growth remains negative (-7.1%).

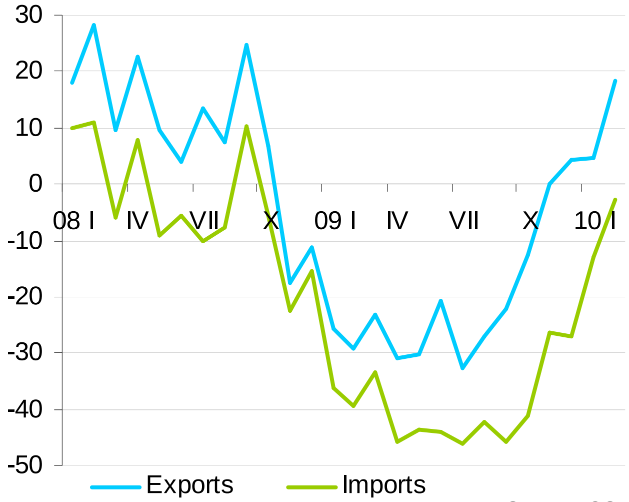
The producer price index slowly approaches inflation with export prices leading the trend. The local market sales prices at a certain distance in time are following. The differences are mostly determined by varying trends in Latvia and its most important export markets. Growth is taking root in the foreign markets which is a good signal for price increase, Latvia has been hit harder by the crisis, the recovery is slower and consumption is very weak. Therefore, the manufacturers are still trying to keep the burden of costs and prices off the consumer's shoulders. In many places optimisation processes are under way. To a smaller extent it still is the explanation for the low inflation in other economies too. Therefore, the rise of producer prices will be reflected in the consumer prices slowly, keeping pace with the consumers' purchasing capacity. As the prices of raw materials and other resources grow in the world and the consumption recovers, the consumer prices will soar with the inflation rate in Latvia following suit.

## Exports accelerating

Rebounding of the global economy and livelier cross-border trade has improved the opportunities of Latvian businesses to sell their goods abroad. The earlier fall of costs and prices have been good for Latvia's competitiveness in export markets.

The statistical data for February show a significant rise in the volumes of exported goods. After the drop in the previous month, in February exports of goods returned to the level of December 2009, over the month gaining 45.7 million lati or 17%.

**Foreign trade by months** (%, Y-o-Y)




*Source: CSB*

At the same time, annualised exports growth has exceeded a two-digit figure and in February 2010 the volume of exported goods was 18.2% up, year on year. The results of the first two months of 2010 show an 11% rise in exports compared with the same period last year. Export volumes keep growing in such groups as wood and wood products approaching the pre-crisis levels. As the Latvian firms are increasing their activities in the CIS countries and the price of milk goes up, considerable rise is seen in dairy products exports. In February exports of pharmaceutical products fell year-on-year which is not a definite trend. It just shows some rather inconsistent distribution of export volumes across the months influenced by seasonal factors.

In February foreign trade balance improved and its deficit decreased to 64.2 million lati. Imports rose by 35.3 million lati on the January result while the annualised imports dropped to 2.6%. Import volumes are stabilising and the rate fall may soon stop. Despite the shrinking local demand and weak consumption in the domestic market, imports may show some slight monthly growth already in the 2nd quarter of this year. It may happen due to the rise in raw material prices and growing industrial activity.

Exports will continue to grow in annual terms in the coming months. The growth will be boosted by the better situation in the external markets and the increasing competitiveness of Latvia's export products.

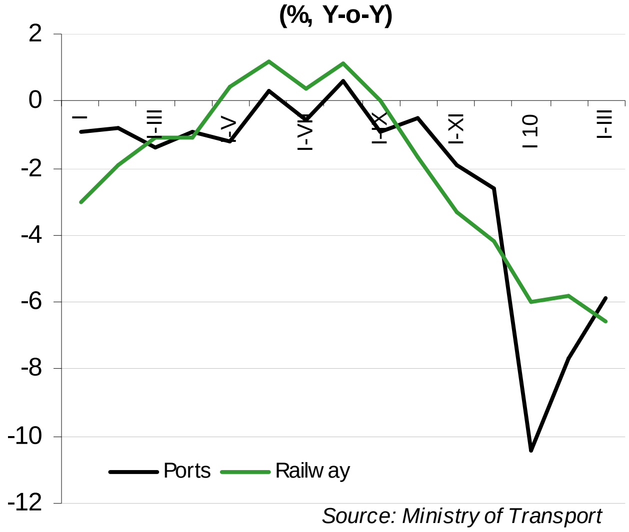
## Cargo turnover drops, passenger traffic rises

In Q1 of 2010 cargo turnover in Latvia's ports amounted to 15.6 million tonnes or 5.9% less year on year, and 5.1% more than in Q4 of 2009.

The drop in the turnover of the ports was mostly affected by the decreasing volumes in the biggest product groups – oil products (-16.9%) and coal (-26%). On the other hand, the rise was seen in the volume of exported wood materials (+69.2%) and mineral fertilizers (+30.9%). As the global demand for iron ore is growing, its turnover in the ports in Q1 rose 15.6 times to 0.8 million tonnes.

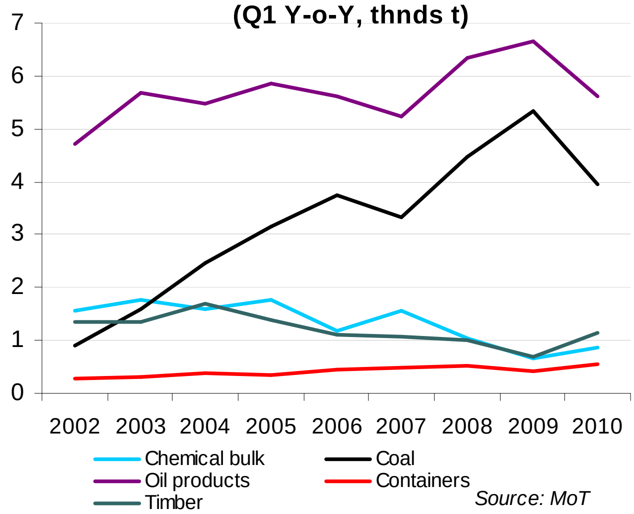
In Q1 of 2010 the turnover drop was due to the negative trends in Riga and Ventspils ports. Thus, at the Port of Ventspils 7.2 million tonnes of cargo was loaded and unloaded or 8.1 % less, year on year. At the same time, cargo turnover at the Port of Riga fell by 4.2 % to 7.1 million t. The rise was observed at the Port of Liepāja where in Q1 of 2010 3.2% more cargo was handled.

**Turnover in ports and by railway in 2009 (%, Y-o-Y)**




The drop in the cargo turnover at the ports was due to the decrease of the incoming cargo. The cargo transported by rail had not shrunk at an equal rate, which means that the decrease in the ports was caused by the local market. The future outlook for the ports is not too straightforward. They can hardly maintain last year's turnover yet a lot will depend on the new transit cargo flows and development of Latvia's exports. The growing competition among the Baltic ports will also play its role and one more rival – Russia - will try to direct more of its goods through its own ports. Therefore it is clear that in the main types of cargo competition will get tougher. The turnover at the Baltic ports will continue to depend on each Baltic country's relations with Russia and Belarus and their ambitions in the transit business. In Latvia's case of great significance will be both domestic and foreign policy, including the railway tariff policy.

**Cargo turnover in ports (Q1 Y-o-Y, thnds t)**



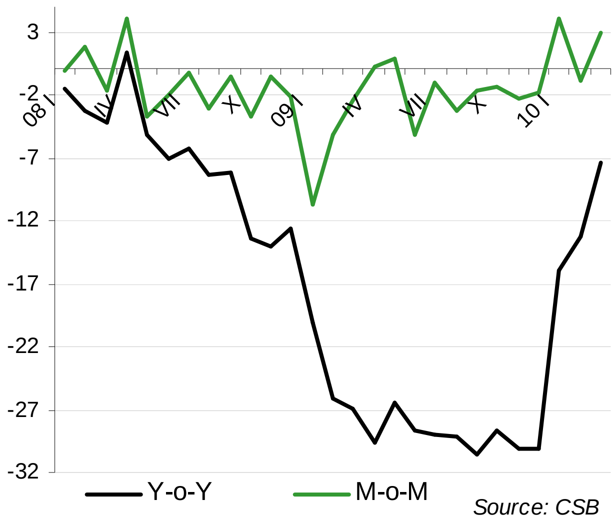

In Q1 2010 passenger turnover rose at Riga Passenger Port. 103.2 thousand passengers arrived at and departed from the port, which was a 32.8% increase year on year. As the schedules stabilised and the prices went down in the Baltic, tourists were increasingly attracted to this part of Europe and paid visits to it by the sea transport. In order to ensure long-term growth, however, the passenger port infrastructure badly needs modernisation.

The enormity of the crisis and calamities in other sectors seem not to have affected Riga Airport. It keeps growing fast. Passenger traffic at Riga Airport is rising and in Q1 of 2010 914.4 thousand passengers arrived and departed from the airport, which is 21% more, year on year. It has been achieved due to the development of Riga as a transit hub increasingly used by travellers from other countries. Therefore, the biggest challenge now is the increasing of the airport capacity enabling airBaltic to pursue its aggressive development strategy. On the aircraft of Latvian airlines in Q1 609.3 thousand passengers (+28.3%) arrived at and departed from the airport. At the same time, the aircraft of foreign carriers brought to and from Riga 305.1 thousand passengers (+8.6%).

## Drop in retail trade slows down

The fall in retail trade is rapidly decreasing. This change is brought by the stabilisation processes in the economy and the decreasing base effect of last year. In March, year on year, retail turnover fell by 7.4%. In February in annual terms the drop had still stood at 13.3%. In March the turnover in the non-food product group dropped by 7.8%, while the turnover in the food product group shrank by 6.7%. It is slightly unexpected, as in February and March of 2009 the fall in annual terms had been similar. Obviously the performance of the industry was influenced by several subjective factors. The flood of bad news about the national economy has calmed down considerably. Good news is coming from foreign markets supported by the export figures. More positive mood gives confidence about the prospects of keeping one's income and job. And arrival of spring after the long winter, together with the falling prices and brisk sales campaigns, is encouraging the consumers to spend more.

**Retail trade turnover (%)**




In contrast to the previous periods, when the fall in petrol trade offset the overall retail decline, in March 2010 it has pushed retail further down. Petrol excluded, retail has fallen only by 6.6%. The soaring petrol price has cut our consumption of it. In comparative prices, we have bought 9% less petrol. However, in actual prices in March, year on year, spending on petrol has risen by 3.8 million or 8.1%. Hence less petrol has been bought for more money.

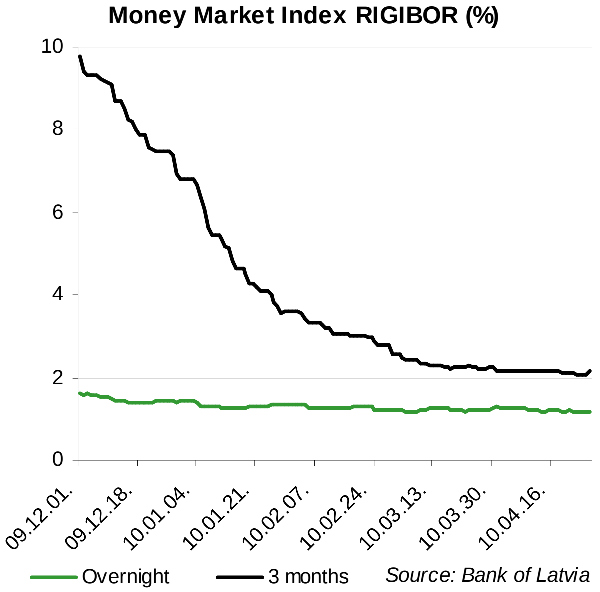
It is possible also; that under the influence of rapid changes, the retail trade last year had fallen faster than its potential level or real purchasing power and due to this and other subjective factors it may rebound. At the same time, the low level of retail trade may create changes even within several percent. It is difficult now to give a straightforward forecast of the developments in retail.

The end of the heating season, a more positive future outlook and the returned pensions in the coming month may blow in some more life into consumption. In the medium term, though, there is no reason to hope for positive changes. The looming reforms of taxes and cutting of state expenditure are sure to have their grim impact on spending.

## Rates record low

In April EURIBOR rates stopped falling and the 3-month EURIBOR index is 0.643%, or slightly above the record low rate of 0.634% that was reached in March. The decline of the 3-month EURIBOR rates this year has been quite noticeable – since the beginning of the year the rates have shrunk by almost half percentage point. Although in April EURIBOR has not yet dropped further, it is not a straightforward sign that from now on they will go up and away from new record lows. EURIBOR trends will depend on the economic health of the Euro zone and the activities of the European Central Bank (ECB) regarding of further „pumping" of funds into the interbank market. If the economy shows the signs of recovery and there are no calamities in the financial sector, ECB will begin gradually to take out of the interbank market the funds lent to the financial sector. In such a case in the second half of the year we can expect a rise in EURIBOR and the 3-month EURIBOR rate might even rise to 1% by the end of the year. Whereas, if „pumping" of money continues at the current scope, EURIBOR may stay at the present level until the end of 2010.

In April the lati market index RIGIBOR kept decreasing both in its long- and short-term rates. The supply of lati in the market currently essentially exceeds the demand which has created a considerable surplus: the funds that commercial banks deposit with the Bank of Latvia in April amounted to 600-700 million lati on average. If this great surplus stays untouched, the lati rates, logically, will keep falling. At present the 3-month RIGIBOR has hit its historically lowest level of 2.11% and in the nearest future this record can be broken.




However, in the current economic situation the decline of RIGIBOR has exhausted its potential. RIGIBOR at present stands 1.5 percentage points above the respective EURIBOR rate. Historically this difference has been bigger and at the beginning of 2010 it was above 5 percentage points. In the second half of the year, most probably we shall see the rise of RIGIBOR rates influenced by the coming elections of Saeima, the worries about the budget consolidation measures in 2011, and the possible rise of the EURIBOR interest rates.

# Baltic macroeconomic data

| | Latvia LV | Lithuania LT | Estonia EE | Period |
|---|---|---|---|---|
| Population (mln) | 2.25 | 3.33 | 1.34 | 2010 I |
| GDP growth (% yoy) | -18.0 | -15.0 | -14.1 | 2009 |
| GDP (mln EUR, at current prices) | 18845 | 26746 | 13728 | 2009 |
| CPI (% yoy) | -3.9 | -0.2 | 1.7 | III 10 |
| Current account balance (mln EUR) | 1779 | 1022 | 632 | 2009 |
| Current account balance (% of GDP) | 9.0 | 3.8 | 4.6 | 2009 |
| Foreign direct investment flow (mln EUR) | 52 | 250 | 1204 | 2009 |
| Foreign direct investment stock (mln EUR) | 8159 | 9639 | 11268 | XII 09 |
| Foreign direct investment stock per capita (EUR) | 3643 | 2895 | 8409 | XII 09 |
| Foreign trade balance (mln EUR) | -198 | -216 | -19 | I-II 10 |
| Foreign trade balance (% of GDP) | -8.0 | -4.8 | -6.0 | 2009 |
| Exports of goods (mln EUR) | 829 | 1937 | 1133 | I-II 10 |
| Exports of goods (annual growth, % yoy) | 11.0 | 6.3 | 17.6 | I-II 10 |
| Imports of goods (mln EUR) | 1027 | 2153 | 1152 | I-II 10 |
| Imports of goods (annual growth, % yoy) | -8.5 | 9.9 | 2.5 | I-II 10 |
| Industrial output (% yoy) | 4.8 | -6.3 | 4.8 | LV; LT I-II 10<br>EE II 10 |
| Retail trade turnover (% yoy) | -12.5 | -14.5 | -9.0 | LV; LT I-III 10<br>EE I-III 10 |
| Assets of commercial banks (mln EUR) | 30651 | 25698 | 20206 | III 10 |
| Average weighted long-term annual interest rates on deposits in national currency in commercial banks (%) | 8.0 | 4.6 | 3.1 | III 10 |
| Average weighted long-term annual interest rates on credits in national currency in commercial banks (%) | 13.8 | 13.1 | 15.6 | III 10 |
| Average gross monthly wage (EUR) | 626 | 614 | 783 | X-XII |
| Growth of average gross salary (% yoy) | -12.1 | -8.7 | -6.5 | X-XII |
| Official unemployment rate (%) | 17.3 | 14.3 | 14.6 | III 10 |
| Job-seekers rate (%) | 19.7 | 15.6 | 15.5 | X-XII |
| General government debt *(% of GDP)* | 36.1 | 29.3 | 7.2 | 2009 |
| *Standard* & *Poor's* long-term credit rating | BB | BBB | A- | |

** Provisional data. Sources: National statistics, Central banks, the ministries of the Baltic States, SEB banka.*