



Macroeconomic Review of Latvia

May 2010

In Focus

- The flash estimate shows that in the 1st quarter of 2010 GDP grew by 0.3%
- Registered unemployment by the end of May had dropped by 0.5 percentage points over the month and reached 16.2% of economically active population
- Turnover in the ports, after the drop in the first quarter, in April rose by 6.4% year on year
- The provisions for doubtful loans created by Latvia's banks by the end of April had grown by 0.3 percentage points or 35.4 million lati to 1.6 billion lati or 10.6% of the banks' total credit portfolio
- In April revenues in the state budget amounted to 353.4 million lati exceeding the target by 13%. The company income tax was collected in the amount of 13.1 million lati or 45.6% more than planned while the value added tax revenues amounted to 72.5 million lati exceeding the target by 30%
- In the first three months of 2010 the surplus in the current account of the balance of payments reached 250.2 million lati which six times exceeded the amount registered in the first quarter of 2009
- SEB Housing Price Indicator for the second month already has been positive, rising by another 3.5 percentage points in May to 5.0 points. It shows the increase of positive sentiment in the population in respect of the real property price trends

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Latvia's key economic data and forecasts

	2007	2008	2009	2010	Period	2010P
GDP growth (%)	10.0	-4.6	-18.0	-6.0*	I-III	-2.8
GDP at current prices (mln LVL)	14780	16240	13244	-	-	12550
Consumer prices index (% annual average)	10.1	15.4	3.5	-0.4	IV	-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	-42	III	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	3839	IV	5100
Manufacturing output (% yoy)	-1.0	-8.3	-17.7	4.7	I-III	4.0
Retail trade turnover (% yoy)	18.8	-8.2	-28.0	-11.2	I-IV	-7.0
Unemployment rate (% , end of period)	4.9	7.0	16.0	16.2	V	16.0
Job seekers rate (% , end of period)	5.3	9.9	19.7	20.4	I-III	19.0
Average gross salary growth (% yoy)	32.0	20.4	-3.9	-8.3	I-III	-6.0
Real wage and salary index (% yoy)	19.9	6.2	-5.6	-9.1	I-III	-7.0
Standard & Poor's long-term credit rating	BBB+	BBB-	BB	BB	-	-

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

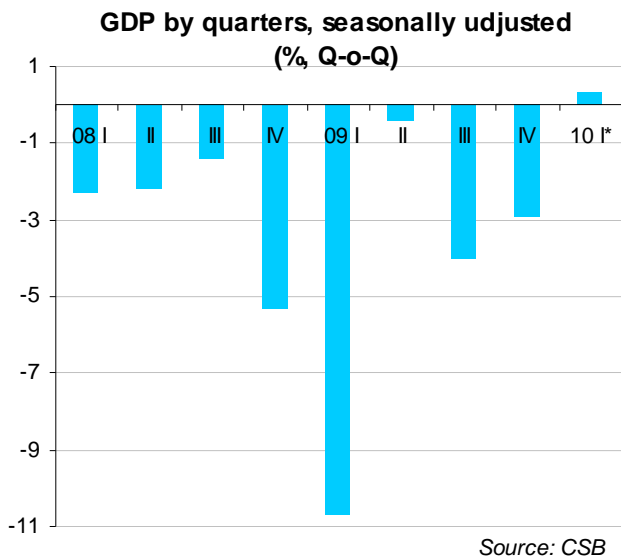
Recession over at last

March statistics registered rebounding in several industries that was duly reflected in the overall GDP figures. According to the flash estimate of the CSB in the 1st quarter of 2010, compared with the first three months of 2009, GDP had shrunk by 6.0%. In industry the output over the year has grown by 9.6%. The process of internal devaluation has helped regain the competitiveness that was lost in the previous years and now with the recovery in the foreign markets is giving the necessary shake up to the industry. It should be noted that the industrial results were improved by the cold winter that increased the demand for the thermal energy. Nevertheless, the households have run up considerable debts for heating that means that upturn is partly based on credit.

According to the seasonally adjusted data, GDP, compared with Q4 of 2009, has gained 0.3%, which is

a formal sign of the end of recession in Latvia's economy. At present the sentiment indicators are steadily rising and the earlier assessments may have been overly pessimistic. However, the information and data show that the situation in every industry is different meaning that recovery now and in the future is not going to be equally smooth.

Hopefully, with the positive trend taking root in other industries the economic fall in annual terms will stay behind the forecasts. The issues of productivity and structural reforms still demand attention both in the private and public sector. It is a precondition of long-term development. The current processes and measures are mostly of short-term nature. The tangible results will be felt by the population slowly and gradually.

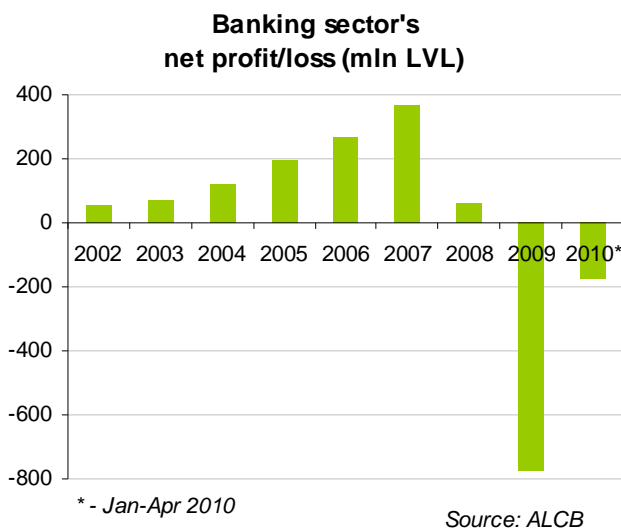


The risk of the second wave of recession still exists not only in Latvia's, but also in the region's economy. A great role will be played by the developments in the Eurozone. If the current turbulence there is contained and settled down, Latvia's prospects of economic development will also look brighter. However, the approaching Saeima elections and next year's budget are factors that will make news headlines and trigger non-predictable developments this year.

Banks' losses will decrease

Latvia's banking sector in the first four months of 2010 continued to operate with losses that grew to 176.5 million lati or twice the negative result for the same period of 2009. The main reason behind the losses was the relentlessly increasing number of overdue loans forcing banks to make provisions for doubtful credit facilities.

billion lati or 18.3% of the banks' total credit portfolio. Last year in April overdue loans accounted for 21.3% of the total credit exposure and the share of 90 and more days' overdue loans was 9.1%. With the number of long-overdue loans rising, the volume of provisions also goes up. The banks' provisions for doubtful loans by the end of April had reached 1.6 billion lati or 10.6% of the total outstanding amount of loans. At the end of April 2009 such provisions amounted to 617 million lati or 3.8% of the loan portfolio. In 2009 the total amount of provisions created for the substandard loans in the entire banking sector was approximately 1 billion lati. In the first four months of 2010 the amount of provisions has increased by 260 million lati. The number of clients with overdue payments in the coming quarters may stabilise thus reducing the amount of money the banks must use for additional provisions, compared with 2009. Therefore the banks' losses posted for the coming quarters and for the year 2010 will be more moderate.



In April the number of clients delaying their debt payments reached 27.7% of the total loan portfolio. Moreover, the number of borrowers who are 90 days behind with their loan repayments also tends to increase. The volume of these loans has reached 2.75

The banks' results are also undermined by the fall of the net interest income as the lower interest rates and shrinking loan portfolios have their negative impact on interest income that decreases faster than interest expense for the attracted cash funds, (including deposits). Net interest income in Q1 of 2010 dropped by 55% compared with the first three months of 2009. Fee and commission income and income from the sale



of financial instruments have also declined reducing the banks' operating income before provisions. In the coming quarters the banks will focus on overdue loans and towards achieving positive operating results.

Clients regain confidence in banks and the lats

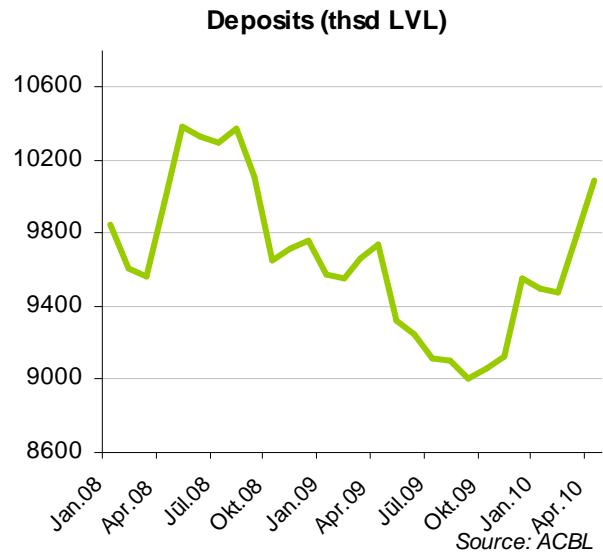
The funds deposited with banks in April 2010 again rose above 10 billion lati – previously this mark had been exceeded in September 2008. Since then, the structure of deposits has slightly changed with a bigger share of the state and local governments', and financial institutions' deposits and decreasing share of households and private companies' deposits. By the end of April the clients had in total deposited 10.086 billion lati or 537 million lati more than at the end of 2009. The rise in the deposits has been growing since September 2009. Besides, during this period both residents' and non-residents' deposits have increased. The amount of non-residents' deposits at the end of April reached 3.84 billion lati or 38% of the total deposits in the banking sector. To date the non-residents' deposits have exceeded the level achieved by the end of 2008 although it is still 13% below the result of September 2008.

The volume of deposits compared with the end of 2009 has most conspicuously grown in the company segment (+6.9% or 379 million lati). At the same time, the total volume of private individuals' deposits by the end of April had grown by 20 million lati or 0.6% from the result at the beginning of 2010.

Exports boom in March

After the prolonged slump from the end of 2009 to January 2010, in February and March export volumes rose significantly: in March exports leaped up by 19.7%. Imports, too, climbed by 4.8%, increasing the negative trade balance to 84.9 million lati.

Exports have recovered and demonstrate rapid growth. Nevertheless, the prospects of consumption in the EU member states are contemplated with some scepticism. The events in Eurozone as well as the misgivings regarding the public finances in other EU countries show that the foreign markets are not yet ready to loosen up their belts and resume spending

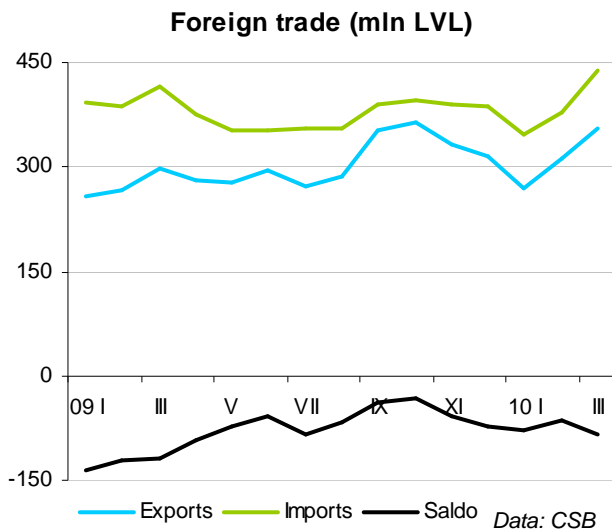


The rising deposit volumes show that the confidence of the clients in the commercial banks of Latvia is returning to the pre-crisis level. Besides, the distribution of deposits by currency is also changing. If at the beginning of the economic downturn more than half of total residents' deposits were in lati, in September 2009 lati deposits had shrunk to 37%. During that period the share of euro deposits increased. This year the volume and share of lati deposits is growing again. In the non-residents' deposit structure euro deposits tend to prevail over US dollar deposits. Most likely, in the coming quarters the share of euro deposits both in the residents' and non-residents' deposit accounts will decrease.

they could afford in the previous years. The states are consistently pursuing austerity measures showing what the future will hold.

Hence the question arises: at whose expense will exports grow further, namely – will they grow with the markets or with the competition? Shrinking of wages and prices has helped raise the competitiveness of the Latvian exports. At the same time, the measures of increasing Latvia's competitiveness that are currently being implemented are crucial for this process. Competitiveness should rise at the expense of productivity growth. In the medium term, as the

labour market recovers, wages will start to go up again, quickly devouring the gains in competitiveness.



Exports also grows due to the rise in the re-exported goods, which is good for the economy, yet at the same time demonstrates the necessity to boost the exports of the goods manufactured in Latvia. The country has still a lot to do in straightening its trade balance and eventually achieving prevalence of exports over imports.

The rise in imports is not a surprise. It is pushed by re-exports, and reviving industry. The prices of imported resources have also gone up both due to the rise of the US dollar rate and increasing global demand. Toward the year end consumption might get livelier, too.

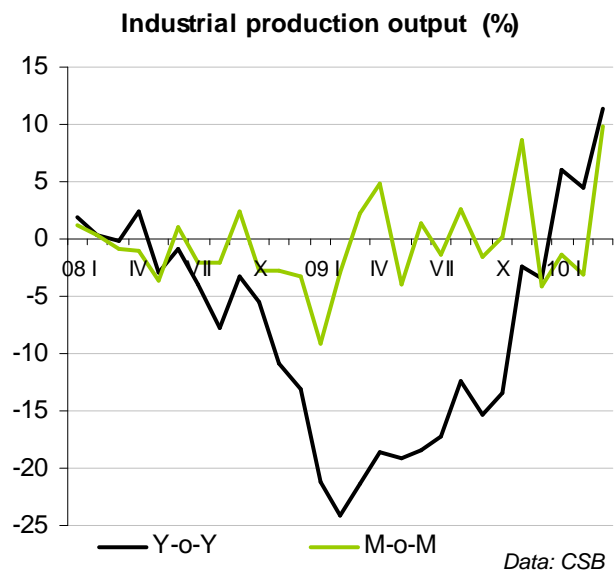
March wake-up call to industry

In March 2010 industrial output rose by 11.4%, year on year. It was particularly notable in manufacturing (+11.1%). The March result gave a decisive push to all the quarterly figures that ultimately had a positive impact on GDP. In the 1st quarter of 2010 compared with the same period of 2009, industrial output grew by 7.4%, while manufacturing industry gained 4.7%.

Currently the performance of industry is improving fast under the influence of exports. The average market indicators are stabilising and due attention to imports is bringing in the first fruits. Basically, the positive results of Q1 were achieved by the substantial and anticipated growth in wood industry (+39.6%) and manufacture of chemical products (+34.4%). Despite the sturdy overall growth, other industries are still in the red. Performance of non-metallic minerals (-21.3%) and pharmaceutical products (-20.6%) is especially weak demonstrating sharp contrasts among the industries.

In the periods to come industry is expected to keep growing. Yet its growth rate is not clear. To a great extent it will depend on the growth tempo sustained by wood industry, manufacture of chemical and metal products. There is also a question about other industries being able to raise their capacity and find

sales markets abroad. Drastic changes may happen in industry in either direction due to exploration of new markets, acquisition of niches and strengthening of positions. Therefore, it is too early yet to speak of a definite trend or stability. The industrial output is too small and every positive result in any of the industries or even a separate deal of a separate industrial heavyweight may change the total result of the industry substantially.

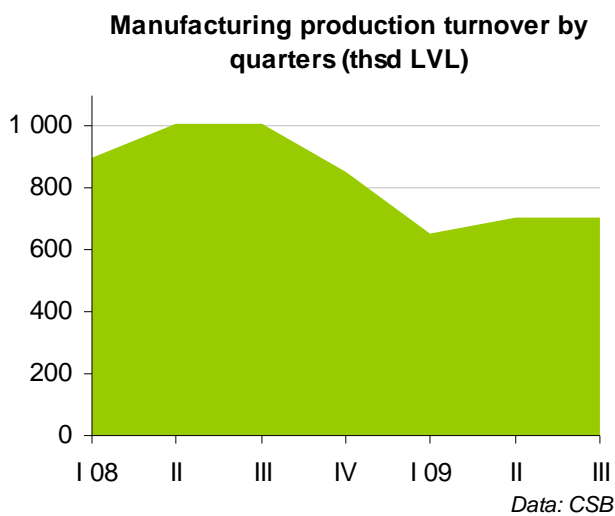


It should be noted that the current results mostly show the rising activity. Because the prices are low, the output growth exceeds the actual turnover. The foreign markets increasingly report gradual movement of many indicators toward the pre-crisis

levels. Nevertheless, there are still risks that threaten the new buds of spring in the EU economy: the events in Greece, the large government deficits etc. The trends will become more visible in the second half of 2010.

Exports' lifeline to industry

Statistics have already been released on the year-on-year rise in manufacturing output by 4.7% in Q1 of 2010. At the same time, the turnover for the same period is less than 0.4% (year on year). It shows that activity is increasing while turnover is still below last year's level. The recovery of the industry in particular and the economy in general is not as rapid as desired.



The focus must be switched from the domestic to foreign markets. In Q1 of 2010 the domestic market turnover shrank by 10.4%, while exports kept growing (+13.3%). Almost all the manufacturing industries have been able to boost the turnover of their export products, except manufacture of finished

metal products that in Q1 reported year-on-year turnover decrease both in its exports and local market. The industry is being kept afloat by exports with its share steadily rising. If in 2008 the domestic and export markets were in balance, this year in the first three months exports have grown to 60% of the total turnover. This trend will keep gaining strength. It is manifested in the increase of new export orders over the domestic sales.

Manufacturing industry is the backbone of Latvia's exports of goods. In the first three months of 2010 Latvia has exported goods for 935.2 million lati. At the same time, in manufacturing industry the turnover of export goods has amounted only to 395 million lati. The difference is conspicuous and most probably shows a significant increase in re-export volumes. Of course, re-exporting has its positive impact and mining industry and electric energy contribute to exports and there may be other aspects. And still, it is development of manufacturing industry that will boost employment and ultimately the welfare. Therefore the exports of manufacturing industry products deserve close attention and should be viewed in the context of overall export growth. It is not an easy task as many countries starting increasingly focus on exports under pressure of the crisis and previous years' extravagant spending.

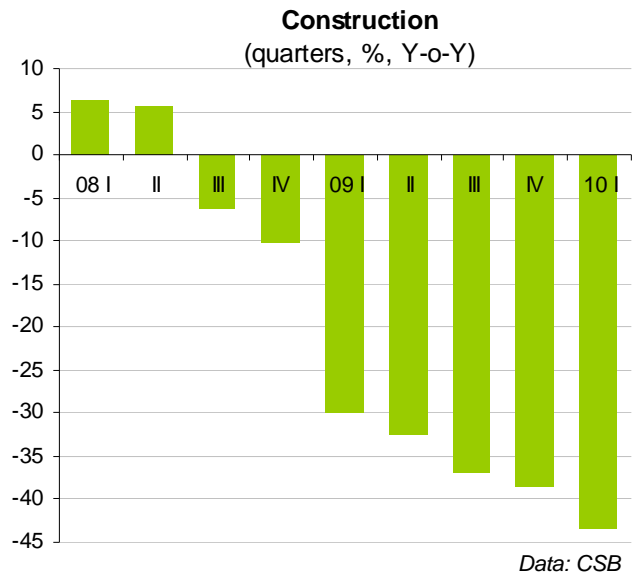
Construction still in sickbed

The speed of recovery in different industries is differing. The rise and slow-down of decline is already seen in industry and retail. At the same time, construction keeps falling. In Q1 of 2010, year on year, construction output volumes plummeted by 43.4%.

The greatest drop in the volume of construction and renovation works was observed in building of main pipelines, power and communication lines (-75.3%), dwelling houses (-74.5%), local pipelines and cable

lines (-61.8%). Construction volumes rose in building of bridges and tunnels (+37.3%). The recovery in construction industry is going to be a slow and painful process that will take several years. This prognosis is manifested in a small number of construction permits issued and aggravated by limited access to finance resources. The households and businesses are still to pay their debts before they can think of assuming new credit liabilities. The

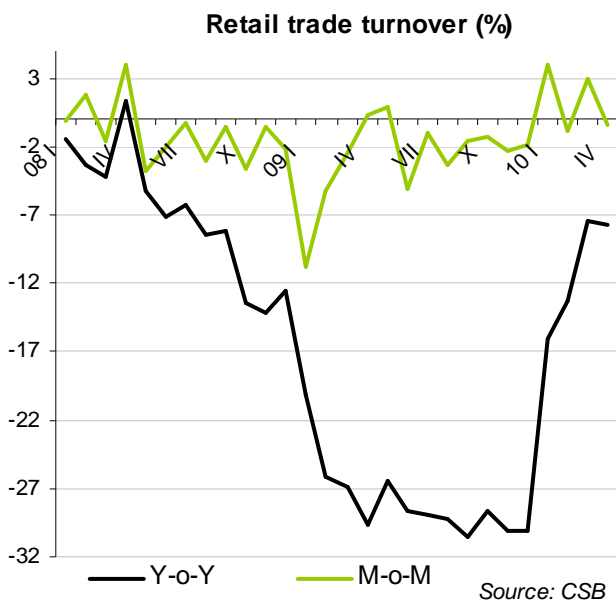
financial sector, too, will take time in issuing new loans. It still has to straighten out its balances. In the mean time, the changes in tax rates will have altered the structure of demand. The market will need time to sort out the unfinished projects arrested by the crisis and there will be no rush to start new ones. The main support to the industry will be rendered by EU infrastructure funds.



The demand is expected to come from the export-oriented companies. It will slowly activate credibility and will be reflected in expansion of operations providing employment to construction businesses. Hence, the activity will increase in this particular segment.

Retail performance slackening in April

In retail this year the rise in one month is followed by a fall in the next one. After the March increase, in April the result dropped, creating a certain disappointment.



Still, there was a hope that some of the money paid back by the government to the pensioners will be spent in consumption. Consequently, retail turnover, compared with March, has dropped by 0.4%. In monthly terms the fall was observed in food products sales (by 1.6%), whereas non-food products retail sales rose by 0.3%. The drop of retail sales in April stopped the annual trend of decreasing retail decline. In April 2010 retail volumes decreased by 7.7% year on year, with the biggest percentage fall in food product group (-9.1%), while the turnover of non-food products over the year had shrunk by 6.8%. In March retail volume in annual terms decreased by 7.4%. In actual prices the retail turnover over the month had been bigger: 288 million lati in April as compared with 283 million lati in March. The consumers are becoming aware of the decline of deflation and the rise of prices in some product groups, e.g. the growth of petrol prices. In April 9.5% less petrol was bought than in April 2009. At the same time, this smaller volume of petrol has cost the consumers 9.8% more than last year. The rise of the prices for food products



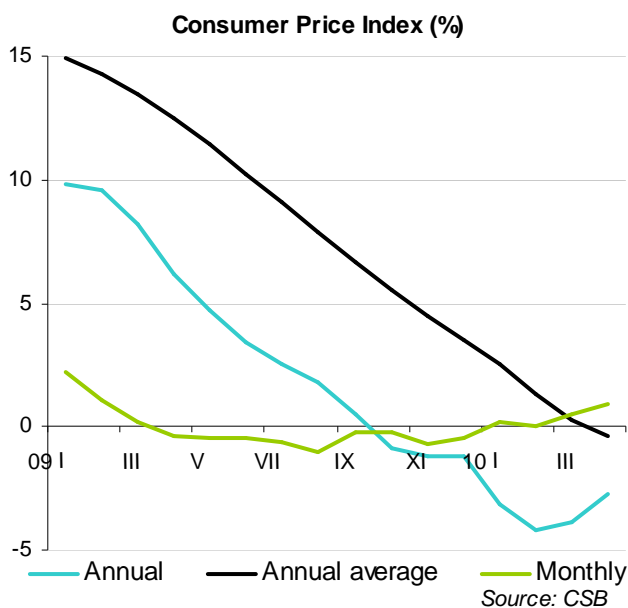
provides explanation for the worse results of food product sales over the last months.

In the coming months, due to the base effect, we can expect smaller retail decline rates in annual terms, yet

the rising prices for food and non-food products may have a tangible effect on this process.

Deflation is losing momentum

The consumer price index in April has soared by 0.9%. The biggest impact on the consumer prices in April, compared with March, was made by the rise in utility payments (heating), clothes and footwear, transport (fuel), health care (medications) and food (vegetables) prices. At the same time, the decrease was mostly influenced by the drop of communication prices. In annual terms the level of prices is still below -2.7%.



Since the beginning of 2010 the inflation trend has set in and it is expected to continue in April. Yet the rise

of inflation by 0.9% is unexpectedly sharp and it pushes the entire economy towards inflation. It arrives under the influence of external factors, through imported goods that in the month's time became +1.4% more expensive. The fall that is more closely connected with the correlation of the price and average purchasing power was seen in the service sector prices (-0.4%). Nevertheless they could not offset the rise of prices for goods.

The producer prices show that the general price trend will go up. They are rapidly increasing and will be gradually reflected in the consumer prices. Further changes in consumer price trends will greatly depend on the global costs of resources and raw materials and the events in the Eurozone impacting the euro exchange rate. The growth trend taking root in other regions will also push the prices up. And the local manufacturers who will turn to export sooner or later are sure to influence the local prices. All these processes are in favour of the opinion that the deflation period in the Latvian economy is going to be shorter than previously thought. Deflation in annual terms will keep decreasing and towards the end of the year it will be close to zero. It is a signal to businesses and the government of new challenges approaching that will primarily influence competitiveness and fulfilment of the Maastricht criteria.

Inflation back in producer prices

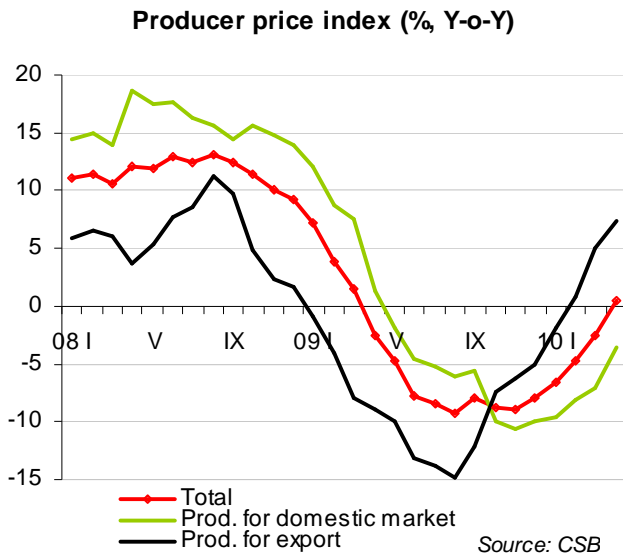
The period of deflation in producer prices that lasted precisely 12 months is over. April saw a leap of prices (+2.2%) that in annual terms showed inflation of 0.5% signalling the rebound in prices. Similarly, in Lithuania and Estonia the rise of producer prices in April was observed, albeit only by less than one percent. The prices jumped due to the rising tariffs of thermal energy and natural gas as well as the rising

activity in manufacturing encouraged by exports and pushing up the prices of resources and raw materials. The return of inflation was to be expected as the export and domestic products were growing more expensive. However, the dynamics of growth in both groups still differs. If export prices over the year have risen by 7.3%, the domestic market products are still at the level of -3.6%. This difference can be explained by a variety of situations in the economies, including



the diverse impact of the crisis on the purchasing power in the export and local markets. Export prices are going through the roof as the economic activity is pushing up the prices for resources and raw materials, and demand.

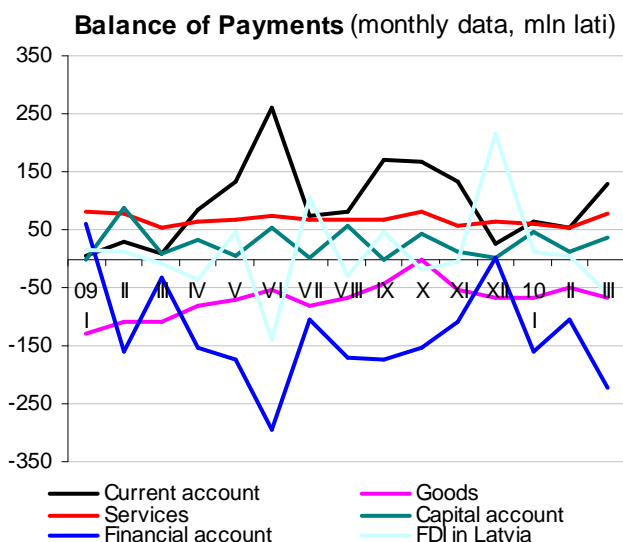
It will gradually be reflected in the produce for local market and the consumer prices. The overall rise in producer prices is expected to continue. It will largely depend on the growing prices for local products. At the same time, uncertainty about the prospects of the entire economy, including the possible trend of export prices, has increased. The events in the Eurozone have shattered the earlier confidence in the stability of growth, which has undermined the rise in the raw material prices. Besides, the vast austerity measures in the EU may influence consumption and do not exclude the possibility of deflation. Therefore, the rise of producer prices in the medium term may stabilise and the growth rate subsides. It will largely depend on the developments in the Eurozone and austerity measures as well as economic stimulation and regulation methods applied. In the domestic market the price developments will dictate monopolies by the tariff and state by tax policy as well.



Big surplus in current account

In the first three months of 2010 a surplus of 250.2 million lati has been accumulated in the current account of the balance of payments. It has increased approximately six times year on year. The surplus was mainly achieved due to the improvement in the trade balance of goods and increase of the surplus in the current transfers balance.

In Q1 there still was a deficit in the balance of goods, which was 186 m lati less than in the same period of 2009. The improvement was mostly due to exports growth. At the same time, imports stood at the same level as in Q1 of 2009.



The balance of services did not present essential difference from last year's result although both export and import service volumes have decreased. It is demonstrated by the underperforming Latvia's ports and the fall in transportation of goods by sea and by rail. Financial services, too, have shown weaker results. On the other hand, the balance has been improved due to the decrease of Latvian travellers' spending prevailing over the decrease of foreign visitors' spending. A better performance than last year is shown by transport carriers.

The income account still continues to improve the current account. However, its positive balance is still due to the losses of investment companies. Although the balance slightly exceeds last year's result, its credit and debit volumes have decreased in the first three months of 2010. This means that Latvian residents



receive smaller interest income and pay less in their credit liabilities.

The growth of the positive balance in comparison with last year was observed in the current transfers account. It was achieved due to several factors, for example, relatively bigger influx of EU funds (e.g. the Social Fund, subsidies to farmers), Latvia's reduced contribution to the EU budget, and income from the sale of emissions allowances.

The capital account still has a positive balance maintained by incoming EU finance flow. The financial account, on the contrary, shows a negative balance of 490 million lati mostly due to the rise in reserve assets and repayment of commercial banks' credits.

In the first three months of 2010 investments in Latvia have been negative (-42 million lati). This was mostly because of the losses incurred by investment companies, which does not mean that all this money has left Latvia. At the same time, investments keep coming in the equity capital and other capital in the amount of 52 and 30 million lati respectively. This flow of investments is due to the tremendous loss that in the case of banks means the need for additional capital.

If last year the other investments account showed the outflow of 700 million lati, this year in Q1 a surplus of 30 million lati has been gained. The most conspicuous

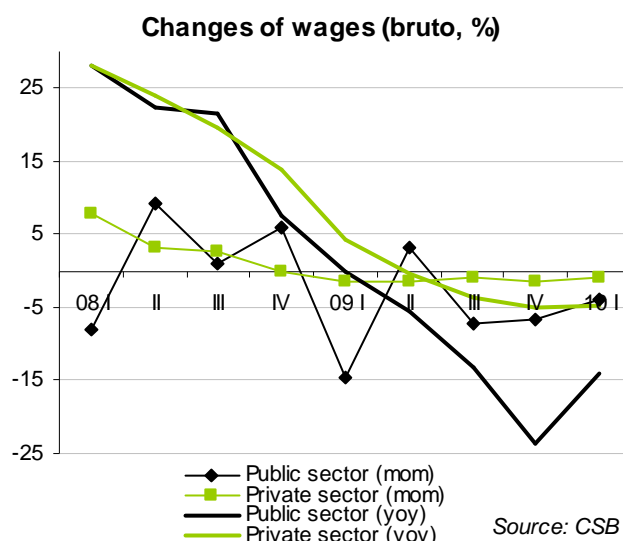
and important changes are due to the loan received by the government that is duly reflected in the Bank of Latvia balance sheet as the increase of reserve assets. The drop of outgoing assets from 1.3 billion lati in 2009 to 716 million lati in Q1 of this year can be explained by the fact that the commercial banks repay their long-term and short-term credits and at the same time attract the non-resident demand deposits that last year fled from Latvia.

This year, too, the current account most probably will be closed with a surplus, which is to be smaller, though, than in 2009. In the quarters to come the banks' losses are unlikely to increase. Most probably they will go down and their positive influence on the current payments account will decrease. The services balance will remain positive yet it will be difficult to maintain its volume intact, according to the signals from the transit sector performance this year. Given the volumes of resource imports and re-exports, we can't expect prevalence of exports of goods over imports in the nearest future. At the same time, the finance account will remain negative, which means that servicing of credits and debts will continue. Obviously, it will not be possible to raise consumption to the level achieved in the previous years. The main concern will be foreign investments into the industries constituting the export potential of Latvia's economy.

Wages keep shrinking

Gross wage in Q1, year on year, has decreased by 8.3%. In the private sector wages were down by 4.7%, and in the public sector by 14.1%.

The statistics for the entire year 2009 showed a relatively small decrease in wages and salaries (-3.9%), with a lion's share of wage cuts in the public sector. The biggest drop in annual terms was seen in Q4 of 2009 when wages plummeted by 12.1% and it is expected that the fall will gradually subside. Nevertheless, wages will continue to decrease under the pressure of market adjustment to the new balance and the government austerity measures in budget consolidation. Therefore, the public sector will keep cutting back wages and their difference in the public and private sectors will continue to diminish.



The private sector has already accomplished most of the work in stabilising of its operations, therefore wage cuts are not the burning issue any more. Of course, adjustment of wages in various sectors will continue, yet it will be offset by the industries that are able to increase their activity at the expense of exports or services provided to the exporting companies. It will help to postpone this issue if not altogether

remove it from the agenda. This future outlook is good news to employees and consumers. At the same time, it raises the question of competitiveness of goods and services that until now improved exactly because of the falling wages and salaries. It should also be noted that the budget deficit has forced the taxes to be increased which has led to more rapid decreases in net wages than in gross wages.



Baltic macroeconomic data

	Latvia LV	Lithuania LT	Estonia EE	Period
Population (mln)	2.25	3.33	1.34	2010 I
GDP growth (% yoy)	-6.0*	-2.8*	-2.3*	I-III
GDP (mln EUR, at current prices)	18845	26746	13728	2009
CPI (% yoy)	-2.7	0.3	2.9	IV 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)	-320	-410	-196	I-III 10
Foreign trade balance (% of GDP)	-8.0	-4.8	-6.0	2009
Exports of goods (mln EUR)	1336	3051	1758	I-III 10
Exports of goods (annual growth, % yoy)	14.1	10.9	17.4	I-III 10
Imports of goods (mln EUR)	1656	3462	1954	I-III 10
Imports of goods (annual growth, % yoy)	-3.9	14.0	11.8	I-III 10
Industrial output (% yoy)	7.4	-3.9	18.0	LV; LT I-III 10 EE III 10
Retail trade turnover (% yoy)	-11.2	-13.7	-9.0	LV; LT I-IV 10 EE I-IV 10
Assets of commercial banks (mln EUR)	30784	25691	19925	IV 10
Average weighted long-term annual interest rates on deposits in national currency in commercial banks (%)	6.5	4.3	2.9	IV 10
Average weighted long-term annual interest rates on credits in national currency in commercial banks (%)	12.1	12.0	15.6	IV 10
Average gross monthly wage (EUR)	613	589	758	I-III 10
Growth of average gross salary (% yoy)	-8.3	-7.4	-2.3	I-III 10
Official unemployment rate (%)	16.7	15.1	14.1	IV 10
Job-seekers rate (%)	20.4	18.1	19.8	I-III 10
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.

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